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Volume 2009/1

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Reforming the Budget Formulation Process in the Brazilian Congress

by
Helio Tollini*

This article provides a view of the Brazilian congressional budgetary process and how it contributes to preventing the budget from effectively determining public spending. Particular elements include revenue estimation, presentation and approval of amendments, sectoral committee involvement, and institutional technical advice.

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1. Introduction

Although the hyperinflationary period the country experienced until 1994 has ended and fiscal responsibility has improved, there are still many obstacles that prevent the federal budget law from reflecting national priorities – defined by mid and long-term plans – while taking into consideration aspects of efficiency, efficacy and effectiveness when allocating public spending. A chronic problem, usually neglected by the authorities because of political issues and because its effects are not visible in the short term, is the prevalence of a certain leniency in the control of recurrent expenditures. Brazilian society does not yet understand that any decisions implying increases in recurrent expenditure, now and in the future, would hinder capital expenditure. It is also not understood that capital expenses represent a wider offer of goods and public services that would generate gains in efficiency to the economy while improving its infrastructure and bringing social benefits to the population. While not being able to control the expansion of recurrent expenditures, and given the country's fiscal restrictions, the government ends up underspending on its present and future investments to the detriment of public spending quality.

The credibility of the budget law depends on its adherence to reality, respecting the federal government's fiscal restriction and promoting the most efficient expenditure allocation possible within this restriction. This adherence did not exist at the peak of the hyperinflationary period, when the buying power of the same budgetary appropriation for expenditures was six times greater at the beginning of the year than at the end. In this sort of environment, it made sense to consider the budget law as a "piece of fiction" and to control only the disbursement of funds. With the end of the three-digit annual inflation, it is necessary to search for another explanation for the budget law's low efficacy as a tool for determining federal government spending, as observed in the last 14 years.

This article analyses some of the problems that prevent the Brazilian federal government's budget law from assuming the role that it is supposed to have, namely to predetermine the amount and allocation of federal government spending with a high adherence level. Unless this goal is obtained, the country will continue to suffer from budget laws that do not adhere to fiscal reality, as well as from the more dangerous (although necessary) consequence: the impoundment (presidential budget implementation decrees)[1] of approved appropriations at the beginning and throughout the budget execution year. During the high inflation period and until the mid 1990s, the impoundments were only a cash control mechanism, but since 1995 they have also become a commitment control mechanism. However, impoundments fundamentally impose strong restrictions on expenditures approved in the budget law, with the objective of achieving fiscal results for the financial year.

The comparison between budget formulation practices in the Brazilian Congress with those in developed countries (the ones that are useful as comparative tools) is somewhat tainted because most of these countries have a parliamentary government system. In these countries, the parliament's revision of budgetary proposals from the executive

branch is normally very limited, since it is unnecessary (in many parliamentary countries, there is not even a budget committee in the legislative branch's administrative structure). Regarding presidential regime countries, the most common comparison is with the practices adopted by the United States Congress. Comparison with other developing countries is hindered by the fact that, especially in Latin America, the participation of parliament in the budgetary process is still at an early stage in terms of its capacity to alter budgetary proposals in an independent way and with the use of competent technical staff.

Another factor that creates difficulty for international comparison of the legislative budgetary process relates to the different levels of budgetary complexity in several countries. The Brazilian budgetary law is probably one of the most detailed. Standard classifications usually found in budget laws of developed countries (*i.e.* organic, functional, economic, by programmes, by projects or activities – as well as the source of resources) are found in the Brazilian budget law in an excessively detailed way. Besides these classifications, there are also some *sui-generis* attributes in the Brazilian budget, such as the budgetary sphere, the primary balance identifier, the application modality, and the use identifier. Because of this excessive detailing of the budget expenditure, the Brazilian Congress ends up getting involved in the definition and alteration of programmatic details that should otherwise be restricted to a technical analysis only.

Since the adoption of the 1988 Constitution, the legislative branch in Brazil once again shares the budget formulation process with the executive branch, and completely exercises its constitutional right to alter the draft budget, even to the detriment of good budgetary practices or the federal government's fiscal capacity. This article analyses issues related to the pressure from federal congressmen for the inclusion of new appropriations in the budget law, which tends to happen without deeper analysis of the public policies or prioritisation of the most relevant ones. To avoid these deficiencies and to transform the budget law into an instrument for planning and allocating public spending, this article proposes the improvement of the budget formulation process in the federal legislative branch through four primary measures. The first two are related to the macro-fiscal situation, and the last two to the quality of public spending.

- Respect for the spirit of the constitutional text in relation to public finances, which does not foresee the possibility of the legislative branch re-estimating the revenue included by the executive branch in the draft budget.
- The imposition of stricter financial and quantitative restrictions on amendments proposed by individual congressmen and by State representations, as a condition for the introduction of the mandatory nature for the execution of these amendments.
- The analysis and voting of the draft budget law by permanent thematic committees in the House and the Senate, in their respective fields of competence, while reserving to the congressional budget committee the responsibility to co-ordinate, systemise, impose limits, and consolidate the analysis process.
- The merging into a single body of the House and Senate units of technical experts in the budgetary field, at the same time providing the technical expertise of Congress with some autonomy from political pressure.

Since it is outside the scope of this article, another fundamental issue in the legislative branch's budget formulation process will not be discussed – namely the fiscal arrangement in the Brazilian federation. In addition to the criticism that there is an excessive concentration of revenue collection at the federal level, the respective competence of each government level in

several areas of the expenditure side is not established in a clear way. Because of these two factors, congressmen feel motivated to seek federal resources to support the financing of practically any activity, even when State and local levels should supply the financing.

Each of the four measures proposed above will be analysed in a specific section of this article (Sections 3 to 6). But to develop the arguments in the right context, a brief description of the budget examination process in the National Congress will be given first, focusing on the measures mentioned above.

2. Examination of the draft budget in the National Congress

Under the terms of Article 166, §1, of the 1988 Federal Constitution, the Planning, Public Budget and Control Combined Committee (CMO) of the National Congress is responsible for examining and voting the draft laws relating to the pluriannual plan (*Plano Plurianual*), the budget guidelines law (LDO, *Lei de Diretrizes Orçamentárias*),[2] the annual budget law (LOA, *Lei Orçamentária Anual*) and the additional credits.[3] Since 1988, the structure, composition, direction and procedures of the CMO have been regulated by several National Congress resolutions (regarded as law).[4] Forty senior members compose the CMO (30 House members and 10 Senators), with an equal number of substitutes represented according to party proportionality. Each year, Senators and House members, as well as the political parties with higher representation in Congress, alternate in the main CMO positions.

The CMO organises itself into four permanent subcommittees, containing five to ten members each. These subcommittees specialise and deepen the assessment in their areas of competence: inspection and budgetary execution control, revenue evaluation, projects with possible irregularities, and amendment admissibility. The examination process in the CMO obeys definite deadlines and special rules and restrictions regarding amendments and approval procedures. The CMO conducts the expenditure examination process in two cycles: first, the CMO divides the draft budget law (PLO, *Projeto de Lei Orçamentária*) into ten thematic areas on which sectoral rapporteurs report; then a general rapporteur consolidates the sectoral reports. The CMO voting takes place first among House members and then among Senators, and any report will be considered rejected if members of one of the houses do not approve it.

The CMO arranges for public hearings with executive branch authorities so that they can present the premises and parameters used for the PLO formulation. Besides having all its processes open to public scrutiny, the CMO promotes public hearings with representatives from civil society entities or authorities from the other two branches of government. The CMO also organises regional public hearings in some States, with its members presenting the draft budget to local political leaders and authorities so that they can discuss the need for federal spending in their States.

An innovation was established by Resolution No. 1/06-CN, in place since the beginning of 2007, whereby the CMO votes a revenue report (prepared by the Revenue Evaluation Subcommittee) before examining the budget expenditures. This change seeks to make known *ex ante* the revenue availability Congress will be working with for accepting parliamentary amendments.[5] However, Resolution No. 1/06-CN allows a second revenue re-estimate up to ten days after the conclusion of sectoral reports, if there have been alterations in the forecasted macroeconomic parameters or in the tax legislation since the original submission of the draft budget to Congress.

Before amendments to the PLO can be proposed, the CMO plenary must vote a preliminary statement, presented by the general rapporteur but subject to amendment by congressmen. The preliminary statement is a document that self-limits the intervention of the National Congress in the draft budget, expanding the restrictions regarding the cancellation of appropriations imposed by Article 166 of the Constitution, by the LDO and by Resolution No. 1/06-CN. This Resolution maintained the obligation for the preliminary statement to include the definition of the value of a financial quota for amendments by individual congressmen in accordance with the norm since 1995. The preliminary statement defines the criteria to be used by general and sectoral rapporteurs to cancel appropriations, with the purpose of creating a "source bank" for the approval of amendments.[6]

Once the preliminary statement has been voted, a deadline is set for presenting amendments to the PLO. Before sectoral rapporteurs examine the amendments, they can be judged inadmissible by the Amendment Admissibility Subcommittee of the CMO. The amendment must follow the admissibility requirements set out in the Constitution, the laws and the rules of procedure, which include a check for compliance with the pluriannual plan and the LDO, and must also respect the norms contained in Resolution No. 1/06-CN and in the preliminary statement.

The amendments can be individual or collective. Resolution No. 1/06-CN increased the number of individual amendments that each congressman can present from 20 to 25. Individual amendments are appropriation amendments, meaning that they propose the inclusion of new expenditures; the annulments they present are merely a formality, since there are difficulties of an operational nature (annulments could be juxtaposed), and congressmen avoid the political onus of reducing proposed appropriations. To prevent these difficulties, at approval time the resources that compose the rapporteur's "source bank" replace the originally proposed annulment in the amendment. These sources originate from the re-estimation of budget revenues carried out by the CMO or from the cancellation of a specific appropriation in the PLO (an LDO-mandated reserve existing exclusively for allocation by the legislative branch during budget formulation).

The collective amendments are made by State representatives from both houses or by a committee.[7] Resolution No. 1/06-CN introduced a new modality of amendment, called "virement", for the State representations and committees. Different from the "appropriation" amendment, the virement amendment can only be effective with the annulment of an appropriation proposed in the draft budget and specified in the amendment, other than the specific congressional reserve.

The amendments from State representatives are presented by at least three-fourths of the House members and two-thirds of the Senators belonging to a specific State (or the Federal District), and limited to 18 to 23 amendments according to the size of the representation. Resolution No. 1/06-CN requires that these amendments have a structuring character or refer to large-scale projects of collective interest, excluding the approval of amendments with generic description or that can result in transfers to more than one federative or private entity during budget execution.

The committee amendments, approved by their respective plenary, are an initiative of the permanent sectoral House and Senate committees and concern actions that are of national or institutional interest and are related to their areas of responsibility. Resolution No. 1/06-CN mandates that the number of amendments per committee is dependant on the number of thematic sub-areas linked to each committee. The larger committees will

present up to eight amendments – five appropriation amendments and three virement amendments. Resolution No. 1/06-CN extends to committee amendments the same restrictions imposed on State representation amendments, namely the need to specify only one public or private entity as beneficiary.

The sectoral rapporteurs of each of the ten thematic areas examine the expenditure programming of the budgetary units under their responsibility, as well as the amendments that propose new expenditures in their areas. The resources released by the cancellation of part of the PLO programming – as authorised by the preliminary statement – coupled with resources transferred from the general rapporteur, are grouped by source of revenue and used for the approval of the amendments.[8] Assessed only in this phase, the individual amendments follow a simplified examination process, with the sectoral rapporteur introducing technical corrections when necessary. At the end, the CMO plenary votes each sectoral statement, approving all individual amendments.

It is the general rapporteur's duty to consolidate and systemise the sectoral reports and examine the pending requests. It is also his/her duty to evaluate the obligatory expenses, the contingency reserve, and the text of the budget law. The general rapporteur can increase or reduce (up to 10%) the values approved for each collective amendment, but cannot approve an amendment which has been rejected in the sectoral phase. Normally, the general rapporteur uses part of the resources made available by the preliminary statement to balance federal government transfers to States, given the high sensitivity of congressmen to the regionalisation of federal investments. The general rapporteur's final statement, together with the revised PLO (which includes the alterations introduced by the approved amendments), is submitted for discussion and voting by the CMO plenary.

After approval by the CMO, the National Congress meets in plenary to discuss and vote the revised PLO (reported by the general rapporteur). Although no further amendments may be presented at this stage, congressmen can discuss the draft budget one more time and, under certain conditions, request a separate vote on any specific clause. However, approval by the CMO of the revised PLO means that the congressmen overcame the political deadlocks, so that the voting session in the full plenary of the Congress usually occurs in a problem-free way. After processing eventual alterations voted in the plenary and adding the consolidated tables required by legislation, the Congress generates a document with the budget law format and sends it for presidential approval.

3. Revenue estimation

Article 166, §3, of the Federal Constitution imposes restrictions on the legislative branch's capacity to alter the draft budget submitted by the executive branch. Besides prohibiting the Congress from introducing modifications in the "personnel and social charges" expenditure group, the constitutional text determines that additional expenditures can only be approved if there is a cancellation of an equivalent amount (Article 166, §3, clause II: "they specify the necessary funds, allowing **only** those resulting from the annulment of expenses"; bolding added). The National Congress cannot alter the total estimated revenues or expenditures established in the PLO. However, since recovering its constitutional prerogative in the budgetary area in 1988, the National Congress has begun to use a controversial tactic to circumvent the Constitution and re-estimate the revenues included in the PLO. In spite of the specific norm cited above, the Congress interprets that the general norm concerning "correction of error or omissions" (Article 166, §3, clause III, line a) applies to the budget revenue estimates.

Therefore, arguing that there are "errors" in the PLO revenue estimates, every year the Congress "corrects" the revenue estimates. Since invariably the "errors" found have been underestimated or missing revenue, the Congress introduces a higher revenue estimate and keeps the difference to finance new expenditures, specified by congressmen in their amendments. Furthermore, expenditure included by the National Congress in the LOA has increased almost every year, positioning itself in values above tens of billions of Brazilian *reals*[9] (BRL) per year since 2004.

To satisfy congressmen's escalating pressure to include additional expenditures in the budget law, rapporteurs in charge of evaluating the PLO revenues gradually began to use unprecedented creativity. For example, under the allegation that the forecast macroeconomic parameters – especially the GNP real growth and inflation rates – had been altered, rapporteurs since 2000 have concluded that the macroeconomic forecasts in the PLO were "wrong". Therefore, every year Congress corrects this "error" by introducing new macroeconomic parameters in the PLO, disregarding the fact that the forecasts were not errors but only changes in the economic agents' expectations resulting from updated information and the evolution of economic conditions. To make matters worse, rapporteurs do not always apply this correction symmetrically: in 2003, the CMO incorporated new values only for the economic parameters whose effects on revenue were positive, ignoring those changes that would have caused a negative impact on the revenues estimation.

In the past, the general rapporteur, who was ultimately responsible for responding to pressures for the inclusion of new expenditure in the LOA, was also responsible for the revenue estimate revision that financed these expenditures. Resolution No. 1/01-CN of 2001 divided the responsibilities for the analysis of budget revenue by creating a Revenue Evaluation Committee with an independent rapporteur. However, this improvement did not prevent the fact that, each year, higher revenue re-estimates succeeded each other in response to pressures for the approval of amendments and additional expenditure. At the end of the examination process, last-minute re-estimates continued to happen, allowing the general rapporteur to meet last-minute demands.[10] Unfortunately, the 2007 and 2008 processes have shown that Resolution No. 1/06-CN does not prevent the occurrence of re-estimates prepared after the beginning of expenditure assessment and with poor technical support, allowing the need to meet peer pressures to influence these re-estimates.

The most perverse consequence of the revenue re-estimation that Congress introduces in the LOA has been the loss of its realism, creating expenses for which there will not be enough revenue. During budget execution, if the bimonthly re-estimation of revenues is below that predicted in the LOA, the Fiscal Responsibility Law (Complementary Law No. 101 of 2000) demands that each governmental branch apply, by internal act and in the necessary amounts, a limitation on the expenditure commitment and cash payment of its entities. In the arrangement established by the Fiscal Responsibility Law, these bimonthly limitations to budgetary and financial execution are necessary to ensure the achievement of the fiscal goal established by the LDO for the financial year. However, the intention was that these impoundments would involve small values to compensate for unexpected variations in the revenue collection *vis-à-vis* the estimated values contained in the LOA. In practical terms, because of the excessively optimistic revenue re-estimation introduced by Congress, early each year the federal government imposes gigantic impoundments which reach tens of billions of Brazilian *reals*. What was supposed to be an exception became the rule and what was supposed to be marginal became bulk: after several consecutive years of impoundments, they became natural and expected by all the agents involved in the

budgetary process. Worse still, because of the great discrepancy between the approved LOA and the authorised ceilings, the impoundments hinder the good practice of foreseeing expenditures during the exercise, since the sectoral entities are not able to know when and if they can spend all their approved budget.

Besides being unconstitutional, the revenue re-estimates that Congress introduces are unnecessary, since the Constitution establishes a mechanism – called the additional credit – to incorporate in the LOA an eventual excess of revenue collection detected during budget execution. Since it is improbable that the effective collection will correspond exactly to the revenue estimates approved in the budget law, the National Congress authorises the executive branch to incorporate additional revenues into the budget law during budget execution, as well as the new expenditures financed by these revenues. Up to a certain percentage (usually 10%), the executive can incorporate these revenues directly, through a presidential decree. Above that percentage, the executive must send an additional credit solicitation to Congress.

There are some alternative ways of eliminating the strong temptation for Congress to increase the estimated revenues and to incorporate new expenditures during the PLO examination process. Ideally, the spirit of the constitutional text should prevail: in order for an amendment to be approved, Congress must identify an equal amount of expenditure to be cancelled. The possibility of Congress re-estimating revenues is not mentioned. The elimination of the tactic of considering everything as a correction of "errors or omissions" can occur voluntarily, by unilateral decision that auto-limits congressional powers (which would be highly improbable) or by a decision from the Federal Supreme Court in response to a lawsuit disputing the constitutionality of these re-estimations.

A second option would be that a new public finance organic law would determine that the PLO and the LOA should strictly repeat the revenue estimate approved by the LDO (which would need to be more detailed than the present one). Consequently, the National Congress, through amending the LDO project, would still have the "last word" in determining the revenue values to be included in the PLO and in the LOA. However, both phases of the budget formulation process, in the executive branch and in the legislature, would work with the same previously defined revenues, eliminating the possibility of Congress incorporating additional expenditures in the budget based on overestimation of revenue.

A third alternative – in reality a variation of the previous one – would be to institute a revenue "supercommittee", with representatives from the executive and legislative branches as well as from the private sector. This committee would have the responsibility of defining the revenue values prior to the PLO submission, with the obligation of explaining them in detail in an attachment to the budget guidelines law. This arrangement would respect the Constitution and would encourage the dialogue between the executive, the legislature and civil society, benefiting everyone with increased gains in terms of procedural transparency. Lienert and Jung (2004, p. 241) describe a similar arrangement in Germany, where an independent working group formed by representatives from local and central governments prepares an initial revenue estimate months ahead of the draft budget submission, and then presents a final revenue re-estimate to the budget committee of the lower house (Bundestag) when it meets to discuss the draft budget.

An interesting practice in some countries for estimating budget revenue is the mandatory adoption in the draft budget of economic parameters synchronised with the average expectation of the private sector.[11] This practice eliminates any possible suspicion

that the executive could be purposely underestimating or the legislature overestimating the economic parameters with the intention of decreasing or increasing the revenue estimates. In Brazil, all the necessary conditions are in place to allow such practice, since the economic forecast reports prepared by the private sector are solid, numerous and diversified. The Brazilian Central Bank reports monthly through the *Focus Bulletin – Market Report*[12] on private sector expectations regarding economic growth, inflation and exchange and interest rates, among other indicators. The "Average – Top 5" index, which considers the average expectations of the five best classified institutions in terms of the accuracy of their short or medium-term predictions, could become a mandatory standard when formulating the budget, instead of just an informal reference mentioned only when convenient to one of the branches.

Whatever the alternative adopted, the National Congress should not re-estimate revenue when pressured by congressmen, local politicians, private entities or even federal public entities. To avoid this scenario, it is necessary to define the estimated revenues before the legislative branch starts examining the expenditure programming. This was the intention of the framers of the 1988 Constitution when they blocked the possibility of Congress re-estimating the PLO revenues. As with any rational economic agent, before making decisions on expenditures it is first necessary to know how much is available.

On the other hand, if the Federal Supreme Court decides that it is the executive branch's sole responsibility to define budget revenues, a punishment mechanism could be established when revenue estimates prove to be clearly underestimated. One alternative would be for the public finance complementary law to determine that an amount equivalent to 10% of the difference between the estimated values and the effective collection, notwithstanding any explanatory reasons, should be destined as additional resources for parliamentary amendments in the budget formulation process of the following year.

4. Individual or collective amendments

The ability of congressmen to present individual amendments to the draft budget is a controversial subject which has divided opinions since Congress recovered its democratic prerogatives in this area with the 1988 Constitution. In a political system where the "concrete" demand predominates over political principles in all federative levels, there is strong resistance from a large part of congressmen to any attempt to eliminate this prerogative. Nonetheless, the debate reappears after every public scandal involving the participation of congressmen in the allocation of federal resources. That is what happened in 1993 after the so-called "budget midgets" Parliamentary Investigation Committee (CPI), in 2006 after the "bloodsuckers" CPI, and in 2008 with the "NGOs" CPI.[13] All these CPIs investigated the receiving of bribes by congressmen as a result of amendments they managed to include in the LOA.[14]

Even if the doubtful motivation that sometimes conditions the presentation of individual amendments is set aside, there are problems related to the allocation and the efficiency of public spending determined by this process. These amendments do not reflect priorities established by a national co-ordinated policy to face a specific problem in the country, but rather the interests of individuals who seek to solve local problems. In consequence, a partial perspective of how to face the problem prevails, instead of an integrated analysis reflecting information about the whole national territory. Because of this interest game, in which congressmen take on the role of "federal city councillors" and

fragment the federal government's actions, localities that have more need than others can end up without receiving the attention they deserve from the federal government. On the other hand, localities that receive benefits through amendments may not represent a priority from a national perspective.[15]

In reality, the existence of individual amendments has caught the interest of both the legislative and the executive branches. While congressmen benefit politically from the possibility of sending federal resources to their electoral bases, the executive branch uses the amendments as a mechanism for co-opting the political parties. It takes advantage of the authoritative nature of the LOA to condition the budget execution of the individual amendments that congressmen propose in regard to the executive branch's projects in the National Congress. It is worth highlighting that "pork barrel" amendments also exist in more advanced democracies, although subject to stricter financial limitations and conditions.

Alston *et al.* (2005, pp. 80-82) point out that changes that decrease the president's costs of bargaining, as additional restrictions to individual and collective amendments, tend to generate gains in terms of implementing the president's political agenda, to the benefit of the country. At the same time, the authors fear that the strengthening of the legislative branch in the face of eventual changes in the present rules of budget approval – like the introduction of the obligation to fully execute and pay for the amendments – can cause a loss in governability. In several joint papers (Alston *et al.*, 2005; Alston and Mueller, 2006; Pereira and Mueller, 2004) the authors defend the efficacy of the Brazilian model in place since the 1988 Constitution. Supposedly, in this model the bargaining between congressmen and various governments (votes for political reforms by catering to certain groups' requests, among them the execution of individual amendments) have allowed the approval of the president's political agenda, including important constitutional reforms, at a low cost to the executive branch.

This thesis was suggested by Santos *et al.* (1997, p. 92) and proposed by Bezerra (2001, p. 185). The latter pointed out that, in a "complex system of asymmetrical and mutual dependence amongst congressmen, private agents and federal, State and local authorities", congressmen's prestige and power is founded in the recognition by the leadership and the public of their capacity and strength to act at another level of relations. Additionally, they have the "moral obligation" of assuring certain benefits to the inhabitants of the localities that they represent. Moreover, Pires (2005, pp. 51-54) demonstrated the direct relationship between favourable votes for the government and the execution of individual amendments during the 1999-2002 legislature. However, a paper by Limongi and Figueiredo (2005, p. 758) caused a controversy when it concluded the exact opposite. Analysing the data related to the 1996-2001 period, the authors proved that it is not possible to establish a causal relationship between individual budget amendment execution and votes, since political criteria such as party affiliation explain both variables.

In the years following the 1988 Constitution, there were only individual amendments, with no restriction as to quantity or to the amount of money that congressmen could request. In 1988, 2 660 amendments were presented for the 1989 PLO; the number increased to 11 180 in 1989, to 13 358 in 1990, and reached the peak of 71 543 amendments in 1991 (of which 18 944 were approved).[16] Henceforth – aware of the impossibility of submitting more than 70 000 amendments to a minimally structured examination process – congressmen approved Resolution No. 1/91-CN, which limited to 50 the number of amendments by each legislator, without value limitations. Consequently, in the following years the number of

amendments dropped to 22 611 in 1992, 13 924 in 1993 (when the preliminary statement established a limit of 25 amendments per congressman) and 23 216 in 1994.

The last decrease in the number of individual amendments occurred after the "budget midgets" CPI, when the CMO was restructured. In the debate prior to adopting Resolution No. 2/95-CN, a reasonable number of congressmen – cognisant of the investigation's final report – defended the extinction of individual amendments. However, many congressmen did not accept restriction of what they believed was their right to propose amendments to draft laws submitted to Congress. To the disappointment of both groups, an intermediary solution prevailed in the political negotiations, and Resolution No. 2/95-CN simply limited the presentation of individual amendments to 20 per congressman.

The value of the financial quota per congressman has increased significantly since 2001, when the quota of BRL 1.5 million – in place since 1995 – became BRL 2 million. In 2003, the quota was increased to BRL 2.5 million, to BRL 3.5 million in 2004, to BRL 5 million in 2006, to BRL 6 million in 2007, to BRL 8 million in 2008, and finally to BRL 10 million in 2009. These recent increases broke up the initial concept of the financial quota, which intended to allocate in total an amount equivalent to 1% of the federal government's net current revenues with this amendment modality. Since then, each LDO has determined that the PLO fiscal table treats this value as a primary expenditure, in the budget's contingency reserve, for appropriation by Congress during the examination of the PLO. In the PLO for 2009, this value was equivalent to BRL 4.5 billion which, divided by 594 congressmen, would mean a financial quota of around BRL 7.6 million each and not the BRL 10 million adopted.

During the debate on Resolution No. 2/95-CN, congressmen saw the collective amendments as successors of the individual amendments. The greatest advantage of collective amendments – which were conceived to promote major interests from the States, regions or sectoral committees – was supposedly the fact that they were free of doubtful motivations, since they would have to be the object of formal negotiation between congressmen (with a minimum quorum). Unfortunately, as time went by, collective amendments started to suffer the same evils as individual amendments. This mischaracterisation began in the smaller State representations, where it was easier to divide the number of allowed amendments per congressman and partly ignore the governor's pleas, so that each State representation amendment would represent a specific congressman's interest. As time went by, other State and regional representations copied this practice, with congressmen dividing themselves into subgroups that "owned" a specific amount of amendments. In the end, congressmen disfigured a tool that had been intended to prevent doubtful negotiations on federal budgetary funds between themselves, local governments and private groups.

Table 1 shows the evolution, by amendment modality, of the number of amendments submitted as well as their approved values since the introduction of the Brazilian *real*.

The data show the increasing legislative greed for the inclusion of new expenditures in the LOA. From 1995 to 1999, the average annual inclusion of new expenditure by the Congress was BRL 3.4 billion; from 2000 to 2004, the average increment became BRL 7.3 billion and reached BRL 14.4 billion in the period from 2005 to 2009. The individual amendments gradually lost importance, in the period analysed, in terms of approved value, because – differently from other kinds of amendments – the congressmen's individual quota has always restricted them financially. The increase in the importance of State

Table 1. **Number of amendments presented and approved values (BRL million)**

Draft budgets (PLO: *Projeto de Lei Orçamentária*) from 1995 to 2009

Draft budget	Individual		State representation		Regional representation		Permanent committee		Total	
	Number of amendments	Value (BRL million)	Number of amendments	Value (BRL million)	Number of amendments	Value (BRL million)	Number of amendments	Value (BRL million)	Number of amendments	Value (BRL million)
PLO 1995	23 216	4 082	429	1 193	0	0	0	0	23 645	5 275
PLO 1996	10 403	862	279	1 608	28	252	110	169	10 820	2 891
PLO 1997	10 348	845	271	1 574	27	118	108	274	10 754	2 811
PLO 1998	8 533	866	245	2 048	26	154	121	464	8 925	3 532
PLO 1999	7 572	866	272	2 323	–	–	120	600	7 964	3 789
PLO 2000	8 334	880	275	3 256	24	224	112	1 334	8 745	5 694
PLO 2001	8 478	1 178	408	4 311	25	238	125	1 470	9 036	7 197
PLO 2002	7 642	1 178	426	5 444	10	75	123	1 733	8 201	8 430
PLO 2003	6 904	1 185	427	6 047	10	78	133	1 769	7 474	9 079
PLO 2004	7 278	1 483	508	3 756	10	75	144	839	7 940	6 153
PLO 2005	7 600	2 076	508	6 139	10	113	150	1 620	8 268	9 948
PLO 2006	7 943	2 964	508	5 767	10	123	160	2 003	8 621	10 857
PLO 2007	8 151	3 533	508	8 665	10	175	153	2 997	8 822	15 370
PLO 2008	8 998	4 743	482	8 755	0	0	139	2 688	9 619	16 186
PLO 2009	8 712	5 928	537	9 407	0	0	146	4 126	9 341	19 461

Source: Brazil (2007), *Technical Note (Joint) No. 11/2007*, CMO Secretariat; and Greggianin (2005), "O Processo de Apreciação Orçamentária no Congresso Nacional: Subsídios para a Reforma Orçamentária".

representation amendments is noticeable, and in 2009 the approved value was eight times higher than in 1995. There is also a noticeably rapid growth of the value of committee amendments, which in the beginning represented only 10% of the total approved amendments but are now responsible for more than 20% of the expenditure added to the LOA.

Unfortunately, the high increase in the amount of money approved by collective amendments does not reflect a planned decision to have them prioritised over time, due to greater representation or capacity to propose sectoral and regional policies. On the contrary, this growth is mostly due to a change in the original proposition that collective amendments should become an instrument for the implementation of national public policies, since congressmen progressively started using these amendments as a tool to circumvent the limitations imposed on individual amendments. By proposing generic actions, which the executive agencies will detail during budget execution, the collective amendment becomes similar to a group of individual amendments, with the difference that there is no restriction on its approved value. It is possible for several congressmen, acting in co-ordination, to individually appropriate part of the approved values.[17] Resolution No. 1/06-CN tried to control this practice, imposing many restrictions regarding the presentation of collective amendments, such as requiring that the benefitting entity be specified.

Worst of all, while the individual amendments were subject to a financial limit, the representation amendments had never suffered that limitation. With no financial restriction on their presentation and approval, these State representation amendments ended up absorbing a great part of the revenue increases introduced by the Congress in the LOA. The combination of huge amounts of money with individual amendments from congressmen, even if disguised as collective ones, has potentially serious implications, not only in terms of the allocation of public spending but also in the correctness of this process.[18]

Many members of the National Congress are of the opinion that they have the "right" to alter the draft budget by their own individual initiative. As such, they undermine the

legitimacy of the democratic institution that they represent, namely their collegiate action in budget formulation. In favour of the individual amendments, one can argue that the *a priori* identification of the final beneficiaries of the resources adds more transparency to the budget process and constitutes a political act in defence of regional or local interests. Another argument is that the legislature funds its actions through logic of a substantive nature, different from the objective nature that drives technocratic decisions, therefore representing an opportunity for the correction of errors or omissions. However, even considering that congressmen represent the population, the individual definition of voluntary transfers from the federal government to public or private entities does not follow the principle of impersonality in the public administration.

One can also argue that the amendments are mere propositions which need the approval of the CMO and of the Congress in plenary to give them legitimacy. However, the approval process of individual amendments occurs almost automatically, without a specific merit analysis since, as long as the amendments are technically admissible, the congressmen are free to define the projects they intend to see executed within their financial quota limits. This procedure allows one individual to introduce – as the federal government's responsibility – expenditure that should be the responsibility of local governments, thus fragmenting federal resources while attending to local needs.

Contrary to what many believe, legislative amendments do have a serious repercussion in the federal government expenses. One recurring argument is that the total value added to the LOA by legislative amendments is insignificant in comparison to the total federal government budget. In fact, the percentage would be insignificant if this comparison was valid, but the federal government budget comprises the amortisation and rollover of the public debt, which distorts its real value, besides huge expenses of obligatory execution (transfers, personnel, social security benefits, etc.). The correct comparison should be against the federal government's discretionary expenses, which are the only ones that the executive branch can reallocate. If done in a proper manner, the calculations would show that Congress alters a significant percentage of the budget every year.[19] Another symptom of that distortion is reflected in the executive branch's need to submit a large amount of additional budget, much of it to supplement recurrent allocations cancelled by the general rapporteur during the examination of the PLO by the National Congress.

In the health sector, for example, it is common for congressmen to present amendments earmarking resources in favour of a health entity that promotes specialised public health care, in both public and private networks. The choice made by congressmen as to which locations will get benefits follows a parochial political logic, not taking into consideration any national policy criteria that should guide this distribution. Therefore, hospitals and hospital equipment – that, for reasons of logistics, economy of scale and maximisation of social benefits, should have regional coverage, attending to a minimum population group within a cluster of cities – can end up being overridden geographically, disfavouring another region that would remain without assistance. Situations like these, which happen in all sectors, are a consequence of Congress' predominant focus on local policies, relegating the debate about national priorities to a secondary status after the needs of each congressman's electoral base have been addressed.

The definition of beneficiaries of voluntary transfers from the federal government programmes should follow formulas founded in social-economic indicators. Accordingly, the process of federal resource allocation would have more transparency and would also

avoid *i)* the detailing of budget appropriations by legislative amendments or *ii)* definition by the executive branch in a less transparent way. Social-economic indicators – such as the benefited population, the human development index or others more specific to each programme – could be attached to the programmes (defined every four years in the pluriannual plans and replicated in the annual budgets) or to the actions (defined annually in an annex to the LDO) or even in the specific laws which created the programmes.

Congress should demand that the executive branch make available, as an appendix to the draft LDO, the criteria and formulas it intends to adopt during the execution of programmes and actions for the regional allocation of federal government funds. A good part of these formulas already exist, such as those in the education, health, social assistance and transport sectors, but are exclusively known by the authorities in the Secretariats responsible for each of these sectors. If they are to be legitimate, these formulas need to be politically debated in the related sectoral committee (see Section 5 below), which would not alter the LDO appendix.[20] Hence, legislative performance would happen at a different level, where the highly criticised and permissive specification of the final beneficiaries of public resources would be replaced by a discussion about the criteria for applying these same resources.

The excessive tendency of congressmen to transfer resources to private entities, added to the fragile and untimely control of these expenditures, point towards eliminating the individual amendment modality. Nonetheless, a recommendation in this sense would be far removed from the political reality of Brazil and would be completely disassociated from the frame of thought predominant among the agents involved in the legislative process of formulating the budget. Therefore, in the short run, the chances of implementing such a recommendation are practically non-existent; for Brazilian society to react and to press for additional reforms in legislative procedures, additional political scandals involving the presentation of budget amendments would be necessary. These reforms would need to avoid being merely cosmetic, as they have been to this day, but should adopt propositions that are more effective.

To succeed, any attempt to change the congressional budget examination process should keep the Brazilian political reality in mind and should benefit both governmental branches. A possible "agreement" would be the introduction of greater financial and quantitative restrictions to individual and State representation amendments in exchange for the executive branch's obligation to effectively execute and finance legislative amendments to the budget. As part of this agreement, the legislative branch should decide not to use the "errors or omissions" tactic to alter the budgetary revenue estimates. The executive branch would retain the advantages of having a more preserved budget and of having prior knowledge of the fiscal cost of the legislature's intervention. On the other hand, an advantage for the legislative branch would be the effective execution of the alterations introduced in the draft budget. Additionally, congressmen will be reassured that they took action to change the budget process before the emergence of new scandals involving congressmen and public budgeting. In order for the new agreement to last, the public finance complementary law should express the additional restrictions to the amendments and the mandatory execution of amendments.[21]

A first restriction on the amendments, of a fiscal and financial nature, would be to limit the global value added to the PLO for each of the amendment modalities to 0.25% of the net current revenue of the federal government, totalling 0.5% of the net current revenue

– equivalent to BRL 2.3 billion in the PLO for 2009. This value is sustainable from a fiscal point of view, and not even the mandatory nature of the execution of this expenditure would prevent reaching the primary result target, since the value of the budget amendments effectively paid in recent years is higher.

A second restriction relates to the beneficiaries and the amount of amendments that each congressman and each State representation can present. In regards to the individual amendments, taking into consideration the problems caused when the beneficiaries are non-profit private entities designated by congressmen, it would be wise to eliminate the allocation of resources thus defined. The control principles do not recommend the participation of congressmen in the allocation of public resources to private entities because it is in fact the Congress which, in the last recourse, follows up and controls how these resources are used. The congressional focus should be on the establishment of strict legislation for the use of public resources, the assurance of transparency in the executive branch transfers, and the guarantee of broad, intensive and timely control from the agencies in charge.

Consequently, individual amendments would send funds exclusively to public entities from any government level. If the financial quota system had been preserved, each congressman would have been awarded an approximate amount of BRL 1.9 million (in 2009 PLO values), a substantial reduction from the BRL 10 million quota established for the 2009 PLO examination process. If the 595 congressmen could present only ten amendments each to the PLO, there would be less than 6 000 amendments, decreasing significantly the fragmentation of federal resources observed in recent years. This number of amendments is sufficient and adequate, so that congressmen can respond to parochial political requests, and allows the execution of small investments in some localities with needy areas. At the same time, it encourages congressmen, in a healthy way, to prioritise the political requests that they receive.

Regarding the State representation amendments, the creation of financial limits will return to the idea behind their creation in 1993, which was for them to reflect a few and important State priorities. It is also necessary to rationalise the amount of amendments per State representation in order to prevent the current practice of dividing the amendments per representation members. Furthermore, the absence of these restrictions allows the political negotiation process for the approval of the State representation amendments to become too complicated. Therefore, not only can these changes recapture the original intentions of State representation amendments, but they can also simplify and speed up the internal decision process of the CMO.

A drastic reduction in the number of State representation amendments (to something around less than 100 amendments total) is necessary to reach these goals. A better distribution of amendments between the State representations must follow that reduction, since currently Resolution No. 1/06-CN gives greater benefit to the smaller representations stipulating a low amplitude variation (between 18 and 23 amendments per State representation). The best would be to establish proportionality with the number of congressmen in each State representation, which would continue to benefit the smaller States of the Union because of the disproportional popular representation in both houses, but would eliminate the excesses that occur nowadays. If direct proportionality by number of congressmen is adopted, the smaller State representations with 11 congressmen would

have the right to two amendments, while the biggest State representation, from the State of Sao Paulo, would have the right to 12 amendments.

5. The permanent sectoral committees

As defined by the Constitution, the CMO (the Planning, Public Budget and Control Combined Committee) is responsible for analysing proposals of a budgetary nature, thus excluding the active participation of the permanent committees of the Senate and the House of Representatives. Resolution No. 1/06-CN and CMO regulations limit the participation of permanent committees: they can present no more than eight amendments (four on appropriations and four on virements); they can only hold public auditions with the purpose of discussing issues related to their own subject areas; and they are allowed to propose priority programming for receiving amendments. Besides being limited to proposals related to only their own subject areas, the committee amendments must be of an institutional nature, must represent the national interest (*i.e.* it is forbidden to designate private entities), and must contain within their justification the elements, criteria and formulas that determine the resource allocation.[22]

In order to analyse the sectoral programming contained in the PLO, Resolution No. 1/06-CN divides it into ten thematic areas. A sectoral rapporteur, designated from among the CMO members who preferably are also members of the permanent committee related to the subject area, reports on each thematic area.[23] The sectoral rapporteurs' job is limited by guidelines and restrictions imposed by the preliminary statement, approved in the CMO plenary. It is their responsibility to approve, totally or partially, or to reject the amendments presented by congressmen in their respective subject areas, as well as to decide about eventual cuts in investment programming contained in the PLO in their respective areas. Therefore, examination of the PLO sectoral programming does not happen in each house's permanent committee, but inside the CMO itself.

In that respect, the discussion and voting of the sectoral programming comprised in the PLO does not happen among specialised congressmen or those interested in discussing specific public policies pertinent to a certain sector. For example, the budget programming in the education and health areas are not discussed in their respective permanent committees, which spend the rest of the year analysing propositions in that area. In this arrangement, the prevailing view is that of the individual rapporteur, whose main worry is to have his/her sectoral report approved by his/her peers in the CMO. For that to happen, it is sufficient for the individual amendments to be approved, which happens in a quasi-automatic way, and for State representation and committee amendments to be treated in a balanced manner, considering the diverse political interests and the limitations in available resources.[24] The discussion does not assess the efficiency, efficacy and effectiveness of the government programmes in their respective thematic areas, nor the targets, indicators and results reached in previous years. Also, the discussion does not take into consideration national priorities, especially because most of the time the amendments cover parochial interests.

Another problem with the current model is the task reserved for sectoral rapporteurs of deciding on eventual cuts in the investment programming contained in the PLO. Usually the rapporteur, who is not always familiar with a certain area, has enormous difficulties in implementing cuts in the programming proposed by the executive branch. In most cases, to escape the political onus of proposing a more drastic cancellation in a certain project,

the sectoral rapporteur prefers to propose an "across-the-board" or quasi-linear cut, which is easier to apply than undertaking detailed comparisons between the proposed allocations and previous years' execution. The absence of more specific knowledge on the part of those responsible for cancellation decisions again jeopardises the National Congress' capacity to evaluate more effectively the executive branch's proposed programming.

The best way to provide the legislative branch with the capacity of effectively assessing the PLO's sectoral programming would be to alter the Constitution in order to delegate the responsibility for examination, discussion and voting, currently concentrated in the CMO, to the permanent sectoral committees of both houses. The CMO would keep the relevant role of co-ordinating the draft budget's transition process in Congress, assessing the most significant expenses (salaries, debt payments) and imposing limits of a fiscal and financial nature to the modifications introduced by each sectoral committee, as well as protecting the good practices in budgeting.[25] The thematic committees would have the role of assessing the sectoral programming, including the individual and State representation amendments that propose alterations in their subject areas. By accepting the alterations they find more relevant, the committees would contribute to an efficient use of available resources through a better prioritisation of the expenditure programming.

One practical problem with the implementation of this alternative comes from the fact that the House and the Senate do not have the same number of committees, and that they are grouped by distinct thematic areas. The Constitution determines that the voting process on all budgetary matters occurs separately in both congressional houses. Therefore, the analysis and voting of the PLO by the sectoral committees in the House and the Senate would demand a huge co-ordination effort from the CMO, which would have to reconcile the increases and cancellations made in each thematic area by the committees of both houses.

Ideally, the duplication in the examination process should not exist, and only one of the congressional houses should be in charge of examining and voting the budgetary law. Alternatively, the Congress could create temporary combined sectoral committees formed by members of the related permanent committees of both houses. However, the first alternative requires changes in the country's higher legislation – which at this time seems out of the question – and the second alternative requires a political understanding between the two congressional houses that seems improbable. To alleviate this deadlock, it would be helpful to revise the thematic areas and sub-areas of each permanent committee, in order to achieve greater thematic harmony between the sectoral committees of both the House and the Senate. The joint regulation of the National Congress (Resolution No. 1-CN of 1970) will need to establish a co-ordination mechanism between the several committees of both houses in the budgetary process.

Furthermore, even though the National Congress has not been entirely applying its joint regulation in this respect, the regulation establishes the way the permanent committees in both houses should collaborate with the CMO in the examination of the PLO. To alleviate the problem of reconciling sectoral analysis, the joint regulation foresees the possibility of both houses' committees holding joint meetings. Article 90, §3 f, of the regulation states that "by deliberation of the majority of its members, the Federal Senate and the House of Representatives' permanent committees that have coincident competence, are allowed to hold joint meetings under the alternate direction of their respective presidents, being able to reach conclusion by a single statement".

With the discussion and voting of the PLO happening in the permanent committees, the Congress could reduce the size of the CMO, as the latter would only be in charge of co-ordinating and systemising the draft budget's transition process. The preliminary statement of the CMO would continue to establish the technical budgetary conditions that the permanent committees must consider in the examination of the PLO, as well as the fiscal and financial limitations that each of these committees would have to follow. Heading the systematisation, a general rapporteur (a congressman with a technical profile who, contrary to current practice, would not have the power to approve additional values for the amendments) would reconcile the increases and cancellations made in each thematic area by the sectoral committees of both houses.[26] Finally, the CMO would vote a consolidated draft budget report and, after approval, forward it for voting in the congressional plenary.

To revitalise the currently weak legislative role of the thematic committees, it is important to pay attention to the way they present amendments to the PLO. If Congress does not well regulate the issue, one can predict that the committee amendments will end up being a way to circumvent the restrictions imposed on other amendment modalities. Therefore, Congress needs to rethink the conception of committee amendments, to avoid having them suffer the same restrictions that made individual and State representation amendments become mere detailing of the actions proposed by the executive branch. The committees need to have the freedom to modify the PLO sectoral programming in the way they find most convenient.

Joyce (2005, p. 9) argues that, when analysing resource allocation, congressmen frequently do not have the incentive to request and use information about budget programme performance because they do not notice a connection between the results achieved by these programmes and their probable electoral benefits. Even if this difficulty is also present in Brazil, there should be incentives for the intervention of sectoral committees in the budgetary process during the examination of the draft pluriannual plan, so that eventual changes introduced in its programming are reflected in the following PLOs. The focus of the committees' interest should be the conception of sectoral programmes and their actions, activities and projects. The committees in the Brazilian Congress should examine – with the support of the budget and legislative advisory units (see Section 6 below) – the pertinence of the programmes, the indicators used and the results achieved.

In the new scenario, in order to make sure that the committees' amendments reflect the debate about which public policies are of interest to their respective areas, taking into consideration a national perspective, these amendments would have to be proposed exclusively by the political parties' representation on each committee, and not by the individual initiative of a congressman.[27] In this context, as a way to improve the performance of their new tasks, all committees should be obligated to invite ministers and other authorities in their subject areas to present and discuss the respective sectoral budget proposal. The examination of the PLOs for 2008 and 2009, when the foreseen public auctions did not happen, are examples of how the committees need to have effective power to change the PLO in order for them to really be interested in discussing the draft budget.

Alston and Mueller (2006, p. 98) are sceptical about the chances of an arrangement where the sectoral committees or the political parties conduct the collective answer from the Brazilian Congress to political negotiations proposed by the executive branch. The authors argue that congressmen do not dominate the sectoral committees' agenda, since party leaders routinely switch the congressmen around from one committee to another

and can even remove proposals under consideration by the committees. In relation to political parties, the authors argue that there are several parties and that none of them is large enough to ensure stability in the negotiations. As per the sectoral committees, the experience of Germany could be adopted, whereby the nomination of sectoral rapporteurs is valid during the entire legislature in order for these rapporteurs to intensify their specialisation and develop deep knowledge of the programming under their responsibility. Concerning the political parties, the new way of organising the congressional budget process would allow society to know their position in relation to the federal government spending priorities, opening up differences in political views.[28]

Nevertheless, Schick (2002, p. 29) considers an evolution: the replacement of a centralised process where everything is decided by a budget committee, by a co-ordinated process where a budget committee decides about fiscal aggregates but programmatic decisions are made in specialised sectoral committees. A co-ordinated process maintains the capacity to control fiscal aggregates and targets, and at the same time deepens the sectoral analysis in a complementary way. This co-ordination is not to be confused with a decentralised process where the sectoral committees retain all the decision power over programming in the respective sectors, an arrangement more commonly found in parliamentary countries. Wehner (2006, p. 771) claims that a well-conceived committee structure speeds up the examination of the draft budget and the follow-up of its execution. Research data from the 2007 OECD study of 38 countries show that the majority of modern democracies' legislatures, even if only presidential countries are considered, still prefer to delegate budget issues to a budget committee (normally one in each house) instead of sharing that responsibility with sectoral committees (OECD, 2007).[29]

Despite having a parliamentary form of government, Sweden is a good example of how a co-ordinated system can work in a positive way (Blöndal, 2001, pp. 40-42). Similar to Brazil, in Sweden the executive branch submits the following year's fiscal aggregates to the parliament in April. After discussions with the opposition, a decision (not legally binding) on the proposal is taken. Then, after the parliament receives the draft budget in September, a finance committee decides on the revenue estimate and proposes expenditure limits for 27 different thematic areas. Hence, each sectoral committee proposes expenditure programming within its subject area and its established limits. By mid-December, the parliament makes a formal decision on the committees' proposed programming in each thematic area. Different from Brazil, there is only one house in the parliament to examine the budget proposal, which simplifies the process in Sweden.

When building indexes to measure the separation of powers and the legislature's control over the budget in 28 countries, Lienert (2005, p. 10) discovered that the participation of a second house in the budgetary process can strengthen the influence of the legislative branch. In Japan, during the draft budget's approval process, when one of the congressional houses makes a decision that is different from the other house, the Constitution and the common regulation delineate a special reconciliation process so that both houses achieve an understanding. A combined committee formed with representatives from both houses has a 30-day period to achieve an agreement; if there is no consensus, the lower house's proposal prevails (Lienert and Jung, 2004, pp. 262-263). In Germany, the budget committee adopts the interesting practice of being traditionally presided by an opposition congressman.

In the United States – a presidential country – the examination of the budget occurs in parallel in both houses of Congress, involving mainly a budget committee and an

appropriations committee in each house (besides the specific committees created to examine revenue). Each appropriations committee is subdivided into 13 subcommittees that are responsible for preparing a draft budget related to their thematic area. The appropriations committees from each house are in charge of consolidating the proposals from the subcommittees, and the budget committees are in charge of systemising revenues and expenses. On the other hand, the United Kingdom and other parliamentary countries that follow the Westminster model do not have a budget committee, instead concentrating the control over the executive branch in *ex post* audits. According to Wehner (2005, p. 13), in these countries any alteration to the draft budget submitted by the executive branch is still considered a vote of non-confidence in the government.

In Latin America, Santiso (2004, p. 63) observes that, in general, the parliamentary sectoral committees' low level of institutionalisation prevents them from making a more effective contribution to the budgetary process. Curristine and Bas (2007, pp. 89-95) highlight the heterogeneity of the legislature's role in the budget process across Latin American countries. Curristine and Bas point out the wide variation in the degree to which the legislatures can alter the budget, and the fact that the legislatures of most of the countries in the region actually approve few budget amendments.

6. The technical-institutional advisory

Anderson (2005, pp. 38-39) highlights the importance for congressmen to have reliable and unbiased information to be able to participate in a constructive manner in budget formulation. They need to rely on an independent and non-partisan analytical unit that would simplify the complex budget information, promote transparency and accountability, increase the credibility of budget estimates, and quickly respond to congressmen's questions. Data from the OECD study done in 2007 show that 70% of the 33 countries which responded to a specific question have a specialised technical unit that conducts budgetary analysis (the data include external auditing units).

Schick (2002, p. 31) highlights the increasing number of legislatures around the world that feel the need to have their own staff specialised in public budgeting to allow for a budgetary examination process that is truly independent of the executive branch. Currently, Brazilian federal congressmen are able to call upon highly specialised technical assistance in budget matters. Institutional advisory units in each house provide this assistance, as well as technical staff knowledgeable in budget matters in the political parties' leadership.

Since the mid 1990s, political party leaders have shown a growing concern for having available specialised technical assistance in public budgeting. Government workers with previous experience in the executive branch – many of whom were originally budget analysts in the Federal Budget Secretariat – usually fill these positions. Every party's leadership in the House of Representatives has at least one technical staff person specialised in public budgeting. With varied levels of competence, these staff members help their respective legislative representation follow the budget matters of the federal government.

With respect to institutional assistance in the legislature, there are highly qualified advisors in budgetary matters in both houses: 40 in the Budget Advisory Unit of the House of Representatives (CONOF) and 25 in the Budget Advisory Unit of the Senate (CONORF). These advisory units, revamped after the 1988 Constitution, prepare analysis, studies and technical reports related to the most relevant budgetary issues or in response to specific requests from congressmen. The advisory units also undertake all the technical processing

in support of the examination processes for the draft pluriannual plan, LDO and LOA, as well as in support of the amendments to these proposals. Regarding the procedures necessary for presenting amendments to the budget proposals, the advisory units prepare a manual containing specific instructions for each sector, and guide congressmen and their assistants with seminars, personal advice or phone availability. Both advisory units have a very horizontal administrative structure, formed by a technical co-ordination and several thematic divisions informally co-ordinated by an advisor, all subordinated to their respective director. The advisors' role is to assist congressmen in a professional and politically unbiased way, including in particular the elaboration of report minutes under the rapporteur's guidance.[30]

According to the information available, no other country has two co-existing budget research units, with practically the same tasks, linked to the legislature. In Brazil, the existence of two advisory units has led to the establishment of informal relationship rules that, although allowing proper budget formulation in the legislative branch, have also generated duplication and unnecessary conflicts. These issues arise first from the very existence of these two separate units with different directors but who have the same spokespeople – namely the budget committee president, the budget general rapporteur, and authorities of the executive branch. The good functioning of this arrangement depends on the personality of the directors, their personal ambition and their desire to share decision power in order to preserve a good relationship.[31]

At the levels of direction and technical co-ordination, there has been apparently no major conflict in recent years, but problems arise with the joint work of the thematic divisions during the budget formulation process. In this case, the technical work is led by the advisory unit which contains the congressman in charge of preparing the sectoral report. Except for a few cases, the participation of advisors from the other house is generally minimal. Consequently, in the areas where there is an annual rotation of rapporteurs between Senators and House Representatives, the memory of what was done in the previous year might be lost (although it can be compensated by the existence of the sectoral report). Alternatively, in the areas in which the rapporteur is always from only one of the houses, there are complaints about excessive workload in a division of that house and about the lack of technical knowledge in that area in the other house.

In 1994, a technical working group formed by advisors from both CONOF and CONORF made suggestions to a group of congressmen in charge of proposing a new resolution to the CMO (the Planning, Public Budget and Control Combined Committee). Although the congressman in charge of writing the report included in the draft resolution the proposition to merge the two advisory units into one congressional budget unit, as suggested by the technicians, the group of congressmen decided not to include the merge of both advisory units in its final report. The reasons for refusal were the resistance to the merge from part of the technical staff, and bureaucratic issues related to the practical implementation of an eventual "Congressional Budget Institute". In reality, the congressmen feared that strengthening the congressional technical staff could somehow, in the future, jeopardise their freedom to act in the budget examination process.

Another aspect that deserves mention refers to the weak relationship between the technical teams in the executive and the legislature. The National Congress' budget advisory units should promote technical dialogue with the Federal Budget Secretariat and other executive branch entities involved in the budget process. However, on the rare

occasions when they meet, there is visible reciprocal distrust. To allow this dialogue to be fruitful, a *sine qua non* condition is that the defence of the best budgetary practices be one of the main concerns of the legislative advisory units, which requires a minimum amount of autonomy in relation to eventual political interference. Furthermore, it is necessary for the congressional advisory units to have only one voice, which is not currently the case because of the duplicate direction and the excessively horizontal hierarchy of their administrative structures.

The Brazilian Congress would benefit from a more independent, single technical advisory unit in the budget area – that is, one that would evaluate the proposals from the executive branch in a more professional way, without the interference of immediate political interests from the leaders of the CMO. According to data from the OECD research done in 2007, Japan (21 specialists), Korea (since 2004, 96 specialists), Mexico (since 2000, 20 specialists in the *Centro de Estudios de las Finanzas Publicas*), Poland (since 1991, 12 specialists plus support from university professors), and the United States (since 1974, 205 specialists) are examples of countries that have set up a technical advisory unit in the budget area linked to their respective legislatures.[32] Both the executive branch's agencies and congressmen recognise the United States Congressional Budget Office (CBO) as an example of a renowned and respected entity. It produces high-level economic-budgetary analysis with no involvement of party politics, avoids providing recommendations or making media appearances, and is able to cater to the committees and not to individual congressmen (Anderson, 2005, p. 43). Meyers and Joyce (2005, p. 79) point out that the CBO has become the most trustworthy source of federal government budget information, even above executive branch agencies.

In Brazil, the nomination of a director for such a unified budget unit should follow a model that would allow him/her to act with a certain degree of freedom, avoiding what happened in 1992. That year, the CONOF director lost his position because of the repercussions of the first technical note produced by the advisory unit, which analysed the draft LDO (budget guidelines law) for 1993 from a technical perspective. Since then, the subsequent directors knew that in order to keep their positions they had to cater to the congressmen who successively ran the CMO each year (presidents and annual budget general rapporteurs), many times to the detriment of the best budgetary practices. If a single budget advisory unit is created, a triple candidate list could be prepared by the advisors and submitted to the leadership of the CMO for selection (with rules to protect the incumbent director from being unjustifiably removed or removed by lesser political issues). Thus, there would be enough stability for the chosen candidate to perform the job of director with relative independence for an entire legislative period (four years).

It would be an evaluation error to imagine that a unified budget advisory unit, formed only by public budget specialists, could supply all the information needed for congressmen to make a qualified analysis of the budget proposals submitted by the executive branch. In order to achieve that, it would be necessary to involve policy specialists in all the different areas of public administration. This knowledge exists in the House of Representatives and in the Senate, where legislative advisory units with technical staff (approximately 200 in the House and 175 in the Senate) are available to advise congressmen. They are specialised in public sectoral policies, and many consider them as some of the most qualified technicians in the Brazilian federal public service. However, under the current model, these advisors (grouped in 21 thematic areas in the House and 32 in the Senate) do not have the opportunity to participate in discussions related to budget proposals in their respective

knowledge areas, which reduces the quality of legislative debates on policies and public programmes.

In order for the participation of these legislative advisory units to be effective and productive, it must occur in conjunction with the work of the advisors specialised in budgeting. Unfortunately, the majority of specialists in public policies are not aware of the programmes and actions involved in their respective budget areas, and even less aware of the values involved in programming. Moreover, few of these public policy specialists have a complete notion of the federal government's limitations in terms of fiscal capacity and, because of their deep involvement with a specific sector, they tend to advocate the allocation of more resources to that sector which could negatively affect the allocation to other sectors and the balance of public spending. On the other hand, budget specialists in Brazil are usually unable to discuss the public policies that should guide the programming of the sectors they analyse. These budget specialists have a deep knowledge of the programmes, actions and values involved in sectoral budgeting, but are unaware of the academic studies and the theoretical advantages and disadvantages of the current and proposed sectoral policies.

Therefore, ideally these two types of professionals should work together to examine budget propositions. One specialist knows best the theoretical side of policies and sectoral programming, while the other knows better the practical side, the fiscal limitations, the budget actions and the evolution of values allocated in the sector. This combined work has its own locus and momentum: the permanent thematic committees of the House and the Senate, revitalised according to the suggestions made in Section 5 above. Members of the permanent committees would perform their new tasks (that is, the analysis of sectoral budget propositions) with the aid of the legislative advisors, many of whom are involved with these committees on a daily basis. The more the legislative advisors are involved, the more information will be brought to the examination of the PLO, allowing for a higher quality of congressional intervention in the budget approval process.

7. Conclusion

In the 18th century, the search by European societies for the right to influence the allocation of public expenditures was partially responsible for the emergence of independent parliaments, as we know today. Folscher (2006, p. 135) argues that the participation of the legislature in the allocation of public expenditure cannot be judged only by the efficiency of the financial management system, but by a more broad view that considers the impact on good governance of a system where the legislature controls and counterbalances the executive's powers. There are plenty of worldwide examples of big allocation mistakes made by executive branches that were not accountable to anyone.

When analysing the legislature's power to influence the budget in 28 countries with different government forms, Lienert (2005, p. 18) suggests that specific factors of each country, instead of forms of government, are predominant in determining the legislature's influence in the budgetary process. Wehner (2005, pp. 8-10) confirms these results by creating an index composed of three parts: the first measures the authority of the legislative branch to alter and impose the execution of expenses; the second measures the complexity of the legislative branch's internal organisation to deal with the budget; and the last measures the legislature's access to budget information. Brazil did not take part of any of

these studies but, if included, it would certainly appear among the countries where the legislative branch most influences the budget.

Despite this power, certain nearsightedness prevails among Brazilian congressmen and even among other agents involved in the National Congress' budget examination process. In Brazil, unfortunately, the Congress is at the mercy of congressmen, and they end up abusing the constitutional power of altering the draft budget at the expense of the federal government's fiscal capacity, the budget reality and the pertinence of the programming included in the LOA. A considerable number of congressmen see any attempt to provide more rationality to congressional intervention in this process as an attempt to limit congressional constitutional rights, and therefore a limitation to democracy as a whole.

There is a weak perception in the federal legislative branch that the strengthening of Congress depends on a reformulation of the way Congress examines the draft budget. A belief still prevails among congressmen that if more amendments are approved, more resources will be allocated to their electoral bases, thus indicating better congressional intervention. In the approval process, the Congress wants to make believe that it assures the next year's fiscal targets, when actually it closes the accounts with revenues that will hardly become a reality. In the execution process, more influential congressmen succeed in obtaining greater resources for their amendments, and others justify themselves to their electorates for the non-execution of their amendments by blaming the impoundment imposed by the executive branch.

The fiscal issue is crucial, and the agents involved in the budgetary process still need to entirely assimilate its importance. As with the executive branch, which initially defines the fiscal target and revenue estimates before establishing the sectoral limits for expenditure programming, the legislative branch also needs to define the fiscal target and the revenue estimate, as well as the mandatory expenses, before presenting expense increase proposals. The Planning, Public Budget and Control Combined Committee (CMO) needs to take these fiscal decisions so that, in a second step, sectoral committees can analyse the programming correspondent to their thematic areas with full knowledge of the amounts available to them. The two-step budget examination process avoids the temptation to look for easy ways out when difficult problems arise, such as prioritising expenditures.

Congress has to recognise the need of having the federal government budget approved with realistic revenues, so that the executive entities can effectively pay the expenses included in the law. This is the only way to eliminate the constantly huge commitment and cash controls which would thus become occasional, smaller or even unnecessary. There are several alternative set-ups that could allow this goal to be achieved, the first being the strict respect of the constitutional text. However, most importantly, Congress needs to have agreement from the executive branch regarding the revenues included in the budget law before the congressional committees start to examine the sectoral programming.

The consequence of incorporating realistic revenues into the LOA is the decrease of its size and of the expenses it includes. The Congress must be encouraged to contribute to this decrease by controlling the programming included by amendments in the budget law. In order for that to happen, there is a need to reorganise the process of amending the draft PLO. The problems with the modality of individual amendments are very evident and pop up from time to time in investigations, creating a negative perception of the National Congress in Brazilian society. Congress must decrease the number of amendments per congressman, reduce the value of the financial quota, and restrict the beneficiaries of these

amendments. The State representation amendments also need to be better controlled. The establishment of financial limits on this amendment modality is crucial, as well as a strong reduction in the quantity of amendments approved, with a more balanced distribution among State representations. It is not wise to insist on increasing the total value of the amendments, given their unsustainability in the medium and long terms *vis-à-vis* the country's fiscal capacity.

When congressmen are content to simply introduce "pork barrel" amendments to their original political localities, by specifying the location of budget actions, they give up the big advantage of the legislature's participation in the definition of public policies and thus the capacity to judge with greater clarity which policies are acceptable to society in general. The disfiguration of the idea behind the creation of collective amendments represented a lost opportunity for Congress to become a forum for political discussion of the budget. If it had taken the collective amendments seriously, Congress could have justified that the conflict, the bargaining and the accommodation of legitimate interests that typically occur in parliaments would counterbalance the technocratic formulation of the LOA, which does not always guarantee the optimum allocation of available resources.

Many congressmen insist on implementing the mandatory nature of budget execution, sometimes for all budget expenses, sometimes for those that come from legislative amendments. One group of congressmen ignores the fiscal and technical requirements that would allow such an obligation to be implemented without generating complete chaos. Others acknowledge these requirements but support their peers, maybe in an attempt to pressure the executive branch to release more funds for their amendments. When restricting the aggregated value in the approved amendments, Congress makes it easier for negotiations where the executive branch accepts the mandatory nature of the execution of legislative amendments.

Sectoral permanent committees in the House and the Senate need to be effectively involved in the legislature's examination of the draft budget. In order for them to be interested in performing their role, these committees need to have real power over the programming of the thematic areas assigned to them. The biggest benefit to the legislature's budget examination process will be the involvement of congressmen with specialised knowledge in sectoral matters, helped by legislative advisors from both houses – factors that will contribute to the improvement of budget programming.

Therefore, ensuring that the two branches are equally aware of the fiscal cost of examination of the PLO in Congress would pave the way for a mature and productive relationship between the technical teams of the Federal Budget Secretariat and congressional budget advisors. This relationship requires that a main spokesperson be designated on the congressional side. Brazil cannot continue to be the only country in the world where two distinct units, with the same tasks, provide budgetary advice to the legislative branch. This duplication is unnecessary, causes a waste of talents, and foments rivalry. A greater independence and subsequent strengthening of the budget technical area supporting Congress is in the interest of congressmen who wish to improve Congress' capacity to examine budget proposals submitted by the executive branch.

Finally, if the proposals suggested here are implemented, Brazil would be re-establishing the federal budget law as an instrument for determining the allocation of federal government expenditure, a function that has been performed unsatisfactorily for many decades. If this function is re-established, the country would be closer to having a more

realistic budget, a goal long sought by many working in the federal budget system. But some second-order problems would still need to be treated in order to pursue this ideal: an effective integration of the LOA with the planning instruments, the focus in the programmes' scope, costs, indicators and results, the feedback to budget formulation, and the transparency of some programmes.

Notes

1. Impoundment (or endowment, detract) stands for the bimonthly reviewed commitment and cash control mechanism which imposes ceilings on the execution of discretionary expenditures of the budgetary units of all three governmental branches, divided by recurrent and capital expenditures, by group of resource source, and by priority programmes.
2. The budget guidelines law is an annual law that sets the directives for the budget formulation and execution processes. The executive branch has to submit the draft LDO for congressional examination and approval four and a half months before the budget submission deadline.
3. Additionally, the CMO examines and issues a statement on *i)* the annual accounts presented annually by the President of the Republic and *ii)* the national, regional and sectoral plans and programmes. It also exercises the budget execution follow up and control.
4. For a detailed presentation on the evolution of Congress' examination of budget proposals since the Federal Constitution of 1988, see Greggianin (2005), Santa Helena (2005), or Sanches (1998 and 2002).
5. Previously, the CMO could re-estimate revenues several times until the end of the PLO examination process, and the general rapporteur could freely allocate the additional resources obtained in this manner.
6. To prevent sectoral rapporteurs from increasing the investment programme by making cuts to recurrent expenditure, since 1995 preliminary statements have stipulated that the sectoral rapporteurs can cancel only the capital appropriations, while the cancellation of recurrent expenditures can only be done by the general rapporteur (whose resources are normally shared with the sectoral rapporteurs).
7. Resolution No. 1/95-CN created the regional amendments which should comprise actions related to a geo-economic region and should be approved by the absolute majority of that region's congressmen. Initially limited to five, Resolution No. 1/01-CN reduced these regional amendments to two, and later Resolution No. 1/06-CN eliminated them.
8. Resolution No. 1/06-CN attempted to reverse the situation in which the general rapporteur, using his/her own criteria, ended up providing the majority of the resources necessary for the conclusion of the sectoral reports.
9. The *real* is the Brazilian currency, since 1994. In January 2009, one United States dollar was exchanged for approximately BRL 2.30.
10. On average, the first revenue re-estimate prepared by Congress represents around 70% of the total revenue increase introduced in the PLO revenues estimation during the examination processes.
11. Lienert and Jung (2004, p. 102) cite Canada and the Netherlands as countries which adopt this practice.
12. Available at *www4.bcb.gov.br/?focusmerc*.
13. "Midgets" is a reference to the small physical stature of the main congressmen involved in that scandal; "bloodsuckers" refers to politicians involved in a scandal in the health sector; and "NGO" refers to a scandal regarding transfers to private entities.
14. See, for example, the statement by Sergio Ronaldo da Silva, a federal government employee and director of the Confederation of Federal Government Workers: "These amendments are the big problem. When they are presented, everything is already agreed upon: to whom it will go to, to which project, who the municipality will hire, how much will be executed and how much will be bribed" (*O Estado de Sao Paulo*, 11 November 2007).
15. The pertinence of voluntary transfers from the federal government to the States and the municipal governments, which often happen to the detriment of these governments' duties, is not discussed here.

16. That year, to show how active he was in defending his region's interests, a congressman distributed to his electoral base a booklet with a listing of the almost 1 000 amendments he presented, supporting the statement by Bezerra (2001, p. 51) about the techniques used to broadcast as widely as possible the name of the one responsible for the benefits that were obtained.

17. Before executing these generic expenditures included by Congress, the executive entities await guidance from a congressman (co-ordinator of the State representation) regarding the destination of the budget appropriation.

18. See the speech of Lucas Furtado, General Prosecutor to the Administrative Court: "If there was a real desire to improve the fight against corruption, it would be necessary to change the whole budgetary elaboration and execution system. We do not know the criteria. The impression is that everything is done to allow that members of the Budget Committee request campaign donations, which is, in legal language, getting bribes from private businesses" (*O Globo*, 10 December 2007).

19. On average, the new programme introduced by Congress in recent years has represented something around 20% of the discretionary expenditures included in the LOA.

20. The executive branch needs to have some freedom to allow for emergencies during budget execution.

21. Its absence would weaken the agreement, since the budget guidelines laws (LDOs) would have to repeat its terms every year, thus facilitating its alteration if circumstantial events occur.

22. In 2007 (the PLO for 2008), the first active year of the new resolution, the permanent committees did not participate in the public audience phase nor in the proposal of priority programming for receiving amendments, nor did the committee amendments contain the elements, criteria and formulas that determined the resource allocation.

23. In 1995, the CMO created seven permanent sub-committees, each responsible for a specific thematic area. It was the duty of these sub-committees to evaluate sectoral reports, write bimonthly reports on budget execution, examine the LDO priorities and targets, and promote public audiences. However, the sub-committees failed because of the few meetings held and the lack of follow-up in budget execution, and because they promoted simultaneous voting that prevented the participation of all interested CMO members.

24. Because of their partial view of State requests, Sanches (2002, p. 19) understands that sectoral rapporteurs actually complicate more than help this balance, and that the legislative examination process would gain in transparency, rationality and effectiveness if organised as a single cycle led by a college of rapporteurs.

25. Eventually, one could consider the possibility that such a CMO be composed exclusively of congressmen who are senior members of the finance and fiscal committee in their house, facilitating the discussion on budgetary fiscal issues.

26. Pontes (2004, pp. 8-12) proposes restrictions on the participation of any committees that do not deal with budgetary issues or that deal exclusively with control issues.

27. There has already been a similar initiative inside the CMO: in 1994, during the examination of the PLO for 1995, three political parties used a prerogative established in the preliminary statement that allowed political parties to present budget amendments.

28. Ideally, a political reform that strengthened the political parties with congressional representation should precede the implementation of such a procedure.

29. Of the 38 countries researched, only Belgium, the Czech Republic, Ireland, Korea, Norway, Sweden and the United States adopt a co-ordinated model; Hungary, the Netherlands and the United Kingdom adopt a decentralised model.

30. The House of Representatives' advisors also prepare draft reports on the adequacy of budget and financial propositions in the Finance and Tax Committee, a task not required of the Senate advisors.

31. A recent example of the problems of having two independent structures with the same tasks was the questioning involving the interpretation of a clause in the LDO for 2007. The CONOF prepared a technical note concluding one thing, and the CONORF prepared its own technical note concluding exactly the opposite. The technical expertise within Congress did not have a unified position regarding the clause, obliging the president of the CMO to send two conflicting technical notes to the executive branch entities involved in the issue.

32. In addition to Mexico, other Latin American countries recently implemented budget study centres linked to the parliament: Colombia (*Oficina de Asistencia Técnica Legislativa*) and Peru (*Centro de Investigación Parlamentaria*). The Philippines also has a budget unit with 50 specialists.

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The Changing Role of Parliament in the Budget Process

by
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Legislatures require reliable, unbiased information to be able to participate constructively in formulating the budget. This article explores the value of an independent budget capacity located in the legislature for expanding parliament's role in budgeting and for holding the executive accountable.

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The art of budgeting has always been difficult, and in a world where many societies are ageing, where the effects – both potential and actual – of global warming seem to grow every day, where globalisation has exposed societies more to the actions of others, and where governments increasingly provide a variety of complex financial guarantees (such as public-private partnerships), budgeting will not get any easier.

Unfortunately, the increased difficulty of budgeting all too often promotes efforts by executives to diminish accountability. Rare is the executive who is willing to discuss the long-term fiscal sustainability of his/her government with reference to its promises to the aged, for example. Instead, executives frequently choose to evade discussions of problems associated with ageing, global warming, globalisation, guarantees, and other fiscal risks, and concentrate only on near-term issues. But as the potential consequences of these fiscal risks increase, the costs of this evasion become more severe.

The OECD has looked into the role that legislatures can play to encourage executives to discuss the risks their societies face in a more open and informative manner. It has observed that executives will rarely improve accountability on their own without some kind of external influence encouraging them to do so. The OECD has also observed the success that some countries have experienced in increasing the legislature's involvement in the budget process as the source of this external influence.

As Allen Schick, one of the very few academics able to describe trends in budgeting in an informative manner, has commented (Schick, 2002), two contemporary developments are buffeting legislative work on the budget. One is the drive to discipline public finance by constraining fiscal aggregates; the other is the effort to enlarge the legislature's role in revenue and spending policy. Whether these trends turn out to be complementary or contradictory will shape the budgetary role of national legislatures in the years ahead. One scenario is for the legislature to reinforce fiscal discipline by taking responsibility for the budget's totals. Another is for the legislature to undermine discipline by bombarding the budget submitted by the government with legislative amendments that trim revenues or boost expenditures.

The early signs point to the former course, but the history of budgeting and some contemporary research assume the latter. In a growing number of countries, the national legislature now votes the budget totals in addition to its traditional work on revenue and spending measures. Maastricht-type rules and other efforts to stabilise public finance may spur national governments and their legislatures to frame budgetary decisions within preset totals. Where this occurs, legislative work on the budget will parallel the government's and may result either in greater co-operation or greater rivalry between the two branches. In some countries, the legislature's new responsibility for the overall budget will buy it greater independence in fiscal policy. In others, the legislature will behave more as a partner than as an adversary. The probabilities are that adversarial relationships will predominate in presidential systems and co-operative relationships in parliamentary regimes. But other variables, such as the party system, may intervene to induce co-operation in

governments where power is formally divided and to generate friction in countries where power is formally shared.

As Schick points out, legislative activism may lead in an entirely different direction, however: not to greater fiscal discipline, but to budgets in which pressure to spend more and to tax less generate chronic deficits, as well as to a progressive rise in the share of national income spent by the government. As unlikely as this possibility may appear to contemporary promoters of legislative activism, it has been the predominant view of legislatures for hundreds of years. In some countries, the legislature voluntarily yielded budgetary power to the executive because it accepted the view that parliamentarians cannot constrain their political inclination to tax less and spend more. Legislatures entrusted budgetary authority to the government because they could not trust themselves to make responsible financial decisions. This attitude is endorsed by prominent scholars who correlate the legislature's capacity to amend the budget with fiscal outcomes. For example, in a paper published by the European Commission, Jorgen von Hagen found strong empirical support for the hypothesis that limits on the amendment power of parliament, and other rules, strengthen fiscal discipline and result in relatively small deficits and public debt (Hagen, 1992). There may be reason to challenge this finding, but its validity is less important than its acceptance.

Although there are some notable exceptions, national legislatures generally are now more active in budgetary matters than they were in the post World War II era. An OECD study reported that legislatures in more than half the countries surveyed had a larger budgetary role than they had a decade earlier (OECD, 2007a). The evidence of legislative activism is plentiful: new committees charged with legislative or oversight responsibilities; enlarged budget staffs; a vast increase in the flow of budget-related information from the government to legislators; and increased vigilance by independent or legislative auditors in reviewing the propriety and efficiency of expenditures. But adding institutional capacity does not itself ensure that legislators will stake out an independent position on the budget. To do so, they also need the political capacity to reject salient elements in the government's budget.

To be able to credibly encourage more accountability from the executive, legislatures need help in understanding complex budget issues and processes. Currently, legislatures in different countries play a wide variety of roles in the budget formulation process (Santiso, 2005). Some legislatures are very actively involved, and some are not involved at all. Moreover, the role that the legislature plays in many countries has changed over time and should continue to change in the future (Schick, 2002, p. 33). These changing roles and the need to encourage executive accountability call into question the sources of information that are or may be made available to help the legislature participate in the budget process. Legislatures require reliable, unbiased information to be able to participate constructively in formulating the budget.

This article discusses the value that an independent budget capacity located in the legislature can have for expanding the legislature's role in budgeting and for holding the executive accountable. Section 1 discusses the potential value to the legislature of having an independent research capacity or unit. The next two sections list and discuss each of the core functions that such a unit can perform, describe other possible functions of the unit, and describe the fundamental characteristics required to make the unit nonpartisan and objective, including other characteristics that can enhance the effectiveness of the unit.

Section 4 discusses trends in establishing independent budget units that the OECD has discerned. These trends come from a number of different sources: from the results of two surveys that list the number of countries with specialised legislative research organisations; and from other information that the Budgeting and Public Expenditures Division of the OECD has gathered in its worldwide meetings of senior budget officials, including meetings with officials from Africa, Asia, Central Europe, Latin America, and the Middle East/North Africa as well as with budget officials from OECD countries. Section 5 concludes.

1. Potential value

In its most basic terms, an independent research unit can provide information to put the legislature on a more equal footing with the executive branch. This information is critical if a legislature is to play a real role in budget formulation, and is thus critical in promoting executive accountability. However, as important as this information is, such a unit can do much more than just eliminate the executive's monopoly in budget information and promote executive accountability. Additional benefits of an independent, analytic budget unit include:

- **Simplifying complexity.** Budget information is frequently not made available by the executive's budget office, but even when it is, the information may be so complex that the legislature has difficulty understanding it. An independent unit must have the expertise to be able to make complex budget information understandable to the legislature as well as to the media, academia, and the public.
- **Promoting transparency.** Because of the knowledge and expertise found in an independent budget unit, budgetary legerdemain can be discouraged and transparency promoted.
- **Enhancing credibility.** By encouraging simplification and transparency, an independent unit also has the effect of making all budget forecasts more credible – even those of the executive who is obviously partisan.
- **Improving the budget process.** The combination of a more simple, transparent, credible, and accountable budget can promote a budget process that is more straightforward and easier to understand and follow.
- **Serving both the majority and the minority.** A legislative budget unit – if it is truly nonpartisan and independent – should provide information to both the majority and all minority parties of the legislature.
- **Providing rapid responses.** As a part of the legislature, an independent budget unit can provide much more rapid responses to budget inquiries from the legislature than are usually provided by the executive's budget office.
- **But most of all, promoting accountability.** The accountability of the estimates that the executive uses in the budget process can be enhanced by an independent research unit because of the scrutiny such a unit provides regarding the executive's budget office.

The additional values of an independent legislative budget unit mean that it is much more than just an instrument to assist the legislature in the budget process or to help check the executive's budget power. The unit also serves the society at large and can actually help improve the whole budget process. However, the value of an independent unit can change over time. At first, the information produced by the unit may be more valuable to the legislature as a whole, as a means to balance the executive's budget power.

But as the unit ages and as the executive adjusts to the presence of the independent unit, the information it produces may be of more value to minority parties in the legislature in their relationship to the majority party.

It should be noted that the above list does not include any mention of promoting the use of performance and results information in the budget process – so-called performance budgeting. The OECD actively promotes the use of performance information in the budget process. In fact, a publication was released on the topic: *Performance Budgeting in OECD Countries* (OECD, 2007b). But the OECD recognises that countries need to establish solid budget procedures before they try to build more complex budget concepts into their budget systems. Put another way, countries are encouraged to learn to walk before they learn to run.

2. Core functions

An independent research unit can perform many possible functions, but to best assist the legislature in the budget preparation process, it should perform, at the very least, the following four core functions:

- **Economic forecasts.** All budgetary analyses begin with an economic forecast. The first core function of the unit is to perform an independent economic forecast. Although the unit's forecasts need to be objective, the unit should take into account the forecasts of others – such as private forecasters, central bankers (if available), international organisations, and panels of experts specifically organised to assist the unit's forecasters. The forecasts should be based on laws currently in place at the time – that is, they should not try to anticipate future legislation. The forecasts also should not try to take into account the economic consequences, if any, of policy proposals. The assumptions used for interest rates and commodity prices should not be targets but should be based on the best information available. It is also better for a unit's forecast to be a little conservative, because it is much easier politically to reduce deficits and debt in an economy that is performing better than was forecast than it is to try to find last-minute spending cuts or to increase taxes to meet a revised deficit target that results from a worse-than-anticipated forecast.
- **Baseline estimates.** The forecasts of spending and revenues should be projections, not predictions – that is, they should be based on laws that are currently in place, not on policy proposals. The forecasts should not try to judge the legislative intent of laws; but they should assume, for example, that the expiration dates built into legislation will actually occur and that the spend-out rates of slow-spending capital projects are based on the best technical information available, not on biased political opinions.
- **Analysis of the executive's budget proposals.** The third core function of an independent unit is to perform a budgetary assessment of the executive's proposed budget. Such an assessment should not be a programmatic evaluation, which is basically a time-consuming political exercise, but rather a technical review of the budgetary estimates contained in the executive's budget. Such a review can actually enhance the credibility of the executive's budget. This is particularly true where the difference between the two estimates is not great and, for the government's forecasts as a whole, where the difference between the assessment and the actual outcome is not great.
- **Medium-term analysis.** All of the core functions mentioned above should be performed over at least the medium term, which can then highlight the out-year consequences of current and proposed policy actions. It is particularly important to do a medium-term analysis to take into account various fiscal risks such as those inherent in loan guarantee

programmes, commitments to provide pensions, public-private partnership initiatives, and other programmes that contain contingent liabilities. A medium-term analysis also provides the basis for a long-term analysis, the importance of which grows as societies age and as the impact of programmes that involve intergenerational transfers expands.

Other functions that the independent unit could perform include the following:

- **Analysis of policy proposals.** Hundreds, perhaps even thousands, of policy proposals can be made each year by members of the legislature, and the executive often makes many policy proposals in addition to those contained in the budget. An independent unit can provide valuable assistance to the legislature by estimating the costs of these proposals. But because it can be very time consuming to estimate the budgetary impact of every proposal, it may be appropriate for the legislature and the analytic unit to agree on rules – such as estimating the costs of only the proposals with the largest potential budgetary impact or only those proposals approved by a full committee or significant subcommittee – that limit the number of proposals costed by the unit.
- **Options for spending cuts.** Legislatures can often benefit from having available a list of options for spending cuts prepared by an independent unit. The options selected should be based on programme effectiveness and efficiency, not on political concerns. (Note that this is an area where performance information can be quite useful, but the use of performance information to construct options is much different from setting up a budget system directly tied to performance outputs.) The unit should only list the options; it should not make recommendations for any option, because to do so could raise questions about its independence. As valuable as such a list of options can be to empower the legislature, this function can also be time consuming, although its staffing impact can be mitigated if the listing of options is produced only at the beginning of a new legislative session.
- **Analysis of regulations.** Legislation can affect the economy in more ways than just spending and taxing decisions; through regulations, or mandates, legislation can require actions on the part of corporations, individuals, or subnational governments. An independent unit can review the regulations and provide valuable information to the legislature by estimating their economic impact. But again, this can be a time-consuming task, depending on how many regulations the unit reviews and how complex they are.
- **Economic analysis.** The expertise found in an independent budget unit can also be used to perform more extensive economic analyses. These analyses can contribute to the legislature's understanding of the near-term and long-term budgetary consequences of related policy proposals and can also assist the unit's staff in preparing the core estimates of budget proposals.
- **Tax analyses.** In addition to the types of budgetary and economic analyses mentioned above, a unit can also serve the legislature by performing various types of analyses of tax policies such as estimating the impacts of proposed or enacted tax changes on economic growth, or measuring the distributional impacts of various types of tax proposals. Again, these analyses can be time consuming, and they can require specialised staff whose skills are not easily transferred to analyses of spending proposals.
- **Policy briefs.** The time demands placed on policy makers in both the executive branch and the legislature, and the complexity of budgets, have created a demand for short, straightforward descriptions of complicated budget proposals and concepts. Such

descriptions, or policy briefs, can be of real value not only to busy members of the legislature but also to the media and the public.

- **Long-term analysis.** As mentioned above, long-term analyses – that is, analysis of potential budgetary trends for as many as 75 years – become more valuable to legislatures because of the ageing of the population in many countries, because so many countries have programmes that transfer resources (and costs) from one generation to another, and because of other fiscal risks mentioned previously.

It should be noted that, for the last several years, the Budgeting and Public Expenditures Division of the OECD has been actively encouraging countries to undertake long-term budgetary analysis. Many countries are still struggling with developing reliable medium-term budgetary analysis and thus have difficulty understanding how the analysis of potential budgetary trends for 25, 50, or as many as 75 years can be done and can be useful to the political process. But when countries actually sit down and walk through the process of undertaking long-term budgetary analysis, they can quickly see how it can be done and how it can be useful to politicians, the press, and the public. Specifically, they learn that once they have mastered medium-term analysis, jumping to long-term analysis is not that difficult. Most importantly, they learn that long-term budgetary analysis produces projections, not predictions, and that sensitivity analysis of various potential but basically unknowable outcomes can help frame the near-term fiscal policy debates. It is very relevant to note that, in the last few years, the European Commission has been performing a study entitled "The Long-Term Sustainability of Public Finances in the European Union" which makes projections extending for 50 years.

As valuable as each of these other functions can be to the legislature, the size of the unit and the number of staff required to perform them will limit the functions that can be assigned at the unit's inception. However, independent units can be created with initial responsibilities limited to only the core functions mentioned above, and then the unit's responsibilities can be extended over the years to include many of these other functions.

3. Fundamental characteristics

Establishing and maintaining an independent research unit that provides objective budgetary information to the legislature is not easy. It is an important challenge that requires a carefully designed, step-by-step development process combined with a medium and long-term plan.

Certain fundamental characteristics must be present if the unit is to be successful. Foremost is the nonpartisan nature of the unit. Note that "nonpartisan" is much different from "bipartisan": the former connotes lack of a political affiliation; the latter connotes affiliation with both (or all) political parties. A unit that is bipartisan would attempt to present its analysis from the perspective of both (or all) political parties, whereas a unit that is nonpartisan would not present its analysis from a political perspective at all. Clearly a nonpartisan unit would be superior in presenting objective information. The director of such a nonpartisan unit may be a member of a political party, but this does not make the unit itself partisan as long as the director is more of a technician than a politician, he or she operates the agency in a nonpartisan manner, and the staff is composed entirely of technicians.

Operation in a nonpartisan manner would require, among other things, that the same information be provided to the majority and minority parties. Other fundamental characteristics of a nonpartisan unit include:

- making the outputs of the unit, and the methods by which those outputs are prepared, transparent (especially reports that are critical of proposed policies) and understandable. A corollary is to place all the unit's outputs and methods on the Internet so that everyone has access to them;
- defining the core functions of the unit in law so that they cannot be easily changed to suit political purposes;
- avoiding recommendations;
- principally serving committees or subcommittees rather than individual members of the legislature;
- being willing to meet with lobbyists or other proponents – as well as opponents – of policy proposals, keeping in mind that a fair and balanced process, and the appearance of a fair and balanced process, are always important;
- locating the unit's offices separately from the legislature, but always answering requests in a responsive and timely manner; and
- avoiding the limelight.

4. Trends in independent budget units

More and more countries are setting up independent budget units as their legislatures become more involved in the budget process. This phenomenon is occurring in both presidential and parliamentary systems, and both within and outside the OECD area.

There have been two recent surveys of independent budget units:

- In 2006, the European Commission conducted a survey on fiscal rules and institutions (European Commission, 2006). The results of the survey revealed 22 independent fiscal institutions in 14 EU member states. Of these 22 institutions, 16 issue normative statements or recommendations mainly through regular parliamentary hearings.
- In 2007, the Budgeting and Public Expenditures Division of the OECD conducted a survey of 30 OECD countries and 8 non-OECD countries on budget practices and procedures (OECD, 2007a). One of the survey questions was: "Is there a specialised budget research office/unit attached to the legislature to conduct analyses of the budget?" Of the 38 countries, 16 responded that they have either a specialised unit or some other kind of capacity to conduct such analyses. These 16 include the following countries in the European Union: Belgium, Finland, Italy, Netherlands, Poland, Portugal, and the United Kingdom. The OECD is in the process of expanding this survey to include 60 more countries from Africa and Asia.

In addition to the European countries mentioned above, it is worth noting that Korea and Mexico have set up independent budget offices in the last few years and are continuing to add functions and staff to these units. Canada created an Office of the Parliamentary Budget Officer in 2008 and, although it has only a few staff now, it too is expanding. There are also independent budget units in non-OECD countries, such as Brazil.

The oldest independent budget unit is the Dutch Central Planning Bureau (CPB), which currently has about 145 staff. Although its name is very misleading – it certainly does not do any central planning – the CPB does have two attributes that may be unique. First, it is located

under the executive, not in the legislative branch; nevertheless, it is truly independent, and that is what really matters. Second, in addition to doing most of the functions listed above, the CPB also provides estimates of the campaign promises of politicians. These estimates have been so well received that the public basically demands that any campaign promise made by a political candidate in Holland must be accompanied by a CPB estimate of the budgetary cost of the promise.

The biggest independent budget unit is the United States Congressional Budget Office (CBO).[1] The CBO evolved from a small budgetary research unit in the Congress. The law that created the CBO (the Congressional Budget and Impoundment Control Act, 1975) provided only general guidance as to what its functions should be. Although the CBO now performs all of the functions listed above, it was not clear at its inception exactly what work it would do and what work would be done by the staff of the newly created budget committees. In fact, a former CBO director, who was the first deputy director when the CBO was created, said that one view was to severely limit the CBO role:

> What the House wanted [when CBO was created] was basically a manhole in which Congress would have a bill or something and it would lift up the manhole cover and put the bill down it, and 20 minutes later a piece of paper would be handed up, with the cost estimate, the answer, on it. No visibility, [just] some kind of mechanisms down below the ground level doing this … non controversial [work], the way the sewer system [does] (Bob Reischauer, in Kates, 1989).

The CBO was able to expand its functions far beyond what was stated in this quotation in large part because of the efforts it made from its inception to explicitly structure itself as a nonpartisan, independent, objective analytic agency. The CBO has about 235 staff to do all these functions. I was the Deputy Director and the Acting Director of CBO from 1999 to mid 2003. During this time, I spoke to many visitors from other countries who were interested in providing better budget information for the legislatures in their countries and who wanted to learn what the CBO did and how.

Virtually all of these visitors were somewhat put off by the size of the CBO, saying they could never have a new agency that large in their countries. But before automatically rejecting the CBO as a potential model, I encouraged them to think of the staffing of the CBO in terms of the distribution of staff by core and other functions (see Table 1), as discussed above. This breakdown can usefully be compared with the staffing for core functions of two subnational agencies in the United States (see Table 2): the Legislative

Table 1. **Distribution of Congressional Budget Office staff**

Function	Core	Other	Total
Executive direction	5	5	10
Macroeconomic analysis	5	15	20
Tax analysis	5	15	20
Budget analysis			80
Baseline	20		
Analysis of proposals		45	
Mandates		15	
Programme divisions		75	75
Technical and administrative	10	20	30
Total	45	190	235

Source: Author's estimates.

Table 2. **Staffing by core function**

Core function	CBO (federal government)	Legislative Analyst's Office (California)	Independent Budget Office (New York City)
Executive direction	5	3	6
Macroeconomic and tax analysis	10	5	4
Budget analysis	20	36	12
Technical and administrative	10	9	5
Total	45	53	27

Source: Author's estimates.

Analyst's Office (LAO) of the State of California and the Independent Budget Office (IBO) of the City of New York.[2]

Core functions – executive direction, macroeconomic and tax analysis, budget analysis, and technical and administrative functions – at the CBO and the LAO require about 50 staff each. This figure may be more relevant as a model for a number of countries that have larger economies and more complex budgets, such as Korea and Mexico. However, the size and complexity of the budgets of the United States federal government and of the State of California are much greater than the budgets of many other countries, so that the approximately 27 staff performing core functions in New York City's IBO may offer a more appropriate comparison for many countries.

The point to be stressed here is that an independent budget unit can be created with a relatively modest investment. However, to emphasise what was said previously, establishing and maintaining an independent research unit is a difficult challenge that requires a carefully designed development process combined with a medium and long-term plan.

5. Concluding remarks

As stated at the beginning of this article, to be able to play a substantive role in the budget formulation process, legislatures need help in understanding complex budget issues and processes. This need can be well served by an independent source of budget information. Examples of offices that provide this information can be seen in a number of countries, particularly in the Netherlands and in the United States. However, such independent research units have also been created within the legislature itself and not as separate legislative offices or bureaus. Once created, such a unit must operate in a credible and impartial manner if its value is to be sustained.

Notes

1. Much of the history of the CBO is drawn from Day (2003).
2. See *www.lao.ca.gov* for information on California's Legislative Analyst's Office, and *www.ibo.nyc.ny.us* for information on New York City's Independent Budget Office.

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Public-Private Partnerships: The Relevance of Budgeting

by
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This article examines the budgetary implications of public-private partnerships (PPPs) and how to strengthen budgetary review, budget treatment, accounting and assessment of PPPs.

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1. Introduction

Public-private partnerships have constituted a growing movement worldwide for at least the past decade. Countries have been seeking private partners to finance, manage and maintain infrastructure serving public purposes in a growing range of areas. Transportation, hospitals, prisons and schools are among the leading candidates for private partnerships.

A previous OECD report provided a comprehensive overview of the numerous public management and finance issues raised by this emergent tool of government (OECD, 2008). The issues addressed in that report included: definitions; trends; criteria for assessing economic viability; budget scoring and accounting treatment; and managerial and regulatory issues.

This article examines the budgetary treatment and issues raised by PPPs in more depth. Given the unique budgetary and accounting issues posed by privately financed capital services, the budgetary rules, institutions and procedures applying to these transactions warrant greater assessment.

This article examines the budgetary implications of PPPs, in particular the following questions:

- What are the issues posed by PPPs for central budget offices?
- How do such proposals affect near and longer-term fiscal targets and priorities?
- What approaches are currently in practice to budget for these partnerships and what are their implications for public finance?
- What budgetary strategies and processes should be considered by OECD countries to promote greater consideration of the short-term and longer-term affordability of PPPs with regard to each country's fiscal space and priorities?

The article draws from conversations with budget officials in seven OECD countries (Australia, France, Hungary, Korea, Portugal, the United Kingdom and the United States) and one observer country (Chile). In addition, the experiences of other countries both within and outside the OECD area are included, to highlight emerging budgetary practices and issues. This article also draws on a review of many reports and publications by individual countries as well as by multilateral institutions including the IMF, the World Bank, the InterAmerican Development Bank, the European Union and the United Nations.

2. Background on the use of public-private partnerships to finance capital infrastructure services

Countries have increased their reliance on public-private partnerships in recent years to finance capital asset acquisition and operation. While private firms have perennially been engaged in specific phases of traditional capital construction and servicing, public-private partnerships constitute a different tool to finance and deliver infrastructure and other forms of public capital.

Countries have stepped up their use of PPPs in recent years: PPPs have grown to comprise a portion, although not the majority, of capital budgets in the countries reviewed here. The United Kingdom has had the longest experience, with PPPs currently comprising from 10% to 15% of the capital budget in recent years. France and Korea have had similar experience, with PPPs comprising 20% and 15% of those countries' capital budgets respectively. Portugal reported the highest payments for PPPs, representing nearly 28% of the national budget or 9.4% of GDP; projects could add up to nearly 20% of GDP eventually. In the United States, on the other hand, PPPs are quite limited: the cumulative project costs of such partnerships that had been funded or completed by October 2006 totalled over USD 48 billion (in nominal dollars), a small share of the USD 1.6 trillion in public capital spending on infrastructure by all levels of government during a similar period.

Countries have many reasons for pursuing partnerships with the private sector to deliver goods and services. Much of the impetus is political in nature, arising from constraints on governmental roles and spending, whether from domestic policies, financial markets or regulatory measures such as the deficit and debt limits of the European Union. Some of the push is opportunistic: private provision attenuates the negative aspects of higher fees for services and gives the illusion of making public budgets look smaller, at least in the near term.

However, the principal analytical rationale is that the private sector can achieve equal or greater levels of service with lower costs than pure public sector provision. The private sector has incentives to achieve greater efficiencies than public agencies operating alone, thanks to the competition provided by healthy markets. In his theory of "creative destruction", Joseph Schumpeter attributes economic growth in free markets to a process where entrepreneurs introduce new technologies, new kinds of products, new methods of production and new means of distribution that make old ones obsolete, forcing existing companies to quickly adapt to a new environment or fail (Schumpeter, 1976). As will be discussed below, most countries have rigorous procedures to compare the long-term value-for-money prospects of private partnerships with purely public provision prior to authorising PPPs, and sometimes prior to determining the winning bids on PPP contracts. Since the interest charged to government is inherently lower than private finance, the cost savings for equivalent levels of service must be sufficient to overcome this natural public sector advantage.

Table 1 locates the various combinations of public and private roles in the delivery of public services. When acquiring and operating capital assets, the government traditionally uses a combination of public finance and some form of private delivery for some aspects of capital services. Typically, governments will contract for the design and construction of a major asset, such as a building or a highway, with highly specific public conditions and oversight. Once the asset is completed, the government often performs operation and maintenance functions with public employees. For instance, the Australian national government only uses private contractors to construct traditional government-owned capital.

Table 1. **Public-private roles and tools**

	Public finance	Private finance
Public delivery	Direct government	User fees
Private delivery	Contract	Vouchers, PPPs

Traditional capital infrastructure is financed entirely by government but is often provided through procurement contracts with private firms. The design and construction of school buildings or prisons, for instance, are often accomplished by the government financing a contract with a private company that builds the facility to government specifications. The operation and maintenance of capital projects following construction is typically done by government employees, although separate contracts can also be used. This arrangement obviously varies among countries. The role of the central government in providing infrastructure in federal systems such as Australia, Germany or the United States is often confined to providing public grants to states or localities who are the principal builders and owners of public infrastructure.

When compared to traditional capital infrastructure services provided by government, PPPs are characterised by several important differences:

- First, the private sector provides upfront financing for the costs of building and operating the asset. While the extent of the private role varies as discussed below, the government's role shifts from financing the building and operation of the asset to providing an annualised stream of payments to the private financing partner.
- Second, the private role in most PPPs goes beyond the design and construction of the asset, to also include its operation and maintenance. The comprehensive control of the asset from cradle to grave provides one of the major incentives that motivate private firms to complete the construction of the asset on time and within cost estimates. Delays and cost overruns will hamper the ability of the private partner to collect payments from the government or the public for delivering capital services.
- Third, the private sector bears a significant and appropriate portion of the risk that arises from project operation and management. Private sharing of risks is another critical factor in promoting efficiency gains from private partnerships. The following comprise many of the most important types of risks that can be present in PPPs, risks which under traditional government-owned capital projects are largely borne by the government itself (IMF, 2006, p. 12):
  - ❖ Construction risk: delays and cost overruns.
  - ❖ Financial risk: increases in financing costs.
  - ❖ Availability risk: threats to the continuous supply of capital services.
  - ❖ Demand risk: potential shortfalls in use of the asset by the public.
  - ❖ *Force majeure*: risks from natural or man-made disasters and war.

The OECD report on PPPs (OECD, 2008) went into depth on the factors involved in striking an optimal balance in sharing risks between public and private partners. As the crucible of efficiency gains over public sector provision, the nature and degree of risks borne by the private sector is a key factor for government officials in determining whether to engage in a PPP and how to price contracts to compensate private parties for increased risk.

Beyond the three defining characteristics discussed above, other design features are deemed to be critical for PPPs to realise their efficiency gains. Competition among bidders is crucial to enable the government to negotiate the best value at lowest cost. Competition encourages competing firms to create winning proposals that achieve public value at lowest cost. Competition can also ameliorate principal-agent problems by providing greater information to government officials about costs and outputs. The absence of

competition, in effect, can lead to the replacement of a government monopoly by a privately owned one, with all the costs and sluggish responsiveness that monopolies tend to bring in their wake (Donahue, 1989).

Closely related is the ability of a government to specify all of its major performance goals in the contract. Specifications that cannot be measured are often not met, leading to incomplete contracts which fail to achieve all significant public goals and objectives. While efficiency and output goals are easily specified, quality and equity considerations are notoriously resistant to measurement. When these and other difficult-to-measure considerations become more important in achieving public objectives, there is a stronger case for retaining government ownership and delivery.

3. Public-private partnerships for capital infrastructure services take various forms across countries

There are many forms through which public-private partnerships take shape. As the OECD report indicated, many variations of partnerships fill the broad space between government provision and full privatisation (OECD, 2008, p. 20). The private roles for capital asset creation and operation can include all or several of the following: design, build, operate and maintain. The private sector can either build a new asset or purchase an existing asset from the government. The private firm can own the asset fully or transfer it back to the government at a specified time. In all cases, the financing responsibility is shifted in whole or in part to the private sector, whether it is for construction or just for operation and maintenance. Box 1 contains a taxonomy of potential permutations of PPPs.

The most common form of PPP is "design-construct-manage-finance" (DCMF), in which the private sector finances, builds and operates the asset for a period of many years, often ranging from 20 to 50 years. Here, the government's financing responsibility shifts

Box 1. **Different types of public-private partnerships**

There are many variations in the roles played by each partner in a PPP. A government may assign a greater or a lesser role to the private partner. The following list indicates possible roles that the private sector can assume:

- Build-own-maintain (BOM).
- Build-own-operate (BOO).
- Build-develop-operate (BDO).
- Design-construct-manage-finance (DCMF).
- Design-build-operate (DBO).
- Buy-build-operate (BBO).
- Lease-own-operate (LOO).
- Build-operate-transfer (BOT).
- Build-own-operate-transfer (BOOT).
- Build-rent-own-transfer (BROT).
- Build-lease-operate-transfer (BLOT).
- Build-transfer-operate (BTO).

from upfront payment of asset creation to the purchase of a stream of services that the private partner generates with the asset.

In the case of existing assets, the private sector in effect agrees to operate, upgrade and maintain the asset. This buy-build-operate model (BBO) is being implemented by several states in the United States. For instance, the Indiana Turnpike was purchased from the State of Indiana by a private consortium for USD 3.8 billion in exchange for a contract to operate, maintain and upgrade the highway for 75 years (United States Government Accountability Office, 2008).

Another closely related form of public-private partnership is the concession. A concession transfers the operation of an infrastructure service to a private firm which operates, maintains and finances the asset. Like a PPP, the private partner takes on certain risks specified in the contract, perhaps taking responsibility for a greater share of demand risk than traditional DCMF or other forms of PPPs. Unlike a classic PPP where the government pays the private partner an annual fee, however, the concessionaire pays a fee to the government for the privilege of operating the asset which remains the property of the government. Also, unlike a PPP, the concessionaire receives payment not from government appropriations but typically from user charges levied on the consumers of the asset – for example, highway tolls. However, governments in many cases subsidise and underwrite the risks of the concessionaire through such mechanisms as guarantees and other forms of contingent subsidies triggered by demand shortfalls.

While not defined as PPPs by most observers, operating leases and financial leases share some of the features of PPPs as well. Unlike PPPs, the government leases an asset from a private owner, either for a short time or for a longer period. However, leases have similar budget implications. In effect, they enable the financing of asset construction and operation with private rather than public resources, thereby circumventing upfront funding requirements and other disciplinary constraints in the budget process.

Financial leases are classified as a form of borrowing, since the government bears the risks. International Public Sector Accounting Standards and budget offices in some countries have rules that reclassify operating leases as financial leases based on the substance rather than the form of the transaction. The State of Victoria in Australia, for instance, classifies arrangements as financial leases based on the share of total asset costs financed by the government, the extent of the asset's useful life covered by the lease, and the provision for government acquisition at bargain basement prices (IMF, 2006, p. 22). In the United States, the Office of Management and Budget (OMB) has similar rules, and financial leases require the agency to record the budget authority for the lease up front rather than annually as lease payments are made (United States Office of Management and Budget, 2007).

The United States national audit office, now called the Government Accountability Office (GAO), found that federal agencies often sidestep the upfront funding requirements of the OMB financial leasing rules, by structuring their leases as short-term operating leases. The GAO found that such leases had the function of providing for long-term fiscal space needs, but generated a much higher cost to the government than government ownership or lease-purchase. To ensure that the underlying costs of competing asset financing options were compared on the same terms, the GAO recommended that all tools for financing long-term fiscal space needs be budgeted up front in agency budgets. When provided with a level budgetary playing field, the GAO concluded that there would be a

greater chance that the most cost-effective option to the government would be chosen (Posner, 1994).

Each of these forms of PPPs has its own unique attributes and consequences. What they have in common is upfront financing of asset construction or enhancement with private rather than public resources. However, these are not free resources. In return, the public sector must either provide annualised payments over a number of years to the private firm, or must provide the firm with concessions which permit it to use public resources such as land or to charge fees from the public. These annualised costs have budgetary effects for operating budgets rather than capital budgets. In effect, the costs of capital are converted from upfront payment to annualised payments.

4. The impetus for PPPs: infrastructure and capital budgeting

Public infrastructure, if well chosen and financed within appropriate fiscal constraints, can play an important role in economic growth. Public investment is important for economic growth, but only as part of a sustainable fiscal framework providing a stable long-term macroeconomic platform of longer-term growth, savings and sustainable commitments. The IMF provided a good overview of the criteria that should be used in considering public infrastructure spending proposals:

> A proper assessment of the scope for increasing investment spending in any particular country requires a careful analysis of aggregate demand conditions, absorptive capacity, short-term financing constraints and medium-term public debt dynamics, as well as trade-offs with other types of expenditure in that country (International Monetary Fund, 2005, p. 4).

Government spending on infrastructure can potentially increase the stock of publicly owned capital and may improve the long-term productivity of the private sector and, in that sense, it represents an investment in the future productivity of the private sector. However, the economic payoff from public spending on infrastructure depends on the usefulness of the investments themselves and the extent to which the spending "crowds out" or reduces the funding available for investment in private capital. A recent report by the United States Congressional Budget Office (CBO) concludes that the relative payoff from infrastructure projects tends to be concentrated in the transportation sector and that additional infrastructure spending in other areas is more difficult to justify. Moreover, the agency noted that building new infrastructure is only one option for transportation; upgrading the condition of existing assets and employing congestion pricing to rationalise demands are strategies that may be more cost effective (United States Congressional Budget Office, 2008).

Significant backlogs exist in infrastructure across all countries. A recent World Bank study indicated that for the new EU member states – the so-called EU8 – major investments will be necessary to upgrade their infrastructure to match the levels in other EU countries. A 2004 study showed that EUR 500 billion would be needed during the next 15 years. Furthermore, the environmental investment needs constitute an additional EUR 47-69 billion (Budina *et al.*, 2007, p. 2). For the United States, the CBO concludes that growing delays in air travel and surface transportation, bottlenecks in transmitting electricity, and inadequate school facilities all suggest that some targeted additional infrastructure spending could be economically justifiable. Federal transportation agencies estimate that an additional USD 12 billion in highway funding and USD 4 billion in airport funding will

be necessary just to maintain current levels of service in the face of expanding populations and congestion (United States Congressional Budget Office, 2008).

In one sense, the presence of backlogs and unmet needs for infrastructure is not unusual. While resources are limited in the public sector, needs are relatively unlimited. Policy domains beyond infrastructure have their own inventories of backlog and unmet needs for government spending and other subsidies, whether they be affordable housing, child care for low income mothers, health care for uninsured or underinsured populations, or subsidies for university students. Advocates of spending characterised as "public investment" have asserted a presumptive place in budgetary priorities over pure "consumption" programmes, owing to the potential impact of investment in expanding the economy.

The rationale for public-private partnerships is in no small part predicated on the alleged bias against capital investment in most cash-based budgetary regimes. This central issue makes it important to better understand how political incentives and budgetary regimes interact and what their implications are for both the overall level of public capital investment and the choices of capital projects within the overall budget constraint.

Some would argue that capital spending can provide highly visible benefits to political officials to claim credit with their constituents for delivering specific benefits at the expense of the entire country. Some derisively label capital projects as "pork" and suggest that public officials, if anything, allocate too much infrastructure spending for specific local projects that have little national benefit. In the United States, for instance, earmarking of capital projects has grown exponentially in the past 20 years, as congressmen strive to favour specific projects in their districts to enhance their election prospects.[1] More broadly, public officials face a political asymmetry in the interest group system which one political scientist calls "clientele politics". In short, groups that benefit from narrowly defined projects, such as certain capital projects, have greater intensity about claiming these specific benefits than the broader diffuse public that has to pay for the benefits. Thus, capital projects that concentrate benefits on narrow constituencies while spreading costs more broadly often constitute a winning political formula (Wilson, 1980).

Others argue that capital spending is disadvantaged in cash-based systems because funds for construction must be provided up front in the years when design and construction take place. The uneven, lumpy nature of capital spending makes it difficult to plan for such items in hard-pressed budgets (Premchand, 2007, p. 92). As the modern entitlement state has grown, mandatory items for pension and health care often crowd out discretionary resources such as capital, particularly in recent years when fiscal pressures to reduce deficits and achieve surpluses have become ascendant. Some argue for a separate capital budget freed of the constraints and trade-offs with operating programmes, in recognition of the importance that public investment plays for future growth. Robert Eisner, for instance, has long argued for borrowing for capital, given the rates of return that such programmes provide the country at large (Eisner, 1992). Countries such as the United Kingdom adopted borrowing as part of their fiscal policy, explicitly providing for deficit financing of the capital portion of spending. Countries that have switched to accruals point to the potential to smooth out spikes in capital funding as a distinct advantage of their approach.

In most budgets, countries budget for capital on a unified basis. This means that capital and operating accounts are allocated under the overall budget constraint in the same process. This has important macroeconomic and allocational advantages. Countries

ensure that their total budgets capture all significant outlays from the government in a given year affecting the near and medium-term economy, an important barometer for national economic policy. Countries can also assure themselves that all claims compete against one another within the ceiling of limited resources. Agencies are encouraged to assess trade-offs between capital and labour costs and to explore alternatives for achieving public policy goals from a range of capital and non-capital strategies.

Some countries have provided for a separate capital budget process. In some cases, this involves only separate displays or "pullouts" of capital accounts whose funding is determined through a unified process. In other cases, it may entail a separate budget cycle with its own separate budget constraint and targets. In some countries, such as the United Kingdom, capital budgets have a different fiscal decision rule than the rest of the budget. In the case of the United Kingdom, the capital portion of the budget is intentionally targeted to be in deficit in order to encourage greater building of infrastructure. Under the "golden rule", the budget as a whole must be balanced over the business cycle, with capital deficits being offset by balances in other accounts in expansionary phases. In the United Kingdom, moreover, departments have separate budgets for resources (operating costs) and for capital for new investments.

The accounting treatment is also relevant to both the macro and allocation objectives of budgeting. Countries in cash-based systems generally require capital projects to be funded up front for traditional government-provided capital projects, since the cash flows for design and construction occur in the first several years of the project. This has the advantage of ensuring that public decision makers have to recognise the full construction costs of assets up front at the time when the irrevocable commitment to begin the project is made. Alternatives such as borrowing and depreciation stretch out the budgetary recognition over time to reflect the longer-term benefits and actual consumption of the asset. However, these alternatives fail to force decision makers to consider the full costs at the time they are in effect taking credit for the full benefits of the projects. This potential mismatch of benefits and costs may lower the incentives to carefully deliberate and compare specific capital projects as well as alternatives to achieving their goals through non-capital means such as congestion pricing.

In addition to cash, some countries budget for the total commitment that is encumbered by programmes in the budget. This may be similar to cash outlays for salaries and expense accounts and social services, but it can be very different in timing for capital projects. In the United States, budgets are prepared on both a cash and obligations basis. Budget authority is appropriated by the Congress to provide agencies with the formal legal authority to commit the government to actually expend cash. For capital projects, the OMB requires the budget authority to cover the full costs of building the asset, even though the cash for design and construction may spend out over several fiscal years. This upfront commitment is similar to the capital budget accounts in the United Kingdom and to the new French system which requires parliamentary approval for commitments that involve future payment.

The several countries with accrual budgeting use a different accounting system for capital projects. In these countries, the costs of capital are not budgeted up front, but rather paid over time through a depreciation charge to reflect the consumed cost of that asset in each year. While some assets such as national "Crown assets" are excluded from this regime, agency-owned capital is largely budgeted on an incremental, annualised basis.

New Zealand is the only country that awards funding for depreciation, providing agencies with a funding source to acquire new capital assets. In the United Kingdom, the budget uses cash-based or near cash-based accounts which differ from resource accounts prepared according to generally accepted accounting principles (GAAP).

Accrual-based systems can smooth out capital funding and overcome the spikes associated with cash-based budgets. In cash-based systems, the requirement to assemble sufficient authority or cash becomes challenging and may discourage governments from undertaking important capital projects. However, absent other controls, accrual-based approaches do not provide the discipline of upfront funding. As a result, the government becomes committed to new projects without being forced to budget for the full costs of those commitments. While accrual-based countries do have separate approval processes for projects exceeding certain thresholds, nonetheless at the agency level these projects do not have to compete on a full cost basis against other priorities for limited funds. Those countries that enable agencies to use depreciation as the source for new capital funding have experienced measurement and allocation problems; depreciation is not easily calculated for certain assets, and the government can lose control and flexibility to reallocate to agencies with greater relative needs (United States Government Accountability Office, 2007).

Countries with cash-based budgets have developed various strategies designed to overcome or mitigate the spiking problems that are said to discourage public infrastructure budgeting. Some of the strategies are internal to the government itself. In some cases, funds have been used to accumulate resources over several years from components within or across agencies to enable larger projects to be undertaken. In other cases, incremental budgeting occurs, where agencies build projects in discrete stages designed to reduce the marginal impact on budgets in any one year.

Notwithstanding the particular budgetary concepts and systems used for capital projects, countries that wish to increase the level of public infrastructure have heretofore had a limited and politically painful set of options. They can:

- raise taxes;
- levy or increase user fees;
- cut spending elsewhere in the budget;
- borrow;
- reduce or manage demand.

5. Assessment of the implications of PPPs for resource allocation

Given these difficult options, private financing has become more alluring as an option for public officials to fund increased infrastructure services. Public-private partnerships have obvious economic and political advantages. This section reviews the budgetary implications of PPPs to date, bringing in various other dimensions that have a bearing on the budgetary costs and consequences of these projects. First, the efficiency record will be reviewed: those PPPs that achieve greater efficiency and cost savings than comparable publicly financed projects may ultimately provide greater fiscal space and flexibility, as the government is able to reduce the costs of building and delivering capital services. Conversely, if PPPs increase costs, then budgets are more encumbered than otherwise. Second, the aggregate fiscal impact will be examined: even if individual projects achieve greater value for money relative to conventional public capital (*i.e.* "relative affordability"), it is possible that

the budgetary treatment of PPPs may prompt a government to fund more projects than it can afford under intertemporal budget constraints (*i.e.* "absolute affordability").

5.1. *The efficiency imperative*

PPPs have clear potential to promote greater efficiency and possible cost savings by involving the private sector. To achieve value for money in comparison to traditional capital, private efficiency must be sufficient to overcome the extra financing costs of using private interest rates and transaction costs. Assuming effective competition, risk sharing and contract metrics, a PPP might motivate a private partner to reduce lifecycle costs through higher construction standards, more frequent maintenance, or investments in cost-saving technology. Efficiencies also could result if a private entity charged prices that were more closely aligned with costs, thereby reducing inefficient demands for services.

The comprehensive nature of contracts which include construction as well as operation and maintenance can have several salutary effects. First, this can ensure a level of funding for maintenance over the long life of PPP contracts, thereby providing for improved infrastructure operation and repair when compared to traditional public provision where maintenance is often the first item to be cut in periods of budget austerity. Moreover, the bundling of capital construction and operation and maintenance provides important incentives to private firms to complete construction earlier and with higher quality since this will bring the asset into service more quickly, thereby earning annual income through either fees or government payments.

PPPs, in fact, have shown some early gains in construction timeliness and costs. The United Kingdom National Audit Office reports that PPPs are delivered on time and on budget more often than traditional arrangements. Traditional infrastructure is on time and on budget 30% of the time, while PPP projects are on time and on budget over 75% of the time (Hodge and Greve, 2007, p. 549). Michael Pollitt also concluded that PPPs deliver on time and on budget a higher percentage of the time. While public agencies could do this too, they needed PPPs to stimulate and innovate (Pollitt, 2005). Beyond this, some studies have shown that PPPs were less costly in the United Kingdom for prisons and roads. The National Audit Office estimated that a sample of projects studied in the 1990s experienced cost savings of 10%, attributable to risk transfers from public to private firms (Hodge and Greve, 2007).

In the aggregate, cost savings are achieved through PPPs only if their efficiencies outweigh the higher financing costs and transaction costs that private financing and partnerships inevitably bring. Real cost savings can also be achieved if PPPs enable public officials to impose user charges by shifting potential blame from themselves to the private firms now responsible for managing the asset. Indeed, Portugal was able to impose additional fees for road projects once it became apparent that annual shadow toll payments were insufficient to finance the costs of the private partner under the transportation PPP (Monteiro, 2007).

Yet it is unclear whether value for money has actually been achieved. While the promising evaluations discussed above suggest that project management of the construction phase is more efficient, it remains to be seen whether these projects will ultimately deliver greater value for money than conventional government provision and financing. OECD countries have only invested in PPPs over the past ten years; the United Kingdom, a forerunner, began significant activity under the PFI formulation (private finance initiative) only in the

mid-1990s. Given the long-term nature of contracts, it remains to be seen whether these projects will ultimately deliver greater benefits at lower costs. A recent comprehensive review of international experiences concluded that the efficacy of PPPs is still subject to debate; insufficient research has been undertaken to date (Hodge and Greve, 2007, p. 552).

Some studies suggest that the long-term costs may be higher than traditional government provision when transaction costs and higher private financing charges are taken into account. Transaction costs for PPPs can be higher than traditional procurement; one study suggests that bidding costs represent 3% of total project costs. Moreover, public bodies are often required to compensate the costs incurred by reserve bidders in order to promote competition. Advisory costs can also be significant, amounting to over 5% of contract costs (Marty, 2008a). Shaoul's work provides evidence of flawed value-for-money appraisals, with arbitrary risk transfer allocations that tip the balance in favour of PPPs but that are not sustainable in real-world policy making (Shaoul, 2005). Case studies of PPPs in Canada suggest that governments have found it difficult to reduce either their total costs or their budgetary risks by transferring revenue risks to private partners (Vining and Boardman, 2006). Even where cost savings are achieved, the private sector will have an incentive to realise higher private sector returns in the first instance rather than lower public sector costs.

Classic public management problems complicate the implementation of PPPs and undercut their ability to deliver on their promises of efficiency. Agencies that deliver services directly with their own employees have certain accountability advantages: transactions are internalised within hierarchies that are more cohesive and responsive to central leadership (Lehman, 1989). Obvious challenges are presented when the government must use independent actors it does not fully control to achieve its goals, especially since, as Don Kettl has noted, transferring the work to someone else does not relieve the government of responsibility for the performance (Kettl, 1989). Private partners have independent bases of political power and goals and interests that may conflict with those of government agencies. Fundamentally, public-private relationships are consequently best characterised as bargaining relationships in which both partners have independent sources of leverage over the other. Classic problems include (Posner, 2002):

- Goal conflict: The differing priorities and accountability chains of private and public actors can compromise efficiency and distort the goals themselves, becoming manifest in excess profit taking and failure to achieve public objectives.
- Principal-agent problems: Principal-agent theory tells us that agents enjoy influence by virtue of their inside knowledge about their own behaviours and motivations (Arrow, 1991). Thus, when shortfalls are experienced or costs increase above targets, it is difficult for the government to challenge the private partner due to the latter's control of information about their costs and programme operations.
- Limited competition: These information asymmetries can be offset by competition which provides principals with greater information from multiple agents competing for a contract. However, for many PPPs, competition is limited, partly owing to the large amounts of private capital that must be assembled to finance infrastructure projects. PPPs in the United Kingdom have an average of only three bidders per contract (OECD, 2008, p. 78).
- Rent seeking: Government contracts can draw opportunistic private firms that seek to gain excessive profits and incomes, which can undermine the efficiency goals of PPPs.
- Moral hazard: The more a project embodies a public good, the less the government will be able to let it fail, regardless of formal allocations of risks in contracts. In particular,

when demand shortfalls occur, the government has stepped in to bail out projects that have become financially unviable for the private partner. This undermines efficiency: *i*) governments lose leverage since private partners know that a government will provide a safety net; *ii*) private partners can shirk their responsibilities and avoid making tough decisions in the interests of efficiency, safe in the knowledge that the government will not let them or the project fail.

- Interdependency: Both actors become dependent on the other to achieve their goals. While this situation can be productive, it can also make the government wary of imposing sanctions or other forms of discipline related to a contractor's performance, in fear of the possible impacts on the contractor's ability to deliver services to clients.

The traditional advantages enjoyed by contractors become accentuated with long-term contracts under PPPs. Contracts that are short term can be reviewed, changed and renewed, but long-term contracts increase the stakes and fortify the position of the contractor who gains expertise and a monopoly over production and over resources. The long time periods make it difficult for governments to write detailed specifications and conditions, leaving important issues to be resolved in subsequent negotiations during the long implementation phase. It has been observed that long-term contracts erode competition as governments become more dependent on the contractors' expertise and familiarity. It is inherently difficult to keep contractors in a state of "healthy insecurity" fostered by a robust and competitive marketplace over long periods of time. Contractors often have an incentive to underestimate their costs in original contracts, leading to large overruns as the project evolves. Chilean officials indicate that contract changes for concessions resulted in payments that were 35% higher than original estimates.

Since the cost effectiveness of PPPs depends in no small part on the transfer of risk, it is important to note that, regardless of the formal terms of the contract, governments face asymmetrical risks owing to their abiding interest in continuing with the provision of the capital service. A government is often left with a disproportionate share of the demand risk, but it is difficult to anticipate this at the outset of the contract, leaving the government with uncompensated costs. In effect, governments face uncertainty beyond risk – uncertainty that is difficult to price in PPP contracts or to record as liabilities or even contingent liabilities in the balance sheet. For instance, Portugal's initial contract for suburban rail service – the Fertagus contract – transferred risk to a private provider but stipulated that the government should assume risk if traffic was lower. When this materialised, the contract was renegotiated with the government in a weaker bargaining position.

When a project is too big or important for a government to let it fail, a fundamental discipline of the market which causes private firms to be more efficient – the prospect of market failure – may no longer be influential. If a government is perceived to stand behind the venture, then the project is really public rather than private, and a moral hazard could arise if the private firm realises that it faces no liability from demand failures. It has been said that public-private partnerships have the effect of privatising profits while socialising losses.

This is not to say that private partners do not also face risks as well; indeed, it appears that many PPPs successfully transfer risks for construction and availability. However, private firms can anticipate these risks and adjust their price during contract negotiations. Moreover, the private firm's risks, while greater than traditional procurement, need to be compared with other forms of investment. Some analysts suggest that the alliance with government provides

rent-seeking opportunities, as the guaranteed payment stream strengthens the market position of private partners in dealing with banks and other investors.

In effect, the boundaries between public and private become blurred. As the government becomes more reliant on the private partner to deliver essential public services, the relationship becomes more of a collaborative one of mutual dependence than a competitive or arm's-length relationship such as in traditional procurement. The private firms become dependent on a steady payment stream and business opportunity while the government becomes dependent on the firm as a monopolistic service provider. While both parties can gain, each also loses some of the value that makes them unique and valuable partners. The government loses control over the production of public services, surrendering a portion of control to the private firm that has different interests than government agencies. Private firms lose their competitive edge, as they no longer have to face the discipline of the market. At some point, the private firm becomes functionally similar to a government agency, particularly if it is "too big to fail".

While there is no single bottom-line answer to the efficiency question, there is reason to believe that PPPs outperform traditional government-financed capital in the construction phase, but that this advantage may not be sustained in the operational phase (Renda and Schrefler, 2006). Once the contract has been issued, the government loses leverage. Once the contract is under way, competitors fade away, leaving the government to work with a single contractor.

5.2. The fiscal imperative

The different budget treatment of PPPs compared with traditional public financing also explains their growth as a public infrastructure tool. As will be discussed further below, the private financing of upfront capital investment often means that PPPs do not encumber near-term budgets in the same way that traditional publicly funded capital projects do. As a result, PPPs can enable governments to fund more infrastructure projects earlier than under traditional public capital investment processes within existing deficit or fiscal constraints. One consulting company report summarised the opportunistic case well:

> Because individual projects become more affordable, the public sector can afford to procure a greater number of projects in aggregate, financed over a realistic long-term period (PricewaterhouseCoopers, 2005, p. 18).

PPPs carry important political benefits for public officials under pressure to reduce spending to meet fiscal targets. Fiscal pressures were a prime consideration for using PPPs in some of the eight countries studied. Budget officials in Hungary, for instance, said that bringing the deficit under the 3% target has been critical since its entry into the EU in 2003. When compared to traditional government capital investment, PPPs are a strategy to undertake capital projects with minimal impact on the deficit.

The argument above that PPPs do not have immediate budgetary consequences is a political and perceptual point, but not a substantive one. By assigning financing to the private sector, initial costs do not appear in budgets at the outset of projects. As a result, projects can appear to be far cheaper than they really are. In fact, PPP projects shift the costs from the capital portion of budgets to the annual operating budgets for years to come. This shift appears to free up near-term fiscal space, but at the expense of long-term fiscal space. In a triumph of form over substance, PPPs succeed politically through budgetary

alchemy: costs do not disappear; rather they become less immediately obvious through stretching and amortisation.

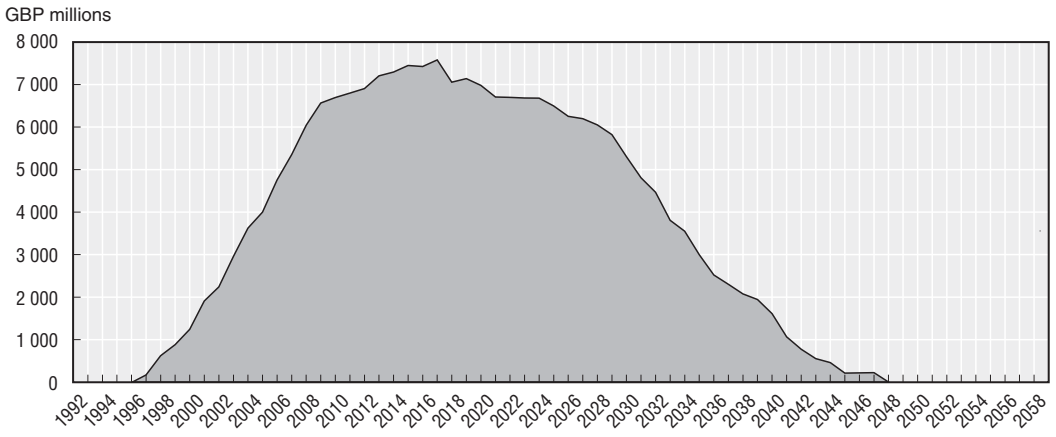
Once choices are made to appear less costly than they really are, the prospects increase for the distortion of priorities and for higher long-term spending within national budgets. Fiscal and allocation risks and distortions occur when there is a mismatch between benefits and costs for projects. In the case of PPPs, benefits can be claimed in the near term while costs can be spread beyond the immediate political horizon. This creates greater potential for several budgetary consequences:

- Higher levels of capital can be funded than can be afforded given current and long-term budget constraints.
- Costs can be shifted to future budgets, placing greater burdens on future generations of taxpayers and public officials.
- Lower-value projects can be selected due to the lack of upfront budgetary recognition of full costs.

The decision to launch a PPP today serves to encumber future budgets for years to come with required annual payments. As a result, a government's ability to adapt to emerging priorities or to fund competing needs is correspondingly constrained. In effect, these mandatory payments further reduce the ability of governments to use spending cuts or shifts as instruments of countercyclical economic policy.

The long-term shift of costs is clearly shown in the United Kingdom. Thanks to the transparent budgetary information from the United Kingdom, it is possible to illustrate the long-term impacts of current PPP commitments (called private finance initiatives – PFIs – in the United Kingdom). Figure 1 shows the annual payments due for all PFI projects launched in recent years. For each PFI project, a series of annual payments, known as the unitary charge, encumbers future budgets for over 20 years into the future. Figure 1 shows that payments begin to subside in about 15 years, but this assumes that no further PFI projects will be initiated when, in fact, the government is continuing to use this tool. United Kingdom Treasury officials indicate that annual PFI charges for larger local governments have grown to encumber 25% of future operating budgets.

Figure 1. **Long-term payment projections for PFI projects in the United Kingdom (GBP millions)**



Source: HM Treasury (2008), "PFI Signed Projects List", *www.hm-treasury.gov.uk/ppp_pfi_stats.htm*.

Notably, the growth of these annual PFI payments corresponds with the growing fiscal pressures faced by the United Kingdom, along with other advanced countries, as a result of the retirement of the "baby boom" generation. Not only will spending on pensions and health care be higher, but economic growth will be slower due to slower growth of the workforce. Notwithstanding these other fiscal trends, these annual PFI unitary charges constitute mandatory payments that must be allocated each year pursuant to the long-term contracts supporting each PFI. While the government can attempt to renegotiate the contracts as technology or fiscal constraints change, the private partner would have to agree.

Importantly, budgetary distortions can occur even when the investment is well chosen and represents value for money. There are limits in any budget to funding even effective projects and programmes. At some point, capital spending crowds out other types of spending, and long-term budget constraints can be undermined as well.

Most OECD countries have focused considerable analytic attention on comparing PPPs with traditional government-owned capital prior to authorising new PPP projects. This focus on what can be called "relative affordability" is commendable and represents real progress. However, countries also need to focus on "absolute affordability", *i.e.* the point at which even projects surviving value-for-money trade-offs exceed some budget constraint. Affordability criteria are not as well institutionalised as value-for-money comparisons. One study of the PPP for financing the London Underground found that affordability was not formally considered, leaving the project with a more than GBP 500 million gap (Shaoul, 2002).

PPPs may also carry allocation risks. By sidestepping the upfront allocation of budgetary resources, PPPs may enable lower-value projects to gain funding. When the full costs of irrevocable decisions committing public resources do not have to be budgeted out of scarce resources at the front end of projects, chances increase for the funding of lower-priority projects that would not survive in a more constrained and disciplined process. In Portugal, while traditional government capital projects must compete against a resource constraint, this is not the case for PPPs, opening the door for funding lower-value projects. Officials in the United Kingdom also report that low-value projects can be supported when PPPs are off the balance sheet and therefore not formally considered in the capital budget on an upfront basis.

Hungary's experience illustrates how budgeting for PPPs can lead to low funding of capital projects that have lower value. In 2003, the Ministry of Education obtained a government licence allowing schools throughout the country to obtain funds to build university housing. Under the PPP framework, universities were automatically eligible to claim approval and funding. A pilot project at the University of Debrecen was followed by 11 similar PPP schemes in other universities. As a result, substantially more housing was built than needed; some of it is now being used for unrelated purposes.

6. Budgeting processes and practices for PPPs

The foregoing suggests that PPPs are not only challenging managerially but also give rise to problems of budget control and accountability. Budget formulation and accounting processes play critical roles in determining the impact that PPPs will in fact have on fiscal policy, resource allocation and public management. This section examines the specific nature of budgetary processes applicable to PPPs, drawing from the eight case studies reviewed in this study. The following specific questions will be addressed: *i)* whether PPPs are on or off budget; *ii)* when they are included in the budget, how PPP costs are recorded

there; *iii)* whether and how PPPs are included in longer-term expenditure frameworks; *iv)* whether specific limits apply to PPP outlays or commitments; *v)* the degree of legislative oversight and review of PPPs; and *vi)* whether and how guarantees and other subsidies provided for PPPs are recorded in budget totals and documents. Wherever possible, a comparison will be made between the processes used for PPPs and those applicable to traditional government-owned capital assets.

The implications of PPPs for the budget are pervasive, if not obvious. The specific public sector costs that have a bearing on current and future budgets include:

- Annual payments for the life of PPP projects.
- Capital contributions to establish PPPs.
- Revenue losses from forgoing user fees.
- Contingent liabilities such as guarantees.
- Tax expenditures such as accelerated depreciation taken for private investment.

The first question is whether the PPP costs are recognised in the budget at all. Unified budget principles call for all significant government financial commitments to be included in a comprehensive budget. Such documents are not only useful for fiscal policy, but ensure that transactions involving government resources all benefit from common guidance and controls. If the PPP is off budget, then none of the budgetary controls that can promote fiscal discipline and accountability for PPP decisions are applicable. Moreover, government officials will be tempted to disproportionately rely on those techniques even if they are more costly. The treatment of PPPs in financial accounting statements often plays a major role in determining whether the transactions will be recorded in the budget. If PPPs are defined as private rather than public assets, they are not accounted for on the government's balance sheet or counted as part of the public debt.

Accounting standards vary across countries, and there are no internationally recognised standards for accounting and reporting in place for PPPs. Countries in the European Union are guided by a decision of Eurostat which governs the statistical data on government expenditures that member states must report for purposes of compliance with EU fiscal rules. This guidance recommends that PPP projects be classified as nongovernmental if the private partner bears the construction risk and either the availability or the demand risk – a characteristic that most projects can easily meet. This 2004 ruling has given rise to concerns that PPPs would be disproportionately classified as nongovernmental, enabling governments to more easily comply with the EU deficit and debt limits. However, countries can and do go beyond this guidance in adopting their own accounting definitions and guidelines to govern the treatment of PPPs for internal budgetary and policy-making deliberations (see Box 2 for an example).

Budgets need not reflect or mirror accounting standards and definitions. After all, many budgets are cash based even though their financial accounting statements are prepared pursuant to accrual-based standards. However, for PPPs, accounting standards play a formative role in determining budgetary treatment. In the United Kingdom, PPPs that are off the balance sheet are not included in the capital budget and are thus not part of the budgetary totals recording capital investment. However, annual unitary payments to PPPs are on budget, regardless of the project's status as on or off the balance sheet. If the London Underground is excluded, most United Kingdom projects are off the balance sheet; only 13% of PPPs, representing 46% of the total value, are recorded on the balance sheet

Box 2. **Eurostat's decision on the accounting treatment of PPPs and the emergence of a dual PPP investment record system in France**

A decision of Eurostat in 2004 mandates that assets involved in a PPP should be classified as non-governmental assets – and recorded off the government balance sheet – if the private partner bears the construction risk AND the private partner bears at least one of either the availability or the demand risks. In all other cases, assets are classified as government assets.

France records all investments in contracts before project implementation starts. Yet not all risks are estimated at the time of contract preparation, which makes it impossible to determine whether a project will be off or on the government balance sheet. As a result, the French government prepares two budgetary documents:

- External documentation presented to Eurostat. These documents do not include PPPs that do not meet Eurostat's risk transfer requirements.
- Internal documentation that includes all PPPs in a balance sheet, whether both risks are transferred to a private party or not. The balance sheet determination for internal purposes is based on which party has control of the project. Given the difficulties and uncertainties of allocating risk, the government decided that the presumption should be given to recording PPPs on the balance sheet.

As a result, the visibility of PPP investments in France is higher in internal budgetary documents than in those presented to Eurostat.

(Marty, 2008b). Experience varies by department: 100% of health care PPPs are off the balance sheet, as are 36 of the 47 defence projects. In Hungary, most PPPs are also recorded as off budget, leaving only the annual payments in the budget.

The budgetary inclusion of concessions varies among countries. In France, concessions are not defined as PPPs and are considered private assets since all risks are formally transferred to the private partner. Portugal includes its concession PPPs as part of the balance sheet, in view of the government subsidies for these projects. However, the commercial-status government agencies are exempted from budgetary controls and information presented on PPPs in the budget. These include projects sponsored by the highway department, which is no longer a government agency but a privatised governmental body funded by user payments.

Budgeting for all financial commitments up front is often viewed as essential to ensure that decision makers can fully consider all known costs at the time that irrevocable commitments of government resources are made. Most of the countries in this study, however, do not require agencies to budget for the full costs of PPPs up front at the time that the commitment of the government is made. Hungary, Korea and Portugal, for instance, only budget for PPPs once the annual charge is payable. This gives rise to a perception that PPPs are zero-cost projects. The annual charges are only recognised and paid over time rather than up front. Moreover, the annual charges are reflected in budgets only several years after the project is authorised and construction has been completed. Thus, the budget reflects the costs of PPPs on a much-delayed basis, far after the fundamental decision has been made.

The budgetary recognition of private engagements differs from traditional government capital projects. Since most countries budget on a cash basis, agency budgets must reflect the estimated cash needed up front to finance design and construction costs, concentrated in the first or second year of funded projects. Accordingly, there is greater upfront recognition for

traditional government capital than for PPPs. However, unlike PPPs, there is no comprehensive accounting for the lifecycle costs including design, construction, operation and maintenance over the lifecycle of the asset. Rather, budgets for operation and maintenance are developed on an annual basis during the entire life of the project.

Another important long-term difference between PPPs and traditional capital involves the nature of the annual payments supporting capital projects. For traditional capital projects, the existence of the asset implies some government obligation to budget for operation and maintenance, but the actual levels of support are decided on a discretionary basis each year. However, for PPPs, the annual payment comprises a mandatory cost in the budget for every year of the project's life, reflecting a combined charge amortising capital financing and operating and maintenance costs. As noted above, the long-term contracts dictate the length of time that annual budgets will be encumbered with this annual payment mandate. In Hungary, for instance, PPPs for motorways are contracted for 20-35 years and airports for 75 years.

Two countries in this study – France and the United Kingdom – do recognise the upfront costs of PPPs in capital and investment budgeting at the time that decisions are made. In the United Kingdom, for projects on the balance sheet, agencies must budget the full costs of the capital portion up front as part of separate capital budget accounts. Similar to traditional capital, this PPP cost must be traded off with other capital budget proposals and budgeted under the agency's fixed budgetary allotment for capital under the separate departmental expenditure limits for capital spending. The PPP proposals are examined at the time of the three-year spending review done for each agency as part of the budget process.

France budgets for PPPs in two ways – for the gross investment costs covering the duration of the contract, and for gross upkeep payments. Thus there is some recognition of the costs of commitment up front when projects are launched. However, this presented a problem because French law prohibited deferred payments from commitments, necessitating a change in statute to accommodate the delayed annual payments for PPPs.

The budgetary treatment for PPPs in some countries is still evolving. In the United States, budgetary recognition of private engagements varies and is done on a piecemeal basis, according to the Congressional Budget Office (2003). There is disagreement between the two budget agencies – the OMB and the CBO – over the proper scoring of public-private partnerships for military housing. OMB guidelines enabled the Defense Department to use housing provided by private partners without recording large budgetary obligations up front. The CBO urged the OMB to score the partnerships as government-owned investments since the government will eventually be responsible for the housing.

The form of budgetary recognition makes a difference for the quality of deliberation on proposed projects. Officials from several countries said that there is more scrutiny of appropriations for traditional government-owned capital for two reasons. First, capital costs are budgeted up front and, second, they must compete with other projects for a limited pool of funding. Since PPPs are not funded up front and are not recorded for several years, the budget itself does not prompt a similar level of debate. However, recognising the longer-term financial issues, a number of countries have initiated scrutiny outside the formal budget process through analytical reviews of value for money for PPP projects. In fact, in some countries such as Portugal and the United Kingdom, officials indicate that PPPs get greater scrutiny through these analytical processes than traditional government-

owned capital. Portugal has decided to extend the same review process and criteria for PPPs to all government-owned capital.

In addition to budgetary payments, some countries provide more indirect forms of subsidies for PPPs and concessions. Guarantees and other forms of payment are often triggered when projects fall below certain financial thresholds, constituting a contingent liability. In most countries, budget and accounting rules do not require appropriations for these contingent claims. France and Korea, for instance, have guarantees, but they are not recorded or recognised until they are triggered. Australia does not reflect contingent liabilities in budget totals but rather in a statement of risk accompanying the budget. The United States, which has very few PPPs, is among the few countries that do budget the costs of guarantees up front in the budget. The credit subsidy records the net present value of costs to the government over the life of the guarantee based on interest subsidies and projected defaults. Chile has an intemporal budget constraint that limits the guarantees and subsidies for concessions, as discussed in Box 3.

Some countries have imposed budgetary limits on annual PPP spending, partly to compensate for the lack of upfront budget recognition and controls. Hungary has a limit of 3% for PPPs as a share of government revenues, while Korea has a limit of 2% of spending. While not having specific PPP ceilings, countries like the United Kingdom that budget for the upfront costs of PPPs have inherent limits since the PPP projects must be allocated from a limited pool of funds provided to agencies for capital projects.

Effective scrutiny and review of PPP proposals calls for a perspective that goes beyond the annual budget to encompass the lifecycle of proposed projects. However, most countries traditionally devote weaker scrutiny to non-cash items and long-term obligations compared to immediate outlays (Budina *et al.*, 2007, p. 14). Having said this, countries are moving in the right direction by providing more information and perspectives on longer-term PPP trajectories as well as longer-term budgetary outlooks.

Box 3. **Concession risk guarantees in Chile**

Chile has developed sophisticated analytical methodologies for the valuation of guarantees provided in the context of concessions. The government guarantees under the PPP contracts are centred in protecting the concessionaire from risks related to demand and exchange rates. Starting in 2002, the demand guarantees are provided at a cost.

The major guarantee offered to cover demand risk is called the IMG. The government compensates the concessionaire if the revenues from the tolls are less than the projected minimum. In exchange for the guarantee, the concessionaire shares 50% of the revenues that exceed the projected revenues. Starting in 2003, a premium is charged for the provision of the guarantee. The guarantees which are triggered are paid in the budget year following the year in which they were triggered. The deferred payment, together with only a partial compensation of the difference with respect to the total projected revenues, limits the moral hazard and problems of adverse selection, as well as the government's exposure to risk and the fiscal cost of triggered guarantees.

The aggregate net present value of the guarantees for PPPs for 2006-30 is 0.15% of GDP. Chile established an "intertemporal budget restriction" (RPI) to limit the total amount of subsidies and guarantees, measured on a net present value basis. While this ceiling is not formally in the budget and does not flow to the bottom line, it is presented in a supplemental analysis of contingent liabilities and is enforced by the budget office.

Most countries include annualised PPP costs in their medium-term frameworks which typically extend from three to five years. In countries like Hungary and Korea, this provides some longer-term assessment of cash payments for PPPs, but falls far short of capturing the full costs. Some countries go further and undertake longer-term analyses of full PPP costs over the life of the project, which appear as supplements to the regular budget. The United Kingdom, for instance, provides data on the year-by-year costs of annual payments for all PPPs in a chapter in the budget. These long-term schedules are included as part of the initial assessment of value for money for each project. Since 2003, Portugal has prepared a memo to the budget director providing the long-term costs for all PPPs, a memo that is appended to the budget document.

The growing movement in OECD countries to examine the longer-term projections for current budgetary policy is also helpful. The United Kingdom, the United States and other countries have developed models to simulate budget outcomes over as much as 50 to 75 years (Ulla, 2006). While these long-term projections do not incorporate or highlight the long-term trajectories of PPPs, they do provide an overall perspective of the fiscal space that will be available over the many years that PPP payments appear in budgets. For most OECD countries, the long-term outlook is worrisome and shows that budgets will increasingly be devoted to paying for the elderly and their doctors, with less fiscal space available for financing capital – either investing in the future or paying debts from the past.

The degree of legislative and public oversight over PPPs appears to be less extensive than for traditional government-owned capital. In most countries, the annual appropriations process will not disclose the presence of new PPPs since there is no upfront budget authority required to start these projects. For traditional capital, the legislature must appropriate the upfront funding necessary to begin design and construction. Among the eight countries, Hungary requires that any major capital project above a certain threshold, whether it be traditional capital or PPPs, gain legislative approval. However, many countries with extensive PPP activity do not obtain legislative approval prior to approving projects. Korea, the United Kingdom and Chile have all decided not to require legislative review and approval. Some officials indicated a concern that legislative review might bring "pork barrelling" into the decisions.

While the budget process is critical, other components of policy making and management also play a vital role in ensuring that PPP projects deliver public value within budget constraints (Akitoby *et al.*, 2007):

- Investment planning: Determination of which projects are suitable for PPPs and whether such projects satisfy both value-for-money and affordability criteria through the use of public sector comparators. For instance, the IMF suggests that PPPs are better suited to economic infrastructure than social infrastructure due to the greater return of sound economic projects for business and the higher potential to charge users for services.
- Legal and institutional framework: Such issues as clear definitions for PPPs, competition and contract management, specific metrics linking contracts with outputs and outcomes, oversight and review units to provide consistency and expert assistance to agencies, and clear delineation of the roles and responsibilities of central budget and line agencies for project review, approval and monitoring. "Gateway processes" are being instituted by countries to provide a strong role for the ministry of finance in project selection and approval (see Box 4).

Box 4. **The gateway process**

Countries such as Portugal have relied in recent years on a gateway system that includes review and appraisal processes addressing efficiency and fiscal risks of PPPs. Specific roles are provided for the line agencies and for the finance ministry, which must sign off on projects at each step of the process. The following is a description of this process based on the experience of Portugal:

Phase 1: Planning, design and preparation of tender

- Project team prepares value-for-money analysis and tender document.
- PPP unit reviews the analysis.
- Budget department evaluates affordability of project.
- Finance minister approves or rejects project.

Phase 2: Bidding and negotiation

- Tender board assesses bids and selects preferred bidder.
- PPP unit assesses draft contract.
- Finance minister approves or rejects the contract.

Phase 3: Construction and operation

- PPP unit monitors implementation by project manager.
- Budget department monitors budgetary flows on regular basis.
- All actors involved in renegotiation of contract if necessary.
- Finance minister must approve any contract renegotiation.

Many countries with weak budgetary controls nonetheless sustain separate analytic reviews focused on PPP projects. Some of these elements can compensate for weak budgetary controls. For instance, most of the eight countries in this study have a dedicated PPP unit in the central budget office, in a line agency, or in both, to review PPP assessments, provide technical assistance and guidance, and oversee implementation of PPP projects. Units in Portugal are constituted as an independent board, while France has established a special task force to review PPPs. The United Kingdom Treasury has a 12-person PPP unit. These units can help ensure that PPPs are selected and designed to be consistent with the government's overall budget constraints. For instance, the units oversee the crucial value-for-money assessments, where PPPs are compared with public sector comparators prior to project approval.

As a result, these review processes do provide transparency about PPP proposals, at least inside the government. Some officials suggested that there is actually a greater degree of review of PPPs than for traditional government capital projects. Portugal extended its analytic reviews of PPPs adopted in 2003 to all proposed capital projects, partly out of concern that special PPP analytic procedures might bias decisions against PPPs.

7. Conclusion

The use of private financing and delivery for public services has advantages. Private efficiencies can deliver real benefits that might overcome higher financing and transaction charges. The risk sharing and bundling of all phases of capital services may very well promote incentives to achieve improved outputs with lower costs.

However, these promises rest on heroic assumptions and ideal conditions that are too often missing in many cases. Deep markets are often not available to provide the level of competition necessary to motivate private innovation and efficiency. Clear demarcation and sharing of risks is often overturned in practice, as public officials face asymmetrical risks that are often impossible to measure and delineate for the long timeframes involved with PPP contracts. Fundamentally, public and private partners have differing interests and, while these differences can lead to a healthy marriage between the partners, they must also be acknowledged as a source of uncertainty and entropy that can complicate and perhaps erode the attainment of public goals and values.

Some policy domains and countries may be better candidates than others: economic infrastructure that can deliver greater productivity for private firms offers better prospects for aligning public and private interests in constructive partnerships. However, the more a service takes on the character of a pure public good, the less private incentives will be congruent with public interest, leading to greater public disappointment with the results. The long-term financial impacts of PPPs may be better absorbed in countries with good long-term growth prospects, while countries with slowing economies and large long-term commitments are advised to be far more cautious.

Public-private partnerships, while promising performance breakthroughs, create significant uncertainties and risks for governments. The lack of upfront budget scoring lowers the level of deliberation for these projects and invites decisions to be taken on the basis of opportunistic exploitation of budget rules rather than evaluations of longer-term risks and rewards. The risks and uncertainties intensify over the long term, as projects face new challenges and as budgets become more encumbered with financial commitments. Accordingly, countries should be wary of using private capital to finance infrastructure and capital assets.

Countries have sought to compensate for the weakness of budgetary controls with impressive analytic initiatives and information that go beyond anything done for conventional public capital projects – and with good reason, given the higher stakes, greater uncertainty and longer-term commitments that public-private partnerships entail.

However, stronger budgetary processes and controls are necessary to provide greater assurance that PPPs are being funded for the right reasons. Given limited fiscal resources both now and over the longer term, countries need to ensure that the projects selected represent the most cost-effective and affordable approach to financing infrastructure and that this particular strategy is compared with other competing needs across the entire budget using similar budgetary concepts and scoring.

The following elements constitute a strategy for strengthening budgetary review and deliberation for PPPs:

- The establishment of upfront funding in the budget for the total commitment entailed for PPP projects should be institutionalised in the budget formulation process. This would help ensure that decision makers face the full cost consequences of their decisions.
- The funding for PPPs should compete with other claims in agency budgets for inherently limited resources. The full funding of commitments up front from scarce resources provides the best assurance that decision makers will deliberate about the relative value of PPP projects compared with other programmes and priorities.

- There should be a presumption that all PPPs will be fully recorded in the budget, even if projects are deemed to be off the financial balance sheet based on relative risks.
- Countries should strengthen the process for analysing PPP proposals by providing for explicit criteria assessing affordability to accompany existing value-for-money reviews.
- Affordability can be operationalised by establishing limits on the total level of PPP commitments undertaken in a given year. Limits can be measured on the basis of total net present value of long-term costs and/or total annual payments for approved projects.
- Guarantees and other subsidies for PPPs, and for other purposes, should be estimated at the time that commitments are authorised. Consideration should be given to using accrual-based approaches to measure guarantees, such as the credit subsidy concept used in New Zealand and the United States. Limits on total guarantees should also be explored.
- Countries should consider establishing or strengthening longer-term budget frameworks for many reasons, including providing a more informed basis for considering the long-term affordability of PPP projects. Modelling long-term fiscal outlooks is the first step. Following this, countries should consider developing their near-term and medium-term fiscal targets with the longer-term outlook in mind.
- Countries should also work to provide greater disclosures on future payment obligations for PPPs in budget documents. The extensive information published in the budget documents of the United Kingdom and the new budget memos prepared by Portugal provide two excellent examples of transparency in support of PPP decision making.

Note

1. One estimate from the United States Congressional Research Service (2006) shows a growth of earmarked transportation projects in congressional appropriations from 140 in 1994 to 2 094 in 2005, or 5% of total transportation appropriations in that year.

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Accrual Budgeting and Fiscal Policy

by
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Can an accrual budgeting system – a system in which budgetary spending authorisations to line ministries are formulated in accrual terms – serve the needs of good fiscal policy? If so, how must such a system be designed? This article addresses these questions and also considers the case for reformulating fiscal policy in terms of accrual rather than cash aggregates.

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1. Introduction and objectives

This article considers accrual budgeting from the fiscal policy perspective. Accrual budgeting means that spending ministries are given budgets which are defined in terms of accrual concepts and, in particular, that the budget sets quantitative limits on the expenses which they incur rather than the cash payments they make. The case for accrual budgeting rests overwhelmingly on its microeconomic benefits in improving the efficiency and effectiveness of expenditure. However, any acceptable budgeting system must support the implementation of an appropriate aggregate fiscal policy. It is therefore of concern that there has been little analysis of the effects of moving to accrual budgeting on the implementation of fiscal policy (other than with respect to the "golden rule"). To fill this gap, this article considers whether an accrual budgeting system can meet the needs of fiscal policy, and whether there are particular design features which should be built into an accrual budgeting system to ensure that it does so.

These questions are closely related to the way in which key fiscal policy aggregates are defined.[1] Many assume that the focus of good fiscal policy must be primarily on cash fiscal aggregates. If this were true, it would raise a large question mark about any move to accrual budgeting because, if the budget places limits on the expenses incurred by each ministry but not on cash expended, it is not immediately clear how the government could successfully target, say, the cash budget deficit. This points to the second set of issues addressed by this article: Is it in fact true that good fiscal policy requires that key fiscal policy aggregates are defined in cash accounting terms? Might it not be possible to base fiscal policy on aggregates derived from accrual accounting, ensuring a more natural fit between accrual budgeting and fiscal policy? Finally, if one does decide to retain a focus on cash fiscal policy aggregates, is one obliged to stick with a cash budgeting system?

The analysis assumes throughout that the two pre-eminent fiscal policy functions which any budgeting system must be capable of serving are the assurance of fiscal sustainability and fiscal stabilisation policy. The latter means, of course, the promotion of macroeconomic stability through the management of the aggregate demand impact of government fiscal operations. Fiscal sustainability, on the other hand, refers to the degree to which current tax and expenditure policies are consistent with the intertemporal budget constraint – in formal terms, whether the present value of projected primary surpluses is sufficient to cover net debt (Blanchard *et al.*, 1990). Because at high levels of net debt it becomes difficult for governments to maintain sustainable tax and expenditure policies, it is commonplace to talk about the "sustainability" of debt. Either way, the practical essence of maintaining fiscal sustainability is keeping debt at moderate levels and avoiding fiscal policies which will result in ballooning deficits.

Fiscal sustainability and macroeconomic stabilisation are, of course, not the only objectives for which governments employ fiscal policy. Other objectives include tax smoothing and intergenerational equity. A good case can be made that accrual budgeting is particularly useful if one is pursuing intergenerational equity via the so-called "golden

rule" (see below). However, even if this is the case, fiscal sustainability and macroeconomic stabilisation would generally be seen as higher-order fiscal policy objectives which it is absolutely essential that the budgeting system support.

For ease of exposition, this article makes virtually exclusive use of the GFS2001 conceptual framework of accrual accounting[2] – which European readers should note is essentially the same as ESA95.[3] The analysis also assumes (as is the case in most, but not all, countries) that fiscal policy is focused on general government fiscal aggregates – which exclude the public corporations sector – and not on public sector aggregates.

2. What is accrual budgeting?

"Accrual budgeting" is not a term with a generally agreed meaning in the literature, which makes a clear definition an essential starting point for any discussion of the subject. In this article, accrual budgeting is defined as the specification of budgetary expenditure authorisations and revenue estimates in terms of accrual accounting measures – that is, measures which are specific to the accrual system of accounting. This means, in particular, the use of accrual concepts to specify budgetary **control totals**. Control totals are the quantitative spending limits imposed on spending ministries, whether as appropriations in the annual budget law or by administrative directive (*e.g.* from the minister/ministry of finance).[4]

The definition distinguishes accrual budgeting from accrual accounting, where the latter refers to the *ex post* recording and reporting of financial operations of government in accrual terms. It is therefore a definition which is consistent with the widely accepted notion that governments may budget in cash terms while accounting and reporting in accrual terms (including cash flow terms). A growing number of governments have introduced accrual accounting in the general government sector, motivated by the belief that accrual information can significantly improve budget decision making and financial management more generally. However, the use of accrual accounting information – such as actual or projected balance sheets or operating statements – merely to inform the preparation of a budget, without redefining the control totals in accrual terms, does not fit the definition of accrual budgeting used in this article.[5]

What does it mean to use accrual concepts to specify budgetary control totals? The most basic type of accrual control total is an **expenses**[6] **control total** – that is, a centrally imposed quantitative limit on the expenses each spending ministry is permitted to incur within the budget year.[7] An expenses control total means that current-year expenses are counted as the use of the budgetary funding, irrespective of the timing of any associated cash payment. For example, the following would be counted against the expenses control total:

- Bills payable: amounts which are owed for goods and services delivered and used during the financial year, even though payment may not be made until the next financial year.
- The additional entitlements for future pension payments which civil servants accumulate during the financial year.[8]
- Stocks (of supplies, etc.) actually used in the production process during the year, irrespective of when those stocks were purchased.
- Vacation or long-service leave entitlements earned by a civil servant during the financial year, even when he or she does not actually take that leave until a subsequent year.
- Depreciation of the ministry's fixed assets.

In some accrual budgeting systems, a so-called capital charge is also charged against expenses control totals (Robinson, 1998a).[9] However, capital charging is a fading fashion, having been abolished in Australia in 2002 and being likely to be abolished in the near future in the United Kingdom (HM Treasury, 2008).

Expenses control totals should not be confused with commitments control totals. At the time an order for the delivery of supplies or services is placed or a contract signed with a supplier, it would be counted against a commitments control total, whereas under an accrual budgeting system it will in principle only be counted when the supply has been received and used in the production process. Multi-year contractual capital expenditure obligations are also counted against commitments control totals at the time the contract is signed (and have historically been particularly used for this purpose in countries such as France and the United States), long before the assets concerned give rise to any depreciation expense which would be counted against an expenses control total. Prepayments for goods and services to be delivered in future financial years will also be counted against commitments control totals, but not against expenses control totals.

As important as expenses control totals are, it should not be thought that this is the only possible type of accrual control total. As will be discussed in detail below, it is possible to have an accrual capital expenditure control total, for the purposes of which an accrual rather than cash concept of capital expenditure is used. ("Accrual capital expenditure" should not be confused with depreciation.) It is for this reason that the definition offered above refers in general terms to the use of accrual concepts to define control totals, and not merely to the use of expenses control totals.

The conception of accrual budgeting employed here parallels the widely understood conceptions of cash budgeting as a system of budgeting in which control totals are defined wholly or primarily as limits on payments, and of cash/commitments budgeting (as, for example, in the Argentine, French and United States systems) as a system in which control totals are set for both payments and commitments. As the latter example makes clear, budgeting systems may be of a hybrid nature, using (say) mixtures of cash and commitment concepts, or accrual and cash concepts, in the definition of control totals.

Using the definition employed in this article, the countries which currently have accrual budgeting systems include Australia, Denmark, New Zealand and the United Kingdom. Other countries are considering its adoption. Accrual budgeting should not be confused with the accrual output budgeting (AOB) systems introduced by Australia and New Zealand in the 1990s.[10]

The main benefits which proponents of accrual budgeting claim for the system are microeconomic, and pertain to the allocative and technical efficiency of public expenditure. Specifically, it is claimed that accrual budgeting:

- improves the effectiveness and efficiency of expenditure. More concretely, by ensuring that these budgetary decisions are made in the light of the true costs of inputs and outputs, accrual budgeting promotes better choices about expenditure priorities (allocative efficiency), about the inputs to be used in producing public services (technical efficiency), and about outsourcing *versus* internal production (technical efficiency).
- improves decision making with respect to assets – including the acquisition, disposal and maintenance of fixed assets, and the management of stocks. Of particular relevance to this article are the incentives for spending ministries to sell unneeded nonfinancial assets, arising from the inclusion of depreciation in the expenses budget.[11] The sale of

such assets reduces the ministry's depreciation charge and thereby permits increased spending on other types of expenses.

It is not the purpose of this article to assess these claims. It is nevertheless relevant that most of the putative benefits of accrual budgeting can only potentially be realised in the context of broader reforms which grant much larger operational freedom to spending ministries as part of a more performance-oriented budgeting and public management system. Without, for example, increased spending ministry freedom to decide the input mix to be used to deliver public services, or to decide whether to produce the service internally or to outsource production, there is little point in worrying about using the budgeting system to fine-tune input price signals to ministries.

3. Fiscal sustainability and capital expenditure controls

To assure fiscal sustainability, it is essential to contain the level of public debt to appropriate levels. To do this, it is necessary to avoid excessive budget deficits (appropriately defined); this in turn requires appropriate budgetary control over aggregate expenditure (again, appropriately defined). The validity of these basic propositions is not affected by the system of accounting used for budgeting.

This problem has crucial implications for the design of an accrual budgeting system. A budgetary regime based on expenses control totals alone is insufficient to contain the level of debt, and cannot therefore support the implementation of a sustainable fiscal policy. The reason is because, if control totals are set only for expenses, capital expenditure will be unconstrained. (The fact that expenses include depreciation arising from past capital expenditure does not limit capital expenditure in the present.) Yet capital expenditure, *ceteris paribus*, adds significantly to net debt, as well as impacting substantially on aggregate demand. It follows that any accrual budgeting system must in some way limit the quantum of capital expenditure. The most simple and transparent way of doing so is the traditional way: to impose budgetary control totals in respect of spending ministry capital expenditure. This is what is done under the accrual budgeting systems which operate in both New Zealand and the United Kingdom.

One reason why this point may not be as obvious as it should be is that two countries (Australia and Denmark) chose to introduce versions of accrual budgeting in which, unlike in New Zealand and the United Kingdom, there are no explicit control totals over annual capital expenditure. In Australia's case, the legal appropriations basis for capital spending provides what is in essence a pool of funding which parliament has authorised spending ministries to draw upon at any time for capital purposes. In Denmark's case, capital expenditure is financed by loans through an internal state loan scheme, and the budget law sets ceilings for such loans to each ministry rather than annual capital expenditure budgets. In both cases, were ministries to draw particularly heavily on this pool of funding in any given year or sequence of years, the result would be a large surge in capital expenditure which would have undesirable fiscal policy consequences. Capital expenditure appropriation arrangements in these two countries are detailed in Box 1.

The reason why this is not a problem in either Australia or Denmark is that the level of annual capital expenditure is constrained by executive government decision. In both countries, cabinet approval is required for major capital projects to proceed. In Denmark, for example, projects worth more than approximately USD 10 million must be approved centrally.[12] In Australia, moreover, spending ministries submit their capital expenditure

Box 1. **Capital expenditure appropriation in Australia and Denmark**

In the Australian system, the main source of funding for ministry capital expenditure is the depreciation component of the expenses appropriation, supplemented when necessary by funding via a separate "equity injection" appropriation.[1] Unlike other accrual budgeting systems, depreciation is not only counted against the expenses appropriation. It is also considered as funding which the ministry concerned can use at any stage it wishes in the future to fund capital expenditure. To the extent that a ministry's capital expenditure in any year is less than its depreciation, it accumulates "surplus" depreciation funding which it can use in future years. At any given time, therefore, each ministry will have a stock of accumulated depreciation funding which it can draw on at its own discretion – without requiring central authorisation – for capital expenditure.[2] The equity injection appropriation, on the other hand, is used to provide ministries with additional capital funding when depreciation funding is insufficient to finance significant capital expenditure which the government wishes to commit. Under this system, ministries can accumulate quite large pools of capital funds (mainly depreciation funding).

In the Danish system, all capital expenditure by government ministries is financed by internal loans from the Ministry of Finance, which must be repaid and upon which interest is charged. Parliament sets loan limits for each spending ministry as part of the annual budget legislation. Something like this type of capital loan arrangement may be found in some other Scandinavian countries which operate cash budgeting systems. However, the Danish accrual budgeting system has given this arrangement a distinctively accrual twist, the most important element of which is that ministries now repay the principal on their capital loans when they are charged depreciation against their expenses appropriations (Finansministeriet, 2006).

1. Ministries are also permitted to supplement their capital funding by asset sales proceeds. We abstract from this and other second-order details here.
2. The original rationale behind this system was a capital maintenance doctrine, discussion of which is beyond the scope of this article. See Robinson (2002).

plans to the finance ministry for approval as part of the budget process.[13] So what has in essence happened in each of these two countries is that regulation of annual capital expenditure by the executive arm of government serves the function performed in other countries by annual parliamentary capital expenditure appropriation limits.

The Australian and Danish systems may have certain advantages, but critics suggest that they each suffer from disadvantages with respect to transparency and democratic control by parliament.[14] The decision of Australia and Denmark to adopt the second approach and to dispense with explicit capital expenditure limits is one way – and not the only possible way – to design an accrual budgeting system. The alternative approach is, as in New Zealand and the United Kingdom, to continue to impose an explicit capital expenditure control total – an explicit quantitative limit on total capital expenditure imposed by the parliament or executive government. What can certainly be said is that an accrual budgeting system must either include an explicit capital expenditure control total or it must employ indirect means of limiting annual capital expenditure so as to achieve the same result.

It might seem that the imposition of a control total on capital expenditure simply reintroduces a key feature of traditional cash budgeting systems. However, this is not necessarily the case. It is possible, as indicated at the outset of this article, to use for this

purpose an accrual concept of capital expenditure, the precise meaning of which is set out below. If a capital expenditure control total defined in accrual terms is combined with an expenses control total, one has a fully accrual budgeting system in the sense that all control totals are defined in accrual terms. Alternatively, one might stick to the cash concept, in which case one would have a hybrid budgeting system with an accrual expenses control total and a cash capital expenditure control total.

4. The accounting basis of key fiscal policy aggregates

The choice of whether to define capital expenditure control totals in terms of a cash or accruals concept is related to a more fundamental choice which has major ramifications for the design of control totals in an accrual budgeting system: namely, the choice of the accounting basis of key fiscal policy aggregates. If the key fiscal policy aggregates are defined in cash accounting terms, it makes sense also to define the capital expenditure control total in cash accounting terms, just as under a cash budgeting system. The choice of an accrual concept of capital expenditure, by contrast, hints at a different approach to the definition of the key fiscal policy aggregates.

As noted at the outset, it is a widely held view that it is essential to define key fiscal policy aggregates in cash terms. With respect to fiscal sustainability, the assumption seems to be that debt is necessarily a cash accounting concept and, therefore, that the key to ensuring debt sustainability must be the management of the cash budget balance (or some variant thereof).[15] And with respect to stabilisation policy, the view seems to be that it is through cash expenditure that government adds to aggregate demand and through cash revenue that demand is subtracted, so that it is once again the cash fiscal aggregates which matter.

It is not the case, however, that fiscal sustainability requires the management of cash aggregates. Controlling the level of debt is certainly fundamental to fiscal sustainability. However, accrual accounting offers a debt measure – what we will call here **net financial debt** (see Box 2), defined as liabilities minus financial assets – which is arguably superior to conventional cash accounting debt for fiscal sustainability purposes. The reason why it is a superior measure is that it captures assets and liabilities which are manifestly relevant to sustainability but which are ignored by the conventional measure. Specifically, net financial debt counts, in addition to conventional debt obligations, quasi-debt liabilities such as civil service pension liabilities, financial lease obligations, *de facto* borrowing via public-private partnerships (PPPs)[16] and the stock of bills payable.[17] These liabilities can be substantial, and fiscal policy is manifestly improved by targeting a broader debt measure which includes them. This is not, of course, to suggest that any type of debt measure can ever provide all the information required to assess fiscal sustainability, the fuller assessment of which will always require projections of expenditure and revenue trends so as to capture challenges such as the fiscal impact of adverse demographic trends. Theoretical constructs suggested by Buiter[18] (1982) and other economists may in principle do this, but these are not intended to have practical ongoing accounting or statistical application.

The considerable difference between accrual and cash debt measures is illustrated by the impact of the recent bank bailouts in many countries. Governments have injected large amounts of money into ailing banks, with the result that their conventionally defined debt will, broadly speaking, have risen by the same large amount. However, they have acquired financial assets – in the form of the transfer of distressed assets, or debt/equity issued by

Box 2. **Net financial debt**

The stock measure that this article suggests is superior – for fiscal sustainability purposes – to the net debt measure provided by cash accounting is what GFS2001 terms **net financial worth** (NFW), defined as total financial assets minus total liabilities. However, for ease of exposition, and following Canadian terminology (Statistics Canada, 2006, p. 45), this article uses the term **net financial debt** (NFD), which is NFW with the sign reversed: *i.e.* liabilities minus financial assets. In addition to recognising on the liabilities side various non-debt liabilities such as those mentioned in the text above, NFD recognises financial assets not taken into account in the conventional net debt measure such as accounts receivable and – if, as in most countries the fiscal policy focus is on general government fiscal aggregates as opposed to public sector-wide fiscal aggregates – holdings of shares in private sector companies (which might be held by a government pension fund). NFD also includes the value of the government's equity in public enterprise, because this is recognised as a financial asset in the general government balance sheet. From a sustainability point of view, the recognition of a broader class of financial assets and liabilities is useful because of their relevance to fiscal sustainability.

It is useful to clarify the relationship of NFW/D to net worth:

Net worth = assets – liabilities = (financial assets + nonfinancial assets) – liabilities = net financial worth + nonfinancial assets.

Or expressed differently:

| Net financial debt | = | net worth – nonfinancial assets |.

the banks – in return for the funds injected. Net financial debt will recognise not only the increase in conventionally defined debt, but also the value of these financial assets. So the impact of the bailouts on net financial debt will be equal to the difference between the capital injected into the banks and the value of the bank financial assets acquired in the transaction. If the financial assets acquired were of the same value as the capital injected, the impact on net financial debt would be zero. Only to the extent that these assets are worth less than the capital injected will net financial debt increase.[19]

The flow counterpart of net financial debt is what in the GFS/ESA framework is the **net lending/borrowing** measure, henceforth abbreviated to "net lending". Reflecting the broader debt measure to which it is linked, net lending recognises as part of the deficit any financing transactions which impact on fiscal sustainability without affecting the level of conventionally defined net debt. For example, net lending:

- counts increases in the government's civil service pension liabilities as part of the deficit, whereas the cash budget balance does not;
- involves a more accurate treatment of interest expenditure, which avoids the measurement distortions that arise under cash accounting from the variety of arrangements for effecting interest payments (*e.g.* zero coupon, etc.);
- cannot be manipulated via the privatisation of public corporations, because such privatisation receipts are treated as financing transactions rather than revenues. Expressed differently, they represent simply the transformation of one type of financial asset into another type of financial asset.[20]

Net lending is often referred to as the accrual equivalent of the cash budget balance, by which is meant that just as the cash balance is the key instrument for managing the

level of conventional net debt, so net lending is the key instrument for managing net financial debt. Expressed differently, the difference between the two measures is that, on the outlays side, what reduces the cash balance are transactions which increase debt – *i.e.* payments – whereas what increases net lending are transactions which increase financial liabilities, irrespective of whether these financial liabilities result in payment this year or in subsequent years. This difference is mirrored on the revenue side in the manner in which revenue is conceptualised.

Net lending and the cash balance will generally track one another reasonably closely – and, indeed, it is easy to map out steady-state conditions where they will be essentially identical. However, the two measures can diverge substantially under some circumstances, examples of which are given in Box 3.

A small but growing number of countries are using these accrual fiscal aggregates as the key policy variables for fiscal sustainability purposes. The most important example of the use of net lending as the headline budget balance measure is the European Union, which uses it for the purposes of the Stability and Growth Pact deficit limit (3% of GDP). In the United Kingdom, so-called public sector net borrowing (PSNB), which is a key fiscal aggregate, is net lending by another name (Government Statistical Service, 1999). Less common is the use of net financial debt as the headline debt measure. Canada appears to

Box 3. **Major divergences between net lending and the cash balance: some examples**

The following are examples of fiscal operations which might lead to a major divergence between the two measures of the budget balance:

- **Cash payout of a substantial portion of the existing aggregate civil service pension liabilities.** Circumstances under which this might occur include: *i)* a significant downsizing of the civil service involving substantial payouts of pension and other leave entitlements to departing civil servants; and *ii)* the privatisation of civil service pension schemes (*i.e.* a move from government-run pension schemes for civil servants to a system where the government pays money into privately operated defined-contribution schemes). These payouts will have no impact on net lending if the cash payout equals the actuarial value of the liability paid out. They will, however, result in a major one-off "deterioration" in the cash balance.
- **A major shift in the timing of tax payments.** If, say, the basis of collection of a major tax is shifted from one of settlement-after-the-end-of-the-financial-year (in which revenue attributable to year t will be collected in year t + 1) to pay-as-you-go, net lending will be unaffected, but there will be a major one-off impact on the cash balance (it will increase by x in year t and then suffer an equivalent reduction of – x in year t + 1).
- **A major increase in the use of financial leases or PPPs to replace conventional government capital expenditure.** This action will "improve", in the short run, the cash balance, but will only change net lending if and to the extent that the cost of financing capital expenditure by unconventional means differs from the cost of conventional financing.
- **Netting off in the cash balance of privatisation receipts and other transfers from the public corporations sector.** In addition to privatisation transactions, operations such as exceptional dividends from public corporations will have major effects on the cash balance while leaving net lending unchanged.

be the only country at present that uses net financial debt to set debt reduction targets (Department of Finance Canada, 2006, p. 7; 2007, p. 18). (One possible reason why the use of the broader debt measure remains rare is political/symbolic: net financial debt is generally a larger number than conventional net debt, providing a political disincentive for governments – even those which have moved the most fiscal and budgetary measures onto an accrual basis – to use it as the headline debt measure.)

Net lending and net financial debt are not, of course, perfect measures, and – just as with cash budget balance measures – governments may find that various adjustments to these measures improve their policy relevance. Indeed, net lending suffers from what might be regarded as the defect that it nets off receipts from the sales of general government assets. It may be appropriate to adjust for this so as to treat such receipts as financing rather than revenue, in the way in which the GFS measure called "overall fiscal balance" does (see Box 4). For simplicity, references in this article to the use of net lending

Box 4. **Netting off general government asset sales receipts?**

While net lending has the considerable advantage, relative to the cash balance, that it treats proceeds from the privatisation of government enterprises and similar operations as financing transactions for the general government sector, it nevertheless has the disadvantage that it treats the proceeds from the sale of general government nonfinancial assets as negative expenditure (analytically equivalent to revenue). An example of the type of general government nonfinancial asset whose sale proceeds would be treated in this manner is the surplus land holdings of ministries such as defence and education. Experience in a number of countries shows that receipts from the sale of surplus general government nonfinancial assets can be quite significant, and may be sustained over a number of years.

The netting off of such receipts from net lending is nevertheless a minor defect by comparison with the netting off from the unadjusted cash budget balance of receipts from transfers such as privatisation receipts from the public enterprise sector, a practice which has led to many episodes of large-scale manipulation of cash budget balance measures. Nevertheless, from a fiscal policy perspective, financing expenditure via such asset sales both adversely affects fiscal sustainability and injects income into the economy, with potential impacts on aggregate demand.

With respect to fiscal sustainability, while the balance sheet value of a nonfinancial asset cannot in general be assumed to measure the asset's contribution to fiscal sustainability (see below), this is not true with respect to surplus assets (assets which are not in use and which are available for disposal), the balance sheet value of which should be their expected sale price (net recoverable value). The sale of the asset therefore has an impact on sustainability precisely equivalent to a reduction in net financial worth to the value of the asset's market price. Raising money by the sale of this type of asset is therefore analytically the same as borrowing the money concerned, rather than raising revenue. Moreover, the macroeconomic impact should be the same as borrowing, as the private sector agents who purchase these assets do not experience a loss of wealth as a result of their transaction, but rather exchange one asset (money) for another (the nonfinancial asset which they purchase).

For fiscal policy purposes, it may therefore be desirable to adjust net lending by adding back general government nonfinancial asset sales receipts, so as to treat such receipts as financing. The GFS "overall fiscal balance" (IMF, 2001, p. 46) does so, among other things. Transparency considerations arguably reinforce this point: note the recommendation of the IMF *Code of Fiscal Transparency* that "the proceeds from asset sales be treated as financing rather than revenue, negative capital expenditure, or negative net lending" (IMF, 2007, p. 99).

as the primary budget balance measure for fiscal policy purposes will be taken to refer also to variants of the net lending measure, such as the overall fiscal balance.

5. Net worth, the operating balance and fiscal sustainability

What about net worth? It is of course the most familiar and comprehensive accrual stock aggregate. So would it be possible to shift the focus of fiscal sustainability analysis from debt measures to net worth? It is suggested here that the answer to this question is "no" – in other words, that net worth and its flow counterpart, the net operating balance, are much less meaningful aggregates for fiscal sustainability purposes than is a net debt measure.

On the asset side, net worth counts not only financial assets but also nonfinancial assets, of which the most important are fixed assets like roads, bridges and public buildings. The relevance of financial assets to sustainability analysis is clear, because in general financial assets can be readily used to repay debt, and are valued at what they would realise if used to do so. This capacity to offset debt makes it reasonable to subtract financial assets from debt when assessing sustainability; hence the relevance of the **net** debt measure, whether defined in cash accounting terms (debt obligations minus cash balances) or in terms of the broader accrual concept of net financial debt (liabilities minus financial assets). By contrast, the balance sheet valuations of fixed assets have no necessary relationship to what they might realise if sold, and selling these assets is in many cases politically impracticable. To treat the balance sheet valuation of fixed assets as an offset against debt/financial liabilities for the purposes of fiscal sustainability analysis is therefore inappropriate.

Some appear to think that the application of the market value principle (or the closely related fair value principle) for the valuation of all assets and liabilities ensures that balance sheet valuations of government nonfinancial assets are relevant measures for fiscal sustainability purposes. But this is not the case. Consider, by way of example, a (non-tollway) bridge. Like many such government assets, such a bridge would typically be valued in a government balance sheet on a "written-down replacement cost" basis – roughly speaking, the original construction cost in real terms reduced by a measure of depreciation and adjusted for maintenance. Because such an asset would have no ready market, and because it is not income-earning, this valuation methodology would be considered consistent with the market value principle (IMF, 2001, p. 114) and also with the fair value principle.[21] One struggles, however, to see the relevance of written-down replacement cost for fiscal sustainability. Any notion that one could treat such asset valuations as in effect cancelling an equivalent quantity of debt would seem quite peculiar.

Viewing the matter from the flow perspective, the problem with reliance on a deficit target or rule defined in terms of the net operating balance (accrual revenue minus expenses) would have the effect of leaving capital expenditure unconstrained. And failing to limit capital expenditure would – as pointed out in the earlier discussion of the inadequacy of an accrual budgeting system based on expenses control totals alone – fail to meet the needs of fiscal policy with respect to the management of fiscal sustainability.

The one clear fiscal policy role for the net operating balance/net worth arises in countries which are committed to the **golden rule**. The golden rule embodies a

Box 5. **Net worth as a fiscal sustainability measure?**

The value of nonfinancial assets in a general government balance sheet in general provides little information about the government's capacity to meet it financial obligations, for the following reasons:

- The only unambiguously relevant measures of nonfinancial asset value from a fiscal sustainability point of view are those which reflect either the future income flows which the asset will yield or the asset's potential sale price.
- Most general government fixed assets are not income-earning (in contrast to physical assets held by for-profit corporations in the private or public enterprise sectors). This means that valuation on the basis of future income flows (sometimes referred to as the "income approach" to valuation) is not relevant.
- Although valuation on the basis of potential sale price – what is sometimes referred to as "recoverable value" – would for many assets be highly relevant to fiscal sustainability, nonfinancial assets are not, as indicated in the text, generally valued in balance sheets on this basis.
- Many government nonfinancial assets would never be sold, even in an acute fiscal crisis. Many are also highly illiquid. Recoverable value in these cases would not even in principle be relevant to sustainability analysis.
- The only category of nonfinancial asset which is systematically valued in balance sheets on a recoverable value basis is nonfinancial assets that have already been identified as surplus (hence the point made in Box 4 that it is reasonable to count the values of surplus assets in assessing sustainability).

For these reasons, the inclusion of nonfinancial assets in net worth makes that measure much less suitable than net financial debt as a fiscal sustainability measure. It is possible for, say, the net worth of a government to "improve" but fiscal sustainability to deteriorate. Similarly, on a cross-sectional basis, two countries with similar economies might have similar net worth/GDP ratios, but completely different fiscal sustainability positions. There is, for example, a vast difference in sustainability terms between two countries both of which have net worth equal to 2% of GDP, where country A has net (financial) debt of 20% of GDP and nonfinancial assets of 22% of GDP, and country B has net debt of 150% of GDP and nonfinancial assets of 152% of GDP.

This is not to say that the stock of nonfinancial assets – including those social assets which provide major services to the community but have little recoverable value – is irrelevant to fiscal sustainability. Clearly, if countries C and D had the same level of net debt, but C had little public infrastructure while country D was very well endowed with such infrastructure, country D would, *ceteris paribus*, be at lesser risk of being unable to meet its financial obligations. However, this does not mean that it would be appropriate to use balance sheet values to measure the contribution of such nonfinancial asset holdings to fiscal sustainability. What it suggests, rather, is that it can be useful at times to supplement debt measures with information on nonfinancial asset holdings, and particularly on the recoverable value of certain manifestly saleable nonfinancial assets (*e.g.* unused land holdings).

traditional conception of intergenerational equity which asserts that taxpayers in each time period should as a group contribute to financing public expenditure in accordance with the intertemporal allocation of the benefits to which that expenditure gives rise (Musgrave, 1988). In doing so, the taxpayers may be regarded as "paying their way" without either subsidising or being subsidised by taxpayers in other time periods. The main implication is that it is reasonable to use debt only to finance capital expenditure, with the debt (and interest charges) being repaid over the lives of the assets concerned, in accordance with the intertemporal allocation of the benefits which they generate for the community.[22]

A simple practical formulation of the golden rule is a requirement that the budget be (structurally) balanced in accrual terms. In other words, (accrual) revenues should cover expenses, so that the net operating balance is zero. This means that the taxpayers are each year paying for the depreciation and interest arising from capital expenditure, rather than for the capital expenditure itself. Expressed differently, borrowing will essentially only be used to finance net investment (see Robinson, 1998b).

The most notable golden rule regime in recent times has been in the United Kingdom, where the rule (currently suspended as a result of the financial crisis) took the form of a requirement that the so-called "surplus on the current budget" (SOCB)[23] – essentially the same as the net operating balance – should not be negative on average over the course of the business cycle.

6. Accrual aggregate expenditure

Containing the level of debt requires managing the budget balance, and this obviously requires control and planning of aggregate expenditure and aggregate revenue. If the fiscal policy focus is on cash debt, then the relevant expenditure aggregate is well-defined: cash aggregate expenditure is defined as payments of cash which increase conventional net debt. But what is the appropriate expenditure aggregate if fiscal sustainability is being managed with reference to the broader accrual measure of debt? This is clearly a very important question in an accrual budgeting environment, but one which has received little attention.

It is suggested here that the appropriate expenditure aggregate for the management of fiscal sustainability in an accrual environment is **accrual aggregate expenditure**, defined as transactions which increase government net financial debt. Accrual aggregate expenditure is a new concept proposed in this article. However, it is close to the GFS concept "total expenditure" (IMF, 2001, p. 46), the key difference being that GFS total expenditure treats proceeds from the sale of general government nonfinancial assets as negative expenditure – reflecting the netting off from net lending noted above – whereas accrual aggregate expenditure is a gross expenditure measure which does not. As suggested in Box 4 above, it may not be appropriate, for fiscal policy reasons, to treat asset sales receipts as negative expenditure.

However, this is a question of second-order detail, from which it is useful to abstract in the analysis in the remainder of this article. In what follows, we will therefore assume (unless otherwise expressly stated) that sales of general government nonfinancial assets are zero and that therefore *net lending = (accrual) revenue – accrual aggregate expenditure*.

Box 6. **Accrual aggregate expenditure**

The GFS framework defines total expenditure as expenses plus the net acquisition of nonfinancial assets (NANFA). Defined this way, *net lending = revenue – total expenditure*. To see this, note that net lending is defined as: *i)* net acquisition of financial assets minus net incurrence of liabilities; or, equivalently, as *ii)* net operating balance minus NANFA. From the second definition we have:

Net lending = (revenue – expenses) – NANFA = revenue – (expenses + NANFA) = revenue – total expenditure.

To understand how total expenditure relates to accrual aggregate expenditure and to the accumulation of debt, note that debt can arise from two types of outlays: expenses and capital outlays.

To measure debt arising from capital outlays, note that NANFA understates the impact on net financial debt of nonfinancial asset acquisition (whether fixed assets or increases in inventories) inasmuch as it nets off both depreciation and proceeds from sale of (general government) nonfinancial assets. The change in net financial debt arising from capital outlays can be measured by what we call here **acquisition of nonfinancial assets** (ANFA), defined as NANFA plus depreciation plus proceeds from sale of nonfinancial assets. With respect to debt arising from expenses, note that depreciation does not give rise to net lending, whereas other GFS expenses do. Hence "expenses minus depreciation" is a measure of the impact on debt from expenses transactions.

From this it follows that the impact of all outlays upon debt is measured by:

Accrual aggregate expenditure = (expenses – depreciation) + acquisition of nonfinancial assets.

By contrast, from the definition of total expenditure above, it will be seen that:

Total expenditure = (expenses – depreciation) + acquisition of nonfinancial assets – proceeds from sale of nonfinancial assets = accrual aggregate expenditure – proceeds from sale of nonfinancial assets.

Moreover:

Net lending = revenue – accrual aggregate expenditure + proceeds from sales of nonfinancial assets.

Hence the point made in the text that GFS total expenditure treats asset sales proceeds as negative expenditure, whereas the proposed accrual aggregate expenditure measure does not.*

* Note that both GFS total expenditure and the proposed accrual aggregate expenditure differ from the accrual expenditure aggregate developed in the United Kingdom, the so-called total managed expenditure (TME). TME is defined as current expenditure (*i.e.* expenses) plus net investment plus depreciation (HM Treasury, 2007b, p. 190) or (expressed in the language above) expenses plus acquisition of nonfinancial assets. This measure would appear to exceed the contribution of outlays to net lending by the amount of depreciation.

7. Fiscal policy for macroeconomic stabilisation

It has been argued that, for the purposes of fiscal sustainability objectives, it is better to specify key fiscal policy aggregates in accrual terms – net lending, net financial debt, or variants thereof – than in cash terms. What about fiscal stabilisation policy? Is it true that cash measures of aggregate expenditure, revenue and deficits are more useful than accrual measures for assessing the macroeconomic stance of fiscal policy – *i.e.* the likely impact of fiscal policy on aggregate demand?

With growing support among economists for the use of fiscal stabilisation policy, this question seems particularly relevant. Until a couple of years ago, majority opinion among economists favoured permitting the automatic stabilisers to operate, but remained sceptical about the efficacy of discretionary fiscal policy (*e.g.* Eichenbaum, 1997; Feldstein, 2002; Taylor, 2000). More recently, the consensus started to move towards the view that discretionary policy can be effective and potentially more timely than monetary policy in counteracting the harm of economic downturn (see Boskin in Federal Reserve Bank of San Francisco, 2008; Elmendorf and Furman, 2008). Support for discretionary fiscal policy has manifestly being greatly strengthened by the widespread perception of the need for a bold policy response to the current severe financial crisis, and the awareness of the particularly severe limits of monetary policy as an instrument of stimulus under current financial market conditions.

With respect to the automatic stabilisers, the choice between cash and accrual measures would not appear to matter much. Allowing the automatic stabilisers to operate means, of course, accepting any increases in the deficit which result automatically from the impact of an economic downswing on tax revenues and on cyclically sensitive expenditure such as unemployment benefits. A policy of allowing the unhindered operation of the automatic stabilisers makes it relevant to measure the "cyclical" component of the deficit, and to distinguish this from the underlying "structural" deficit. However, cyclically induced changes in these expenditure and revenue items are very similar whether measured in cash or accrual terms, because the accounting basis has little impact on the measurement of transfer payments, and the widespread use of pay-as-you-go taxation arrangements means the same is true for the main relevant taxes (*e.g.* personal income tax).

To this extent at least, one can endorse the British decision, in the context of their move to an accrual framework, to use "the change in PSNB [*i.e.* net lending] … to assess the overall impact of fiscal policy on aggregate demand" (HM Treasury, 2007b, p. 8).

By contrast, with respect to discretionary fiscal measures, the choice between cash and accrual measures of expenditure may well matter. The question here is whether, in considering particular options for increasing expenditure (*e.g.* increasing unemployment benefits, boosting infrastructure spending, etc.) or cutting taxes, it is more useful to have regard to the cash expenditure involved or to their cost measured in accrual terms. There are reasons to believe that, depending upon the type of economic agent directly affected by the specific discretionary measure under consideration, cash measures may in some cases provide a better indication of the demand impact of the discretionary fiscal initiative (see Box 7) – essentially because the timing of the injection of cash can be macroeconomically important even when it does not correspond to an injection of income. However, in other cases the cash measure may be quite misleading, and the accrual measure much more informative.

Nevertheless, this is not a reason for preferring cash to accrual fiscal aggregates, because discretionary fiscal policy is formulated by reference not to the aggregates but to the probable demand impacts of specific measures. In other words, the conduct of discretionary fiscal policy is not a matter of simply deciding to boost spending or cut taxes by some quantum. Rather, it is about selecting specific expenditure or tax measures which experience suggests will result in substantial increases in private sector spending. Thus the active political and public debate in the United States on the provision of a

Box 7. **Accrual *versus* cash measures of the cost of discretionary fiscal measures**

Accrual aggregate expenditure was defined as the increase in government net financial debt arising from transactions. Any increase in government net financial debt means an equivalent growth in private sector net financial worth. It follows that accrual expenditure measures the income – in the proper economic sense of increases of wealth – injected by government into the private sector. Conversely, accrual revenue measures the withdrawal of income. Cash expenditure and revenue, by contrast, measure payments or withdrawals of cash which, insofar as they differ in timing from the expenditure and revenue measured in accrual terms, do not represent income but, rather, the bringing forward or postponement of the payment of income acquired in another time period. All the examples in Box 3 of transactions which can lead to significant differences between the cash budget balance and net lending are cases where the cash payment or withdrawal does not actually represent a change in private sector incomes. For example, the bringing forward (or deferral) in the required timing of corporate tax payments does not change corporate profits: corporations account on an accrual basis and record tax as an expense in the year the tax liability is incurred.

The question then is why the "mere" timing of the receipt of cash would make a difference to the behaviour of economic agents. There are two obvious reasons why this might be the case. One is misperception – that is, an agent may misperceive a cash payment as the receipt of income even when this is not the case. For example, the civil servant who receives a cash payout of pension entitlements sees this as a windfall gain – and proceeds to spend some of it on that basis – not understanding that all that has happened is that income which was already his/hers has been made available now.

The other reason why the timing of the receipt of cash may make a difference is "liquidity constraints" (construed broadly not only as the ability of the economic agent to access credit, but also as the differences in borrowing and lending rates available to the agent) – that is, an agent may receive cash from the government, may understand that it is not income, but may nevertheless spend some of it because there is some spending he or she would like to undertake but has been unable to do so because of an inability to access sufficient credit or to obtain that credit on acceptable terms. For example, suppose a civil servant accepts the cash payout of accumulated pension entitlements. He or she might spend a portion of the payout on, say, a new car or an overseas holiday not because he/she misconstrues it as income, but because it allows borrowing against the future much more cheaply and easily than by taking out a loan to finance the holiday or new car.

It therefore seems reasonable to assume that the impact of specific fiscal measures can depend on the timing of the cash transactions where the measures impact on economic agents (particularly in the household sector) who are either subject to liquidity constraints or who misperceive cash payments as the receipt of income. With respect to such agents, therefore, the cash cost of the fiscal measure concerned may offer a better indication of its likely impact on demand. Conversely, however, the demand impact of fiscal measures which directly impact on economic agents (particularly in the corporate sector) who suffer neither from such misperceptions nor (normally) from such credit constraints may be better captured by an accrual measure of their cost, and the cash cost may – where it differs from the accrual measure – be misleading.

discretionary fiscal boost to the economy in the early stages of the subprime crisis in 2008 focused in large measure on issues such as whether accelerated depreciation provisions for corporations could have the same impact as tax relief or targeted assistance for low-income people with a particularly high propensity to consume. Only in the simplest of introductory textbooks is the impact of discretionary policy assessed by taking the cost of the initiative and multiplying it by some standard expenditure or tax multiplier.

Governments which manage fiscal policy with respect to cash fiscal aggregates need to bear in mind that "stimulatory" measures which simply change the timing of cash transactions between the government and agents who are not liquidity-constrained will probably have no impact on demand. Similarly, governments managing accrual fiscal aggregates will need to bear in mind that the increasing accrual aggregate expenditure in ways which substantially defer the associated cash payments will likely also have little impact.

These considerations suggest that there is no reason for a government which has decided to employ accrual fiscal aggregates for the management of fiscal sustainability to feel that it should use cash aggregates for stabilisation policy. There are clear advantages in keeping it simple by using the same fiscal aggregates for both purposes.

8. Designing an accrual budgeting system to support accrual fiscal targets

The proposition that fiscal policy can be formulated in terms of accrual fiscal aggregates – in particular, in terms of net lending and net financial debt (or variants thereof) – seems to immediately broaden the relevance of accrual budgeting beyond the microeconomic benefits which are usually emphasised, because accrual budgeting and a fiscal policy targeted on accrual fiscal aggregates would seem to complement one another. Despite this, the specification of accrual control totals to ensure that fiscal policy objectives are met is not an obvious matter.

How then does one design an accrual budgeting system to tailor it to the management of net lending and, through that, net financial debt? The starting point here must be the recognition that, as discussed above, to exercise direct control over net lending, the budgeting system needs to control accrual aggregate expenditure, defined as transactions which increase net financial debt. One can then distinguish between two categories of accrual expenditure (again, these are new concepts), as follows:

- **Accrual capital expenditure:** transactions which increase net financial debt in order to acquire nonfinancial assets. This concept of capital expenditure differs from cash capital expenditure in that it includes not only payments for the acquisition of nonfinancial assets (*i.e.* cash capital expenditure), but also the acquisition of nonfinancial assets via deferred payment arrangements (*e.g.* financial leases) or by any other means that creates a liability for government.[24, 25]
- **Accrual current expenditure:** transactions which, *ceteris paribus*, increase net financial debt for current purposes (*i.e.* to finance services or transfers rather than to acquire nonfinancial assets). This concept differs from cash current expenditure in that it includes consumption which is not immediately paid for, but which is financed by the accumulation of liabilities which have to be paid in the future.

  Thus:

  Accrual aggregate expenditure = accrual current expenditure + accrual capital expenditure.

This means that the task of controlling net lending would be most directly accomplished by an accrual budgeting system which sets control totals for these two measures.

On the capital side, this is unproblematic. If it is accepted that – as was suggested earlier – it is best to build an explicit capital expenditure control total into the accrual budgeting system, then any government wishing to control net lending should define that control total in terms of accrual capital expenditure rather than cash capital expenditure. This is, unsurprisingly, what New Zealand and the United Kingdom do. (Note, however, that these control totals are for net rather than gross capital expenditure. What this means and some of the issues it raises are discussed in Box 8.)

Box 8. **Net capital appropriations**

The capital expenditure control totals which operate in New Zealand and the United Kingdom – the former via parliamentary appropriation and the latter by Treasury regulation – are based on net (accrual) capital expenditure – that is, they are net of the proceeds of nonfinancial asset sales (New Zealand Treasury, 2005, p. 22; HM Treasury, 2007a, Chapter 6). This is intended to provide a stronger incentive to ministries to identify and sell surplus assets.

The issue which net appropriations raises for fiscal policy is that financing new capital expenditure from the proceeds of the sale of nonfinancial assets will increase accrual aggregate expenditure. (This is the same issue discussed in the text below in relation to the virement from the depreciation component of an expenses appropriation to the accrual current expenditure component.) Expressed differently, there would be a potential fiscal policy problem if spending ministries were given untrammeled freedom to sell their nonfinancial assets and use the proceeds to increase their new capital expenditure. Such additional capital expenditure would impact on aggregate demand. It would also potentially impact on fiscal sustainability insofar as one would be replacing surplus assets with a balance sheet value equal to what they can be sold for (their "net recoverable value") with new assets which may not necessarily have a significant recoverable value (on this subject, see Box 4 above).

In practice, however, such a problem does not arise in either New Zealand or the United Kingdom because of the constraints on the freedom of ministries to sell large assets at their own discretion. Moreover, asset sales generally take significant time to carry out, and the finance ministry is able to estimate the relevant receipts in making budget decisions.

One could arguably retain the incentives benefits of this approach while improving the transparency of the budgeting process by setting an explicit quantitative limit in each year's annual budget on the amount of capital expenditure each ministry can finance via asset sales.

It is on the current side that the matter gets a little more complicated. If a control total were to be imposed over accrual current expenditure, how would this relate – if at all – to the expenses control total concept which is at the heart of an accrual budgeting system? To answer this question, consider the relation between expenses and accrual current expenditure. Expenses are a measure of the costs of government services and transfers, irrespective of when those costs are paid. Some expenses need to be paid either in the year they are incurred or in subsequent years, and it is these expenses only which increase net

financial debt. It is these "debt-inducing" expenses which represent accrual current expenditure. However, not all expenses are accrual current expenditure, because some expenses do not involve present or future payments – depreciation being the most important example, and the capital charge (where it exists) another[26] – and therefore do not increase net financial debt. Summing up, accrual current expenditure is expenses which require payment in the present or future years, and is equal to total expenses minus depreciation and similar "non debt-inducing" expenses.

Because accrual current expenditure is a subset of expenses, it might be thought that the imposition of an expenses control total would be sufficient (in conjunction with the capital expenditure control total) to directly control net lending. However, a potential problem would still remain if, within the limits imposed by expenses control totals, spending ministries were able to shift ("vire") money from the non debt-inducing expenses in order to increase debt-inducing expenses. If that were the case, then it might be necessary to also impose a control total over accrual current expenditure.

In fact, this is precisely the conclusion which the British government reached after some experience with accrual budgeting. When accrual budgeting was first introduced in the United Kingdom, there was only a control total for expenses. Subsequently, however, a separate control total was set for the accrual current expenditure component of total expenses – what the British call near-cash expenses (as opposed to what they call non-cash expenses, which are the expenses such as depreciation that do not contribute to net lending). The British had found that spending ministries were able to reallocate significant amounts within their total expenses budgets from non-cash to near-cash expenses, on a scale that could potentially put real pressure on the government's debt limit. The spending ministries accomplished this by a range of methods, including accounting revisions which significantly reduced their depreciation and capital charges (*e.g.* by substantially reducing the book value of specific assets or by lengthening their estimated lifespans), and by the sale of capital assets. It was the "need to protect the fiscal position" which led to the imposition of the additional control total on near-cash expenses as a means of "preventing funds from being switched from non-cash to near-cash spending" (HM Treasury, 2008, p. 17).

Perhaps as a result of the United Kingdom's choice of the term "near-cash", its imposition of the control total over accrual current expenditure has been misinterpreted as the reinstitution of cash budgeting. Thus the United States Government Accountability Office (2007, p. 27) asserts that in Britain the "Treasury has imposed limits on departmental cash spending because spending affects the country's cash-based fiscal position". However, it is wrong to characterise the near-cash control total as a control on cash spending.[27] It is equally wrong to describe British fiscal policy as being targeted at cash fiscal aggregates, given that the key budget balance measure is net lending rather than the cash budget balance. (However, it is true that the United Kingdom continues to use a cash debt measure[28] and that this raises an issue of consistency between flow and stock fiscal aggregates.)

This analysis suggests, then, that the most direct manner to target net lending under an accrual budgeting system is to accompany the capital expenditure control total with a control total over accrual current expenditure (in British terminology, near-cash expenses). The latter could take the form of a sub-control total within the expenses control total given to each ministry, which is essentially the United Kingdom system.[29]

The problem with this approach is that it directly interferes, in an important respect, with the microeconomic advantages of accrual budgeting. As mentioned at the outset of this article, part of the rationale for the inclusion of depreciation in the expenses control total is to give spending ministries an incentive to identify and sell surplus assets, because in doing so they reduce their depreciation charge and increase their capacity to spend on other expenses.

In dealing with this conflict between microeconomic and macroeconomic considerations, the other possibility is to dispense with any explicit control total on accrual current expenditure, and instead impose other limits on the scope to vire funds from non-cash to near-cash expenses so as to prevent such virement on a scale which could threaten debt limits. The ministry of finance could, for example, impose quantitative limits on the magnitude of such virements without central approval, and could accompany this with other measures such as banning virement arising solely from accounting write-downs of the asset value.

The British have been wrestling further with this problem, and in late 2008 they announced their intention to abolish the "near-cash" limits. However, in foreshadowing this, they indicated – without being specific – that "different controls will need to be put in place to protect the fiscal position ...with some arrangements specific to particular departments" (HM Treasury, 2008, p. 17).

It should be noted that this issue has an implication for the definition of accrual budgeting. It would be quite feasible to have an accrual budgeting system in which there is a control total on the accrual current expenditure (near-cash) component of expenses, but no control total on expenses. This is an additional reason for defining accrual budgeting in terms of the use of accrual concepts to specify control totals, rather than as a budgeting system based on expenses control totals *per se*.

9. Targeting cash fiscal aggregates under accrual budgeting

Accrual budgeting and accrual fiscal aggregates may be a natural fit, but what about a government which, having adopted accrual budgeting, determines that it wishes to continue to base fiscal policy on cash fiscal aggregates – in particular, the cash budget balance, conventionally defined debt, or variants thereof? Is this something which an accrual budgeting system can deliver?

If the fiscal policy focus is upon cash aggregates, the budgeting system must be capable of delivering sufficient control over aggregate cash expenditure. But if control totals are defined in accrual rather than cash terms, the centre is no longer imposing quantitative limits on the annual payments made by each spending ministry. At first glance, this would seem to make it impossible to target cash budget outcomes.

In fact, however, the position is not this bad. Although direct control over cash outcomes is relinquished under an accrual budgeting system, the aggregate cash outcome will nevertheless remain reasonably predictable. It is therefore possible to adopt an accrual budgeting system while continuing to pursue cash fiscal targets. This is in fact what Australia has done.[30] More generally, it is not necessary that the accounting basis of the budget be the same as the accounting basis of the key fiscal aggregates.[31]

The reason why it is possible to continue targeting the cash budget balance under an accrual budgeting system is that the net lending and the cash balance can normally be expected to track one another reasonably predictably. The key sources of large divergences

between the two will be either significant changes in the required timing of tax payments, or actions which result in a major change in the stock of non-debt liabilities (see Box 9), examples of which are:

- cash payout of a substantial portion of the existing aggregate civil service pension liabilities, *e.g.* arising from major downsizing of the civil service or from privatisation of a civil service pension scheme; or
- pay-off of a large stock of arrears to suppliers.

In general, these types of actions are under the control of the government and the finance ministry, rather than under the control of spending ministries. (For example, even if line ministries enjoy considerable managerial freedom over matters of hiring and firing, any civil service downsizing across the whole of government could be initiated only by the centre.[32]) From this it follows that the centre should be able to project with reasonable accuracy the aggregate cash balance which will result from the execution of any given accrual budgets.[33]

Box 9. **Net lending *versus* the cash balance**

The difference between net lending and the cash budget balance comprises two elements: *i)* the difference between accrual aggregate expenditure (AAE) and cash aggregate expenditure (CAE); and *ii)* the difference between accrual revenue and cash revenue.

We can therefore say that:

AAE requiring cash payments = AAE – non-cash AAE = CAE – payments of liabilities from previous years,

where "non-cash accrual aggregate expenditure" means those elements of accrual aggregate expenditure which are not paid for in the financial year concerned, and which therefore result in a liability that will need to be paid in future years (*e.g.* unpaid accounts for supplies received and used this year; increased pension entitlements of serving civil servants; the present value of financial lease liabilities).

This gives us, approximately speaking:

AAE = CAE –Δnon-debt liabilities.[*]

What this makes clear is that large differences between accrual aggregate expenditure and cash aggregate expenditure must arise from actions which substantially change the stock of non-debt liabilities.

On the revenue side, an example of the type of action which would lead to a major divergence between accrual revenue and cash revenue is a shift from the pay-as-you-go basis for income tax to settlement at the end of the financial year (or *vice versa*).

This discussion abstracts from a number of other potential sources of difference between cash and accrual measures, such as differential treatment of transactions between general government and the public enterprise sectors.

* To be more precise, this refers to the change in non-debt liabilities arising from transactions – *i.e.* excluding valuation effects (which are "other economic flows" in the GFS framework).

10. Controlling budget execution under accrual budgeting

The analysis to this point has made it clear that there is no technical difficulty in defining accrual control totals suitable for supporting the targeting of appropriate fiscal aggregates. If these control totals are then properly enforced during budget execution, accrual budgeting will not cause difficulties for the conduct of sound fiscal policy.

However, before concluding that accrual budgeting presents no difficulties for fiscal policy, it is necessary to consider its implications for central control of budget execution. This is because, under accrual budgeting, the ministry of finance's task of policing budget execution – *i.e.* preventing agencies from breaching their budgets – becomes more difficult in a way which could be problematic in some countries.

Under cash budgeting, the cash expenditure control totals are the basis for one of the most powerful instruments of financial discipline – namely, the control by the ministry of finance of spending ministry access to cash. Cash has to be actually released by the ministry of finance in order for payments to be made, and the budget control totals serve as clear quantitative limits on how much cash will be released. This control needs to be backed with appropriate disciplines to prevent excessive commitments being entered into (and, thereby, to limit the accumulation of payment arrears), but is nevertheless a powerful one.

In an accrual system, there is no such cash limit. By giving spending ministries control totals expressed in accrual terms, the government is delegating to spending ministries significant discretion about the timing of the cash payments associated with those expenses. Naturally, the budget preparation process each year under an accrual budgeting system will include the projection of cash requirements for each ministry and for the government as a whole. However, a projection of the anticipated cash requirements of a particular spending ministry is not the same as a cash limit for the coming year. The ministry's actual cash requirements for the execution of its accrual budget can easily change during the year. Indeed, the greater the managerial freedom accorded to ministries – *e.g.* to change the input mix or to choose between outsourcing and internal supply – the greater the potential variability in their cash requirements. It would therefore not be appropriate to turn the budget projections of ministry cash requirements into cash limits for the year. To do so would be to revert to cash budgeting and would undermine the managerial flexibility rationale for accrual budgeting. The presence of dual accrual and cash limits would also make budgeting intolerably complicated for line ministries.

Superficially, the British budgeting system looks like one in which both cash and accrual control totals are imposed, because the parliament sets appropriations for both the expenses incurred (the "net resource requirement") and the cash payments to be made (the "net cash requirement") by each ministry. However, superficial appearances are deceptive in this case. In practice, if the execution of ministry expenses budgets increases their cash requirements above the level authorised by the parliament, the net cash requirement is changed via supplementary parliamentary estimates. The truly binding control totals in the United Kingdom system are those for expenses, accrual capital expenditure and (at the time of writing) the near-cash component of expenses.[34] The British system should therefore be considered as a fully accrual budgeting system and not a hybrid accrual/cash system.

Spending ministries' compliance with accrual budget limits cannot therefore be monitored (other than very approximately) in terms of their access to cash. Spending

ministries use up their accrual budgets by incurring expenses and liabilities, and these show up in their accounts rather than in their use of cash. In policing the execution of an accrual budget, the ministry of finance must rely primarily on the monitoring of ministry accounts. Central financial control therefore relies primarily upon *ex post* monitoring and sanctions, whereas under cash budgeting *ex ante* control through the release of cash is the primary instrument. This makes the degree of spending ministry respect for budget limits, the level of accounting competence in the spending ministries, and the quality and timeliness of their within-year financial reporting, extremely important.

Can ministry of finance control over the release of cash nevertheless play some supporting role in policing budget execution? To answer this question, it is useful to consider a little more closely the implications of accrual budgeting for the release of cash to spending ministries. As background, it helps here to think of accrual budgets as constituting a type of bank account – a cash-drawing facility at the ministry of finance – upon which the spending ministry can draw to make payments arising from expenses (as well as from capital expenditure liabilities if there is an accrual capital expenditure control total). Suppose that a spending ministry receives in year t an expenses budget of Y million, of which the amount Z is cordoned off for depreciation and other "non-cash" expenses, leaving X million to cover all expenses which require payment in the current or future years (*i.e.* to cover accrual current expenditure). The X million is then like an amount of cash placed in the ministry's notional bank account upon which it can draw for the purpose of making payments in year t and in subsequent years, arising from expenses incurred in year t. This means that after the ministry has drawn from the X million in year t the amount that it requires in order to pay those year t expenses which require payment that year, what remains needs to be sufficient to meet all the payments it will have to make in future years arising from expenses incurred in year t but not paid in that year. Expressed differently, the ministry always "saves" enough to meet its liabilities. At any point in time, it should therefore have in its notional bank account sufficient "savings" from the expense appropriations of previous years (years t-1, t-2 ...) to permit it to pay liabilities inherited from those years when they become due.[35]

The question is then what approach the ministry of finance takes to the release of cash to each spending ministry from its notional bank account. One approach – approximately speaking, the Australian approach – is to say that this is a matter entirely for the spending ministry itself. The spending ministry is not restricted from drawing as much or as little cash as it feels it needs to execute its budget. Accountability for the proper use of these funds is entirely *ex post*, with sanctions for abuse. For government-wide cash management purposes, the ministry of finance receives projections of cash requirements from spending ministries at regular intervals during the year, and manages the cash position accordingly. However, the finance ministry makes no attempt to approve/control those spending ministry drawings.

The potential danger of this arrangement will be obvious. There is nothing to stop the spending ministry from overdrawing on its notional cash bank account or from spending cash which it should be reserving to make future payments associated with liabilities which it is incurring. By doing this, it would of course be exceeding its accrual budget. However, the finance ministry would only become aware of the situation after the horse has bolted. And if the quality of spending ministry financial reporting is poor – or, in the extreme, if the spending ministry manipulates its accounts – it could take some time for the ministry of finance to become aware of what is going on. Particularly in the early days

after the shift from a cash to accrual budgeting system, there is also a real danger that the spending ministry might overdraw its cash account as a result of a misunderstanding – viewing the cash in its notional bank account as a pool of unused funds it can spend, rather than as money that has to be kept aside to pay liabilities.

The alternative approach would be for the ministry of finance to release cash only in line with a cash plan which it approves itself. The spending ministry would have to submit to the finance ministry a plan which indicates its cash requirements during the year and justifies these by reference to the timing of payments associated with its expenses, liabilities and nonfinancial acquisition plans. When its cash requirements change during the year, the spending ministry would have to submit a revised plan. The ministry of finance would then scrutinise these cash plans and form a view as to whether they were reasonable.

This latter course of action is obviously the safer one. However, it should be borne in mind that the review and approval of spending ministry cash requirements – including variations in those cash requirements during the financial year – is a considerably more complex process than required under cash budgeting. The question which would arise in many countries – particularly low-income ones – is whether the skilled human resources and systems required for such a complex task exist. More generally, the task of policing budget execution becomes more complex under an accrual budgeting system, and the scope for spending ministries to exceed their budgets becomes greater.

11. Conclusion

An accrual budgeting system – in which budgetary expenditure authorisations (control totals) are formulated in accrual terms – is compatible with good fiscal policy. However, this is only true if the accrual budgeting system is designed properly. A budgetary system in which each line ministry's resource utilisation is limited only by an **expenses control total** (limit on the expenses it incurs) is inadequate for the implementation of good fiscal policy, because such a system is incapable of controlling the level of government debt. In order to limit debt and thereby ensure fiscal sustainability, it is essential also to impose limits on capital expenditure, and the best way of doing this is the traditional way: through explicit capital budgets. It is also necessary to design the accrual budgeting system in such a manner as to prevent line ministries from shifting the composition of their expenses in such a way as to increase government debt.

The technical specification of control totals in an effective accrual budgeting system can only be discussed in relation to the specific fiscal policy aggregates which policy makers aim to manage through the budgeting system.

Accrual fiscal aggregates fit naturally with accrual budgeting. A fiscal policy focused on accrual fiscal aggregates can, moreover, be very effective. More specifically, fiscal policy can be improved by shifting the primary policy focus from the cash budget balance and cash debt to their accrual counterparts: **net lending** and **net financial debt** (or variants thereof). Such a shift of key fiscal policy aggregates is advantageous for the management of fiscal sustainability because the accrual debt measure is a broader measure of indebtedness. Controlling net lending, rather than the cash budget balance, will help to ensure that one contains not only conventional debt, but also quasi-debt such as financial lease commitments and civil service pension liabilities.

Shifting the primary focus of fiscal policy to net lending and net financial debt will not, moreover, cause difficulties for fiscal stabilisation policy. Discretionary fiscal policy is not a matter of deciding what quantum of public spending to inject into the economy, but is rather about the careful selection of specific measures which appear most likely to boost aggregate demand. The budgetary impact of automatic stabilisers, on the other hand, will in general be similar whether measured with respect to the cash budget balance or to net lending.

The case for the use of accrual measures as key fiscal policy aggregates relates specifically to net financial debt and net lending (or variants thereof) and not to net worth and its flow counterpart, the net operating balance. Net worth is not a good indicator of fiscal sustainability. To use it as a sustainability indicator would be, in effect, to assume that increasing the stock of nonfinancial assets has the same impact on sustainability as an equivalent reduction in debt. Although the stock of nonfinancial assets has some bearing on fiscal sustainability, this is not measured by the balance sheet value of these assets. The only clear case for the use of net worth and the net operating balance as key fiscal policy aggregates is in countries which choose to pursue the "golden rule" approach. Even in such countries, however, the crucial importance of ensuring fiscal sustainability means that net financial debt and/or net lending should remain key fiscal policy aggregates.

Although in principle an accrual budgeting system is fully compatible with good fiscal policy, in practice considerable risks arise from the complexity of accrual budgeting. Only if the financial management system is sufficiently strong to ensure effective implementation of the accrual control totals can it be said that the adoption of accrual budgeting poses no problem for fiscal discipline. Under an accrual budgeting system, central control of payments or of the release of cash to spending ministries is no longer available as an instrument, and this makes central control of budget execution considerably more demanding than is the case in a cash budgeting system. The ministry of finance's task of policing spending ministries' observation of budget limits becomes considerably more complicated, as does the task of cash management. This factor – in addition to others, such as additional complexity – makes accrual budgeting inappropriate for many countries.

Notes

1. By "key fiscal policy aggregates" we mean the aggregates in terms of which the government specifies its main fiscal policy objectives, targets or rules – such as a balanced budget over the business cycle or reduction of debt to below 60% of GDP.
2. GFS refers to government finance statistics (IMF, 2001); ESA is the European system of accounts of the European Union. Although GFS/ESA is the appropriate framework for fiscal policy, spending ministry financial management – and therefore the control totals used in the budgeting system – will in practice be based on some version of generally accepted accounting principles (GAAP). The precise specification of control totals under an accrual budgeting system will need to take systematically into account the important differences between these two frameworks. We abstract almost entirely from these more detailed issues in what follows.
3. There is one major qualification to this, which is that ESA95 does not recognise the pension liability of governments to their civil servants as a balance sheet item, with the further consequence that changes in the pension liability are not part of ESA95 net lending. This represents an inappropriate exclusion from consideration of a government liability which is in many countries quite large. The analysis in this article assumes throughout that, as under GFS2001, the pension liability and pension expenses are recognised.

4. In this respect, this article largely abstracts from consideration of those expenditure authorisations which do not take the form of quantitative limits (*e.g.* authorisations to pay formularised entitlements such as social benefits or authorisations for spending ministries to retain and spend certain own-source revenues – so-called "net appropriations").
5. The definition employed here is therefore more limited than that of Lüder and Jones (2003, p. 35), for whom "the term 'accrual budgeting' means, in practice, the extent to which the accrual accounting records and measures are used in the budgeting process".
6. Throughout this article, the term "expenses" always refers to the accrual concept. Expenses are, of course, a measure of the costs of service delivery (and transfers), irrespective of when those costs are paid. Equivalently, using GFS terminology, expenses are reductions in net worth arising from transactions.
7. As explained later, it is not essential that an expenses control total cover all categories of the ministry's expenses. The imposition of an expenses control total covering most categories of each spending ministry's expenses should, nevertheless, be regarded as a core feature of any accrual budgeting system.
8. Note that the liability to pay civil service pensions when civil servants retire is usually not left in the hands of spending ministries, but remains with the ministry of finance or a government-wide pension organisation. Where this is the case, accrual budgeting requires that spending ministries be charged an employer contribution estimated to be sufficient to cover the additional pension entitlements accrued.
9. The capital charge is not an expense in the accounting sense, but rather a synthetic charge which is supposed to reflect the "opportunity cost" of capital employed by the ministry. It is typically calculated as a percentage charge (*e.g.* 3.5% in the United Kingdom) on the net assets of each spending ministry.
10. While accrual budgeting was one element of AOB, these systems went well beyond accrual budgeting in attempting to restructure budgeting on a "purchaser-provider" basis in which the government was to pay agencies competitive "prices" for their outputs (Robinson, 2007). This led to the conceptualisation of budget funding provided by the government to agencies as "revenue" in spending ministry accounts, earned as a price paid for the delivery of outputs. Such an accounting treatment is derived not from the use of distinctively accrual concepts, but from the treatment of government agencies as if they were businesses.
11. And also arising from net capital expenditure control totals, discussed subsequently.
12. Sums below that limit also require central approval – namely, those that require an increase in the ministry's borrowing limit.
13. In Australia, state governments which have introduced the same type of appropriation model as the national government have other arrangements which remove the discretionary power of spending ministries over the aggregate level of capital expenditure. In the State of Queensland, for example, spending ministries are not able to carry forward for future use any excess of the depreciation element of their expenses appropriation over the capital expenditure they undertake in the year concerned. And in the State of Victoria, spending ministries must obtain central approval from the ministry of finance to access depreciation funding.
14. A committee of the Australian Senate has criticised the depreciation appropriation regime as "opaque" and has asked the government to consider the reintroduction of capital expenditure appropriations. More generally, the committee noted that the appropriations regime associated with the Australian accrual output budgeting system has "posed challenges for parliament's control of the appropriations process" (Senate Standing Committee on Finance and Public Administration, 2007, pp. ix, 58, 75-76). As Blöndal *et al.* (2008, p. 31) report, the Australian ministry of finance is reconsidering the capital appropriations arrangement.
15. Subject possibly to an acknowledgement that, in practice, it may be appropriate to make certain *ad hoc* accrual adjustments to the cash budget balance used for this purpose (for example, excluding privatisation receipts).
16. That is, the component of the contractual payments made by a government to the private provider which represents the reimbursement for the cost of construction of the PPP asset. In practice, of course, estimating this component can sometimes be difficult.
17. Discussion also continues on whether other items such as social security obligations should be treated as liabilities.

18. Buiter's theoretical construct incorporated the implications of current fiscal policy by, for example, treating the present value of future revenue flows as an asset.

19. At the same time, this example highlights the practical issues that the accrual measure can occasionally face with respect to the application of the market valuation principle to difficult-to-value assets, because a key factor behind the banking crisis has been the difficulty of valuing many of the complex financial assets held by the banks. Another interesting aspect of the example is the implications of market valuation in a context where financial meltdown temporarily reduces the value of some financial assets to a level well below what they may be worth when the crisis is over. Under these circumstances, the initial impact of the bailouts on net financial debt will be greater than the longer-term impact when there is some recovery in asset prices.

20. This refers, of course, to general government net lending.

21. In the fair value framework, it would often be regarded as an appropriate application of what is referred to as the "cost approach" to valuation (FASB, 2006, §18.c).

22. As pointed out by, among others, the proponents of generational accounting, intergenerational equity cannot in fact be reduced simply to a question of the intertemporal allocation of the costs of capital. Proponents nevertheless argue for the golden rule as a fiscal smoothing device and as providing at least a better approximation of intergenerational equity than the traditional balanced cash budget principle. Discussion of the merits of these propositions is beyond the scope of this article.

23. SOCB is defined as the public sector national accounts aggregate current expenditure plus depreciation less receipts (HM Treasury, 2007b, p. 5).

24. In principle, at least, it would also cover not only fixed assets, but also increases in inventories. It is also necessary under an accrual budgeting regime to decide which control total (*e.g.* the expenses or the capital expenditure control total) prepayments should be counted against.

25. We might also define "accrual net capital expenditure" as accrual capital expenditure minus (general government) nonfinancial asset sales receipts. This gives us: *(GFS) total expenditure = accrual current expenditure + accrual net capital expenditure*.

26. Provisions are another example. Provisions are non-cash expenses under GAAP accounting, whereas the capital charge is (as noted at the outset of this article) not an accounting expense proper. Under GFS/ESA, neither provisions nor, obviously, the capital charge are recognised as expenses.

27. It is clear from the context that the GAO was referring to the near-cash control total. If, however, it had been referring to the parliamentary cash appropriation, its claim would still be erroneous. See the text below on the role of the cash appropriation.

28. A cash debt measure is also still used by the Stability and Growth Pact, the debt limit of which is specified in terms of gross cash debt, which is inconsistent with the use of net lending for the budget deficit limit. The definition of the SGP debt limit can only be modified by changing the Maastricht treaty, whereas the budget deficit definition was able to be changed by agreement.

29. In practice, it is a little more complex than this, because some virement from non-cash to near-cash expenses is permitted, subject to case-by-case approval.

30. There was a brief period after the move to accrual budgeting when the government preferred net lending (which it referred to as the "fiscal balance") as the headline budget balance. However – for reasons which are extraneous to the present article – the fiscal policy focus quickly reverted to the (adjusted) cash budget balance.

31. Note here that the European Union's key deficit measure is defined in accrual terms (net lending), while the great majority of EU countries have cash budgeting systems.

32. It is true that under an accrual budgeting system spending ministries could in principle significantly influence the aggregate cash balance if they were to engage in large-scale across-the-board "leading or lagging" of payments (deliberate early or late payment of liabilities). However, under an accrual budgeting regime, they have no incentives to do so.

33. Setting aside, of course, the impact of uncertainty in exogenous factors such as the state of the economy.

34. There are, of course, additional elements of the control total system which are not relevant to the subject matter of this article, such as the distinction between departmental expenditure limits (DEL) and annually managed expenditure (AME).

35. This raises an important transitional issue: when moving from cash to accrual budgeting, it is necessary to give each ministry a drawing facility equal to the liabilities the ministry has accumulated up to the transition date, because the cash needed to meet these liabilities when they become due will no longer be provided via the budgetary control totals. The failure to fully finance transitional liabilities of this type was one of the problems which arose when accrual budgeting was implemented in Australia (Blöndal *et al.*, 2008, p. 21).

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Impact of Budget Support on Accountabilities at the Local Level in Indonesia

by
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A thorough analysis of existing governance and accountability structures in a decentralised country is necessary before deciding to deliver development assistance directly to the regional level. This article examines the mechanism of donor-provided budget support at the local level in Indonesia and its potential impact on accountability structures.

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Accountability is a key driver in the quest to deliver effective development outcomes. Donor-provided budget support offers a mechanism with which to deliver development assistance to a partner government that can promote accountability more so than traditional project-based aid. While some evaluations of budget support have assessed its impact on accountability, the evaluations and analyses have rarely examined the concept of accountability in all its complexity. This article unpacks the concept of accountability and argues that experiences in delivering budget support in one area, let alone one country, cannot simply be transposed to assume that budget support will improve accountability in a comparable way in another context. Accordingly, existing local accountability structures must be thoroughly examined in the context of broader political dynamics, particularly where budget support is provided in a decentralised country directly to the regional level of government.

To demonstrate this, this article looks at one of Indonesia's 33 provinces, Gorontalo, in order to examine existing local dynamics and predict how these might be impacted upon with a donor providing budget support. Section 1 introduces the concept of budget support in its historical context and presents current trends in its provision. Section 2 explains what is meant by the nebulous concept of "accountability" and how this concept can play out in a decentralised country such as Indonesia. Section 3 briefly canvasses Indonesia's public financial management reforms, including reforms to the budfget process and the introduction of a new "on-granting" mechanism for budget support to regional governments. Section 4 delves into the detail of the particular public financial management context of Gorontalo, including examining the impacts on accountability of central government grants to regional governments. This information is used in Section 5 to draw valuable lessons for a donor providing budget support.

This research is timely, given Indonesia's new regulations to govern the provision of budget support to regional governments and the increasing interest by donors in providing budget support. This article raises issues that would need to be carefully addressed in the design of a programme of assistance to ensure that budget support does not undermine recent reforms in Gorontalo but instead results in positive impacts on accountabilities and consequently more sustainable development outcomes.

1. Budget support: history and trends

1.1. Historical context for the provision of budget support

In the 1960s, developing countries[1] usually financed their recurrent budget[2] from locally raised revenues, and donors – particularly the relevant former colonial power – largely funded the capital budget.[3] Developing countries typically had a national development plan with donors' funds aligned with this plan and recorded in the budget. With the economic crises of the 1970s, rising levels of poverty in many developing countries led to increased aid inflows, and many developing countries ceased funding their own capital expenditure (Moore, 1998, pp. 108-109). Donor influence increased at the expense of local authority. Donors began to fund projects directly and entirely, and

bypassed domestic budget and planning systems. Particularly in the health and education sectors, donors funded both recurrent and capital costs in many developing countries. Given the fungibility of money and the weakened budgeting process, developing countries could leave sectors of interest to donors – such as public infrastructure and service delivery – to foreign funding and focus on short-term priorities, in some cases military expenditure (Moore, 1998, pp. 108-109).

To increase developing country ownership of reforms and to promote accountability for the use of funds, in the 1990s donors began to deliver development assistance through sector-wide approaches (SWAPs). A SWAP occurs where multiple donors pool their funds to support a government's policies in a certain sector (Moore, 1998, p. 109; White, 2007). Australia is the major donor funding a SWAP to support Papua New Guinea's health sector, for example. While these approaches have been found to reduce transaction costs for a partner government, experience shows that donors tend to dominate in the policy dialogue with limited sustainable impact on the partner government's policy implementation (for example, White, 2007).

More recently, donors have begun moving away from supporting particular sectors to contribute funds directly to a partner government's budget, known as budget support. Some early examples of countries receiving budget support include Uganda – where donors now finance nearly half of total government expenditures (Atingi-Ego, 2006) – and Mozambique, where 35% of total foreign assistance is provided through budget support representing nearly 20% of government expenditure (Binkert and Sulemane, 2006). Budget support can also be provided to local governments in decentralised countries, such as World Bank budget support to states and provinces in India and Pakistan (Devarajan and Shah, 2006).

1.2. What is budget support and why is its incidence increasing?

The World Bank defines budget support as regular development assistance provided directly to a government's budget in support of a medium-term programme, and which uses the government's own financial management systems and budget processes (Koeberle and Stavreski, 2006, pp. 1 and 5). Budget support is not earmarked for expenditure on specific activities or budget line items (Koeberle and Stavreski, 2006, pp. 1 and 5).[4] There may be an understanding between a donor and the government that the donor's funds will be spent on certain priority sectors, but this is not usually mandated. Although spending is not earmarked, the support is rarely completely untied. For example, the support may be conditional on performance indicators being met or the partner government developing a certain policy, and to this effect the partner government may need to participate in policy dialogue and receive technical assistance (DFID, 2007b, p. 1).

In general terms, a donor's decision to provide its assistance through budget support is usually motivated by two fundamental drivers: first, to improve development outcomes and, second, to improve the effectiveness of aid delivery (DFID, 2004, p. 1). With respect to the first, development outcomes are dependent on public spending to improve public services such as health and education, and public spending depends on the government's budget process. By supplementing a government's budget with foreign-provided funds, more funds are available for public spending. Second, and partly in response to the negative impacts of past policies of conditionality and structural adjustment (Stiglitz, 1998; Wade, 2001), donors provide budget support to reduce strain on partner government systems, harmonise donor activities behind the partner government's own policies and priorities, and empower rather than impose conditions on partner governments.

In practical terms, as rich countries are called upon by the United Nations to increase their aid spending to 0.7% of gross national product,[5] donors need to seek new aid modalities to facilitate the "scaling up" of assistance (Koeberle, Stavreski and Walliser, 2006, p. xv). Donors need to find mechanisms that can deliver greater amounts of aid more effectively and without a commensurate increase in administrative costs. Budget support provides an appealing option to provide significant funds without needing to manage large contracts and implement projects.

Inherent in both of the two drivers of budget support above is the objective of promoting accountability (DFID, 2004, p. 1) and it is to this nebulous concept that we now turn.

2. Budget support and accountability in a decentralised environment

2.1. What is accountability?

"Accountability" can be defined in a host of different ways but will be used for the purposes of this article to refer to how people can hold their political representatives responsible for the way in which their decisions and activities impact upon them (Blair, 2000, p. 24). Technically,

> accountability denotes a relationship between a bearer of a right or a legitimate claim and the agents or agencies responsible for fulfilling or respecting that right… [it] is a two-way relationship of power. It denotes the duty to be accountable in return for the delegation of a task, a power or a resource. (Lawson and Rakner, 2005, p. 9).

Accountability can be further understood by breaking the concept down into three aspects: *i)* transparency – that is, decisions are taken openly; *ii)* answerability, meaning that there is an obligation to justify decisions publicly; and *iii)* controllability, or the existence of a means to sanction decisions, or at least threaten to sanction them (Lawson and Rakner, 2005, p. 10; United Nations Capital Development Fund, 2005, p. 180).

Accountability operates in a number of different directions, involving different stakeholders. Direct accountability from decision makers to the public is usually referred to as "vertical accountability". Vertical accountability can be promoted from both the supply and demand sides. The supply side refers to institutional mechanisms, such as the provision of accurate and accessible budget information and processes to gather and action feedback from civil society organisations,[6] parliament, auditors or other external stakeholders (Fölscher, 2006b, p. 134). The demand side encompasses stakeholders external to the executive who request information and take action to hold the executive responsible (Fölscher, 2006b, p. 134), for example to ensure that budget allocations are transferred into development outcomes (Ablo and Reinikka, 1998, p. 30). The parliament, the media and civil society are key external stakeholders on the demand side of vertical accountability.

"Horizontal accountability" refers to the way in which indirect accountability between decision makers and the public is delegated among the arms of government (Lawson and Rakner, 2005, p. 10). For example, it can refer to relations: between the legislature, executive and judiciary; within these arms of government; and between elements such as the Cabinet, line agencies and other departments, auditors and special commissions (Lawson and Rakner, 2005, p. 10). It is also used for the purposes of this article to refer to accountability relations between different levels of government, such as the central and regional governments in Indonesia.[7]

2.1.1. External accountability in development assistance

Specifically in a development context, "external accountability"[8] usually refers to the accountability of partner governments to international entities such as multilateral institutions or donor governments, for example for the use of foreign funds. External accountability also encompasses lines of accountability between the donor government and the institutions and beneficiaries in the partner country – the targets of development assistance. From the perspective of domestic politics within the donor country, external accountability is in turn important so that the executive branch of the donor country can demonstrate vertical accountability to its own parliament and taxpayers, showing the effective use of public funds allocated for development assistance (De Renzio, 2007, p. 2).

In adopting the 2005 "Paris Declaration on Aid Effectiveness", donors resolved to reform the way aid is managed and delivered (High-Level Forum on Aid Effectiveness, 2005, paragraph 1). Accountability is integral as signatories reaffirmed their commitment to enhance both "donors' and partner countries' respective accountability to their citizens and parliaments for their development policies, strategies and performance" (paragraph 3[iii]). Under the Paris Declaration, donors should avoid "creating dedicated structures for day-to-day management and implementation of aid-financed projects and programmes" (paragraph 21) and rather should better co-ordinate their activities, commit to longer-term predictable assistance, align their assistance with partner government policies and use partner government systems (including budget and accounting mechanisms) as much as possible (paragraphs 3, 4 and 26).[9] The increasing popularity of delivery of development assistance through budget support reflects pledges made under the Paris Declaration.

2.1.2. Accountability is a nebulous concept

It must be recognised that the above discussion of accountability reflects a largely Western academic tradition that is not always clearly translated into a developing country context, particularly at the local level. Accountability is frequently used in the development context by partner countries, but different meanings are often intended. In developing countries, the term is often used to refer to financial transparency or visibility of decision making, and people may consider the term from the perspective of a number of different traditions (Lawson and Rakner, 2005, p. 20).

For example, leaders at the village level in Indonesia may justify decisions based on local notions of justice and morality, taking into account religious values and subsistence living, rather than more Western notions of reasonableness, consistency and rationality (Lawson and Rakner, 2005, p. 20). Many Indonesians have varied expectations of the restraints on their leaders and representatives, and in practice there may be considerable overlap between village institutions of government as one leader may take multiple roles, reducing the perception of balancing power (World Bank, 2008a).

> Using the … concepts of [transparency, answerability and controllability] to capture the experience of accountability locally is like trying to nail jelly to the wall; the concepts pin down the reality with great difficulty. Reality at local level is a fluid field of interpenetrating institutions and actors, informed by co-mingling cultures of accountability which place rather loose, and not always consistent, restraints on the actions of leaders. (Lawson and Rakner, 2005, p. 20).

2.1.3. Why is the promotion of accountability important and not automatic?

There are sound reasons why signatories to the Paris Declaration have agreed to the promotion of accountability as being an integral part of development assistance. Vertical accountability between a partner government and its citizens is an important precursor to country ownership of development programmes. Country ownership has been found to be a key determinant of the sustainability of reforms and to discourage misappropriation of funds, for example through corruption (Mfunwa, 2006, p. 8; De Renzio, 2007).

However, the complex nature of different accountabilities outlined above means that the process of promoting accountability is not always as linear as the commitment to enhance donors' and partner countries' respective accountability to their citizens and parliament suggests (DFID, 2007a, p. 57). For example, external accountability can undermine vertical accountability. Accountability to a donor country's parliament and taxpayers may reduce the donor's and partner government's accountability to the beneficiaries in the partner country.[10] This can result in detrimental development practices – for example, donor countries may prefer to: provide more funding for avian influenza and HIV/AIDS which may threaten their own interests more than basic health care; focus on short-term highly visible outcomes such as media-friendly vaccination programmes that bypass the local health system needed to sustain such programmes in the longer term; or provide assistance conditional on the use of parallel management and reporting systems to ensure donor government control over the use of funds (De Renzio, 2007).[11]

Accordingly, the development community – in aiming to promote "accountability" – must tread carefully through the minefield of competing and complex concepts and lines of accountability to make sure that its actions actually do promote sustainable development outcomes.[12]

2.2. Accountability in a decentralised environment

One way that partner governments attempt to improve vertical accountability is by decentralising government functions. Decentralisation is the empowering of local governments and represents "a massive reorganisation of the state" (Alicias *et al.*, 2007, pp. 4, 5). The main premise of decentralisation is that "by building popular participation and accountability into local governance, government at the local level will become more responsive to citizen desires and more effective in service delivery" (Blair, 2000, p. 21). To be successful, decentralisation requires that local-level public servants be held accountable to locally elected representatives who are in turn accountable to the public (Blair, 2000, p. 21).

Free and fair elections are the most direct way to ensure that representatives are responsive to the public. Since the advent of the decentralisation policy in Indonesia, there have been over 350 direct elections for local representatives. Added to the very high voter turnout rates, more Indonesians have voted in more elections than citizens in any other democratic country in the past decade.[13]

However, elections alone are not sufficient to ensure vertical accountability due to the duration between elections and the broad policy issues that are the subjects of campaigns. Governments must be held to account far more regularly than each time there is an election. On the demand side, accountability requires regular mechanisms for the public to express preferences and views on policies and activities, and for the public to monitor government processes and outcomes to ensure the effectiveness of government spending and clean government (Blair, 2000, p. 27). Vertical accountability between governments and

their citizens has been found to be more likely not only where the budgeting process is transparent but also where there are strong checks and balances built into the system of government, where citizens participate in government, and where the relationship between civil society and parliament is constructive (Mfunwa, 2006, p. 8).

Here, the capacity of civil society and parliaments to monitor and advocate during a transparent budget process and implementation of that budget is crucial. Accountabilities will also be promoted by the existence and capacity of other stakeholders such as political parties and the media, and by the use of public meetings, polls and opinion surveys, and formal complaint processes (Blair, 2000, p. 30). The existence of local government makes it easier for vertical accountabilities to operate, as citizens and other stakeholders are more proximate to their representatives.

Although research in developing countries indicates that, other than elections, political parties, civil society and the media are the most important pressure groups for promoting the accountability of representatives to the people (Blair, 2000, p. 31), the dichotomy between supply-side and demand-side accountability factors is somewhat circular. While a strong civil society will encourage local governments to be more accountable by facilitating the mobilisation of community voice, the existence of an effective government that is worth lobbying is often a precursor for the development of vibrant pressure groups (United Nations Capital Development Fund, 2005, p. 186).

In a decentralised environment, local governments represent another link in the accountability chain (United Nations Capital Development Fund, 2005, p. 195). Although local governments have considerable powers and authorities in many decentralised countries, local governments remain accountable to the central government for adherence to its priorities, policies and laws. To this end, information must flow upwards, yet accountability between public servants and elected officials at the regional level will be higher where public servants are not predominantly answerable to the central agency (Blair, 2000, p. 27). Accordingly, decentralisation presents opportunities for vertical accountability but considerable challenges for horizontal accountability, which will be discussed further in the Indonesian context in Section 4.

2.3. Budget support and impacts on accountability

As discussed above, budget support in theory promotes the achievement of pledges made under the Paris Declaration to enhance accountability. In terms of vertical accountability, budget support brings foreign-provided funds under the control of national stakeholders: both the government, which receives and controls the funds, and the population, which may indirectly control the funds via political mechanisms including scrutiny of the budget process, elections and the other mechanisms mentioned above (DFID, 2007c, p. 1). In this way, providing assistance via budget support should help to ensure that partner countries assume ownership and that development assistance reflects national objectives rather than donors' choice of projects (DFID, 2004, p. 6).

Providing budget support should also improve horizontal accountability relationships within a partner government. For example, rather than donors working directly with line ministries in relation to projects that may impact negatively on power dynamics between ministries and reduce policy co-ordination, the ministry of finance usually takes a more central role in co-ordinating development assistance through budget support and implementing country policies. Line ministries' accountability to the ministry of finance

would increase rather than their accountability to individual donors (Koeberle and Stavreski, 2006, p. 14). In time, policy co-ordination and management within partner governments may improve as a result of budget support provision.[14]

Demonstrating external accountability between the partner government and the donor for use of that donor's funds generally relies on the credibility and transparency of the partner government's budget and auditing processes.[15] Where a partner government has weak financial management and accountability systems, there is a greater fiduciary risk that development assistance will be misappropriated, and donors may be more reluctant to provide budget support. However, rather than setting up parallel systems to manage donor-funded projects, in some circumstances donors many provide technical assistance to accompany the provision of budget support to strengthen the accountability of public financial management systems, for example in transparency and reporting standards (DFID, 2007b, p. 4; DFID, 2004, p. 6; Koeberle and Stavreski, 2006, p. 16).

The United Kingdom Department for International Development (DFID) has evaluated a number of budget support programmes and found that budget support has at times made concrete improvements to accountability. For example, in Mozambique published agreements and joint performance frameworks were agreed between donors and the government and were used by parliament to evaluate the performance of both the government and the donor against their respective agreed commitments, boosting both vertical and external accountabilities (DFID, 2007c, p. 5).

Accordingly, budget support can not only reduce the negative impacts of the tension between external and vertical accountabilities described above, but also promote improvements in domestic vertical and horizontal accountabilities. How this may play out in the context of Indonesia's decentralised environment will be explored below.

3. Indonesia's public financial management and the framework for budget support

3.1. Indonesia's own brand of decentralisation

Indonesia's population of over 230 million people is spread over a vast resource-rich archipelago of over 17 000 islands. Regional disparities are large, with huge variations in population density, language, culture, poverty levels and access to resources. Indonesia has undergone significant change since it was severely impacted upon by the Asian Financial Crisis beginning in 1996 and culminating in the fall of President Soeharto in 1998. Soeharto's immediate successor, President Habibi, announced the decentralisation policy as an ambitious agenda to reform Indonesia's political and fiscal management.[16] Considerable fiscal and political power has been transferred from the central government to Indonesia's 440 regions, known as *kabupaten* and *kota*.

The decision to decentralise reflected the central government's desire to stem the rising resentment of outer regions that wanted self-determination, most notably the resource-rich provinces of Aceh and Papua and the former East Timor, as well as the rise of democratic sentiment following the fall of Soeharto (Fitriani *et al*., 2005, p. 60). Another significant rationale for decentralisation was to improve vertical accountability by bringing government closer to the people, enabling Indonesia's diverse and disparate population to have a say over the policies that impact upon them. The more direct line of accountability between local governments and their constituents was expected to improve local service delivery, particularly in infrastructure development, health and education.[17] This is in sharp contrast

to the Soeharto years, where power was concentrated in Jakarta and the central government was heavily criticised for taking considerable resource profits from the regions for the benefit of Java, the most densely populated island that houses the capital city.

Decentralisation is primarily established under two central government laws: the first on regional governance which focuses on political and administrative decentralisation[18] including expenditure responsibilities and accountabilities, and the second on fiscal balance which governs the distribution of revenues to the regions.[19] Under the Law on Regional Governance, regional governments have responsibility for a range of public services including education, health, public infrastructure, agriculture, industry and trade, investment, the environment, land, labour and transport.[20]

Under the Law on Fiscal Balance, regions are responsible for managing their own public finances.[21] On the revenue side, regional governments have the power to impose taxes and service fees. In addition, they receive from the central government a portion of revenues from central-level taxes, for example for natural resources, and various grants. Transfers from the central government aim to reduce fiscal disparities between the regions – resulting, for example, from variations in natural resource wealth – and have significant accountability implications which will be explored below (World Bank, 2007, p. 119). Provincial and regional governments now manage over a third of Indonesia's total public expenditure (World Bank, 2007, p. 116).

Specifically with respect to accountability mechanisms, decentralisation has shifted accountability to "a local political accountability model" (Fitriani *et al.*, 2005, p. 61). The head of the region is elected and is accountable to the regional parliament, and the regional executive and parliament should act in partnership.[22] The regional parliament approves the regional budgets as well as local laws and regulations that regulate village-region relations, including accountability mechanisms (Fitriani *et al.*, 2005, p. 61). How accountabilities play out in practice in local-level budget processes will be discussed below in relation to one province of Indonesia, Gorontalo. But first, the national and regional budget processes will be briefly canvassed to place Gorontalo's financial management system into context.

3.2. Indonesian budget process

3.2.1. Central-level budget process

Indonesia's budget operates on a calendar year basis. Between January and April, the Ministry of Planning issues the government's annual work plan, in line with its five-year Medium-Term Development Plan. Budget formulation is based on this annual work plan.[23] The annual work plan and the Ministry of Finance's fiscal policy statement are deliberated by the National Parliament in May. Agreements achieved in the deliberations, Cabinet pronouncements of general budget priorities, and the Ministry of Finance-issued indicative budget ceilings are used by the line ministries and agencies to prepare their annual budget proposals. The parliamentary commissions consider their relevant ministries' and agencies' budget proposals in June, and results are submitted to the Ministry of Finance in July. Around August, the Cabinet submits the draft state budget to the Parliament for deliberation and approval.[24] The Parliament approves the budget by unit of organisation, type of expenditure, function, programme and activity.[25] The President issues a regulation on budget details in November, and ministries and agencies revise their annual work plans and prepare their budget execution documents in December (World Bank, 2007, p. 101).

Indonesia is implementing three key reforms in relation to the central budget process: unifying the budget so that previously excluded items are included, such as subsidies; implementing performance-based budgeting; and commencing medium-term expenditure frameworks.[26] However, the budget system still has many flaws. To date, the budget formulation process has focused more on inputs than on implementing the government's political priorities, and the system is highly inflexible (World Bank, 2007, p. 102). Accountability mechanisms remain weak in practice, and the audit process is complex and not independent. For example, the Parliament has a limited role in accountability (World Bank, 2007, p. 106), and its deliberations of the budget focus on approving or rejecting individual line items and not whether the budget translates the government's political priorities into outcomes for citizens.

3.2.2. Regional-level budget process

Following decentralisation, the central government passed a number of regulations governing the regional budget process.[27] Regional governments must undertake performance budgeting and develop medium-term expenditure frameworks. Participatory planning and community input are mandated parts of the budget process. Community consultation meetings, *musrenbang*, have been held in relation to local planning processes since the Soeharto years, but have now been mandated by regulation.[28] In the development planning process, *musrenbang* are typically held in January each year at the village level and in April or May at the regional level. *Musrenbang* aim to be a deliberative forum where government and non-government stakeholders express aspirations and negotiate differences in order to reach consensus on identifying and prioritising community development policies (USAID, 2008; problems with the process are also canvassed on pp. 5-6). The regional government should use the outcomes from the *musrenbang* process along with sectoral plans to develop the region's development plan along with potential funding sources. The plan is considered in the provincial-level *musrenbang* which in turn feeds into the provincial development plan, and ultimately the national budget process (SMERU Institute, 2008, p. 35).

Budgets are being unified with the inclusion of more revenue sources in the budget. Enhancing vertical accountability and transparency, all revenue from the central government (other than deconcentrated funds)[29] as well as own-source revenue must be included in regional budgets, and all use of the funds must be justified to the regional parliaments.

In reality, an average of less than 10% of regional revenue comes from regional taxes and service fees.[30] Most of the regional governments' revenue comes from the central government and is designed to reduce regional wealth disparities. This "balancing fund" is made up of three parts: *i)* shared revenue which includes property and income taxes imposed by the central government and revenue from natural resources; *ii)* a general allocation grant (not earmarked); and *iii)* special allocation grants (earmarked to finance areas of national priority) (World Bank, 2007, p. 119). The domestic accountability structures applying to grants are canvassed below, to help understand the local conditions into which budget support would be provided.

Despite significant reforms, the World Bank states that, in practice, the regional budget process is not yet transparent or accountable. A joint central government and World Bank study to measure the performance of the average region against the standards set by law showed that less than half of the regions meet nine standards in finance management,

ranging from planning and budgeting to reporting and external oversight (World Bank, 2007, p. 126). Some of the findings of the study can be explained through the lens of the three aspects of accountability described in Section 2 above.

First, in relation to transparency, the required reporting of financial information from the regions to the central government is irregular and incomplete, let alone disclosure of fiscal information to the public (World Bank, 2007, p. 126). This brings risks of financial mismanagement ranging from corruption, inefficient use of fiscal resources and misallocation of central government-provided funds (World Bank, 2007, p. 126).

Second, with respect to answerability, although performance-based budgeting does have the potential to improve accountability for results to regional populations on the expenditure side, to date implementation has been weak due to limited technical capacity of regional governments and conflicting regulations and directions from central ministries (World Bank, 2008b, p. 75). The cumbersome budget processes described above result in delays and uncertainties for regional governments.The central Ministry of Home Affairs must authorise provincial budgets, and provincial governments in turn must authorise district budgets, which delays regional government disbursements.[31]

Revenues from the central government tend to come late in the fiscal year and are often unpredictable and not fully expensed.[32] This has impacts on regional governments which have to review their spending plans and delay programme implementation. Expecting central government transfers, regional governments rarely use own-sourced revenue on areas of priority, such as health and education (World Bank, 2007, p. 128). The result is that the participatory and performance-based regional budgeting process does not effectively translate into development outcomes for citizens.

Third, in relation to controllability, the State Audit Agency only regularly audits around 60% of regional governments partly due to lack of resources. Where regions are audited, the reports are submitted to the regional parliaments but significantly not disclosed to the public. Accordingly, it is not surprising that audit findings are rarely followed up and that corrupt practices are not punished (World Bank, 2007, p. 127). The study sponsored by the World Bank recommends that "financial information on budgetary performance and allocations, and the enforcement of accounting standards, would enhance accountability mechanisms inside local governments and across levels of government" (World Bank, 2007, p. 127).

3.3. Granting mechanisms

Having canvassed the central and regional budget processes in broad terms, the different mechanisms to allocate grants to regional governments will be outlined, with particular focus on the new on-granting mechanism that would be used to provide budget support.

3.3.1. Existing granting mechanisms

The un-earmarked general allocation grant mentioned above has two components: a lump sum which covers public service wages, and a sum calculated on an individual region level to cover the difference between fiscal capacity and expenditure needs. This grant will not be considered in great detail, as the experience with implementing the special allocation grant has more relevance for explaining the new on-granting mechanism. Suffice to say that the general allocation grant's lump-sum component serves to reduce the vertical accountability of regional governments to their citizens because priorities are not set with a participatory process, and that it reduces the incentive for regional governments

to increase efficiency of the regional governments (for example, an increase in public service efficiency bringing down salary costs would reduce the lump sum received by that region) (World Bank, 2007, pp. 120-121).

Special allocation grants are usually earmarked by the central government for health, education, infrastructure development, local industry or the environment. Funds are provided from the central government budget and included in regional budgets. Regions must also provide matching funding equivalent to at least 10% of the grants to provide for operational costs.[33] The amount of the special allocation grant is determined by the central government by considering the overall fiscal position of a region, its level of underdevelopment, conflict and natural resources, plus criteria set by the relevant central government ministries.[34] The impacts on accountability of the special allocation grants will be taken up in Section 4 because they are particularly relevant to an attempt to predict the impact on accountabilities of the new on-granting mechanism.

Not included in regional budgets but impacting upon regional development spending are deconcentration funds. These funds are provided directly by central line agencies to their counterpart sectoral agencies at the regional level. These funds are generally decreasing in significance and will soon be channelled through general allocation grants (World Bank, 2007, p. 125); however, they remain a significant source of funding in Gorontalo, and the impact of these funds on accountabilities will also be discussed in Section 4.

3.3.2. New on-granting mechanism for budget support

The on-granting mechanism recently established by the Indonesian government must be used for all donor funds, including budget support, being provided to regional governments. Given that, under decentralisation, it is now regional governments that are responsible for policies that have the most impact on poverty, including service delivery, many donors including Australia are looking to target their assistance to the regional level. Even though Indonesia is now categorised as a middle-income developing country, there remain huge disparities in wealth across the country, with some provinces' poverty levels at low-income developing country levels (Commonwealth of Australia, 2008, pp. 2-3). Accordingly, donors are able to use the on-granting mechanism to target their aid to the poorest areas while supporting the decentralisation process.[35]

Although all the on-granting regulations have not yet been tested in practice, the process on the face of the regulations will be outlined.[36] Under the current regulations, two agreements must be negotiated before funds can be on-granted, establishing two lines of accountability. The first agreement is between the central government and the donor, and the second between the central government and the relevant regional government.[37]

***a)* The agreement between the central government and the donor.** The first step is to select a proposal for development activities using foreign funds. A regional government can submit a proposal to the central Ministry of Planning.[38] A proposal must relate to activities to improve governance functions or the provision of basic services, to protect natural or cultural resources, to support research and technology and/or to provide humanitarian assistance.[39] The Ministry of Planning evaluates the proposal in terms of the President's Plan of Priorities for Foreign Loans and Grants (although exactly how this Plan is formulated is unspecified) and the Medium-Term Development Plan (the central government's five-year development plan).[40]

The Minister of Finance should then approach foreign donors with selected proposals.[41] Where commitments are made, the relevant regional government prepares an activity plan.[42] After all the preparations are complete – including finalising monitoring and evaluation indicators, baseline data, matching grant allocations, any necessary land acquisitions and project management plans – the agreement between the Minister of Finance, in consultation with the Ministry of Planning and the Department of Foreign Affairs, and the donor is negotiated.[43] The foreign grant and matching funds must be included in the national budget or, if it has already been passed, in an amendment[44] as well as in the region's budget.[45]

***b)* The agreement between the central government and the regional government.** The agreement between the central government and the relevant regional government must be finalised within two months of the head agreement.[46] This second agreement must specify the purpose, amount, source and donor of the grant, any conditions, and the requirements for reporting and monitoring of the grant.[47] As the grant and matching funds must be included in the region's budget, reporting must mirror the reporting for all other government finances.[48] The money flows first from the donor to the Ministry of Finance, and then the Ministry of Finance on-grants the funds to the region.[49] The central government can cancel the grant if there is a breach of any provision in the agreements.[50]

The regulations mandate that the receipt of the grant must be managed and implemented transparently and accountably through the regional budget process.[51] The regional-level agreement must be provided to the Ministry of Finance, the Ministry of Planning and the financial auditors.[52] The regional government is also required to report to the central government quarterly about the progress of the activities and expenditure of the grant.[53] The central government is to conduct quarterly monitoring and evaluation of the use of the funds, the progress of activities and compliance with the agreements.[54] Internal and external monitoring institutions can monitor the implementation of the grant.[55] Although details are not given about how this oversight could be done, the Minister of Finance is to publish information about foreign-funded grants including the amount, type and source of grants, any conditions imposed, reporting and oversight requirements, rights and responsibilities of the grantor and grantee, and any sanctions included in the agreements.[56] It is not specified in the regulations, however, how the public can access this information.[57]

How the on-granting mechanism may work in practice remains untested.[58] For example, the regulations do not clarify horizontal accountabilities between the Ministry of Finance and the sectoral agencies. However, given donor interest in supporting decentralisation, targeting regional inequities and moving to donor support modalities, the use of the on-granting mechanism is likely to become very significant.

4. How might the on-granting mechanism impact on accountabilities in Gorontalo?

In light of the considerable financial information available on Gorontalo and donor interest in providing budget support to regions within the province, this article will analyse Gorontalo's public financial management structures. The impacts on accountabilities of existing grant mechanisms will be investigated, to raise issues relevant for the implementation of the new on-granting mechanism.

4.1. Gorontalo and the provision of budget support

Gorontalo is a newly established province[59] consisting of six regions in the northeast of the island of Sulawesi. Gorontalo was the poorest area in Indonesia but, after it was established as a separate province, the additional resources received from central government general allocation grants and deconcentrated spending by line ministries have raised income levels. Nevertheless, Gorontalo has the third-lowest per capita gross regional domestic product in Indonesia, with public service delivery and socio-economic indicators continuing to be weak (World Bank, 2008b, pp. 2, 3, 19).[60]

Despite this situation, Gorontalo has made significant progress in terms of public financial management reforms which make it a popular contender for receipt of development assistance through budget support. Reforms include streamlining the bureaucracy and improving institutional capacity (World Bank, 2008b, p. 8). Some regions in Gorontalo have made improvements to budget transparency, have issued regulations on access to information and have established one-stop government service offices.[61]

As Gorontalo offers significant lessons learned for other provinces, it has been the subject of a World Bank public expenditure analysis (World Bank, 2008b). Gorontalo performs well in terms of public financial management relative to other provinces, although its constituent regions do not rate quite as highly, largely due to lack of capacity (World Bank, 2008b, pp. 72-73). Nonetheless, the World Bank analysis found that the regions in Gorontalo perform well in reporting, auditing and supervision, partly due to strong public expenditure capacity and monitoring at the provincial level (World Bank, 2008b, p. 8).

Given its significant poverty levels but progressive government, Gorontalo is a likely contender for trial budget support programmes. A pilot programme being considered by several donors would aim to improve the quality of public service delivery and public financial management of selected regions by providing incentives to regional governments. Budget support would be provided via the on-granting mechanism to high-performing regional governments where certain additional improvements in financial management performance are achieved. The provision of technical assistance would also be considered to support implementation of the reforms.

4.1.1. Existing public financial management and accountability structures in Gorontalo

Gorontalo's regional governments have not yet provided quality development outcomes for their citizens. The regions tend to run budget surpluses, and per capita expenditure is well below the national average (World Bank, 2008b, p. 34). Further reducing spending on public services and other development objectives, one-third of the money spent is spent on government administration. Spending on education has decreased, as will be discussed below, but remains the second largest item of expenditure at 20% of spending, followed by infrastructure at around 15% (World Bank, 2008b, p. 36). Of revenue that is included in regional budgets, over 80% consists of general allocation grants (World Bank, 2008b, p. 22). Special allocation grants to Gorontalo, making up about 10% of regional budgets, have primarily been used to finance education and health programmes and the construction of roads (World Bank, 2008b, p. 26). However, not included in the budget is a particularly high level of deconcentrated funds received by regional line agencies directly from their central government counterparts.

Deconcentrated spending grew from 24% of regional spending in 2002 to 60% in 2006 (World Bank, 2008b, p. 34) and now represents the sixth-highest figure in the country (World Bank, 2008b, p. 41). Most is spent on education, infrastructure, health and agriculture (World Bank, 2008b, p. 42). The high level of deconcentrated spending has a number of impacts. First, central line agencies play the major role in determining spending priorities in Gorontalo. Second, although regional budgets have been increasing, regions are spending an increasing percentage on government administration and a decreasing percentage on social services, particularly education, reflecting the fact that these funds come from the separate pool of deconcentrated funds (World Bank, 2008b, p. 4). For example, 35% of regional expenditure was spent on education in 2002, but in 2006 this percentage had decreased to around 27%, reflecting a 300% increase in deconcentrated spending on education during that time period (World Bank, 2008b, pp. 36, 50). Accordingly, Gorontalo's education sector now relies on central government funding for three-fifths of its education spending (World Bank, 2008b, p. 50).[62] Third, and most significantly, high levels of deconcentrated funds do not promote accountability as they are not included in the regional budget planning and accountability processes, which provides little incentive to increase regional-level leadership of sectors crucial for development and poverty reduction.[63]

With respect to the remaining revenue sources that must be reflected in regional budgets, Gorontalo has implemented a number of reforms in its budgeting process. In line with the nationally mandated regional planning system,[64] regional governments must draft long-term (20 years), medium-term (five years) and annual plans (World Bank, 2008b, p. 74). Performance-based budgeting, discussed above, was initiated in Gorontalo in 2003 (World Bank, 2008b, p. 76). In addition to audits by the State Audit Agency,[65] Gorontalo implements its own comprehensive audit procedures at the provincial and regional levels.[66]

Gorontalo's participatory approach to its budget formulation process has significant vertical accountability benefits. In addition to the series of *musrenbang* starting at the village level, feeding into the regional level and then the provincial-level planning processes, the parliament also conducts a community consultation process called *jaring asmara*. Another notable reform in Gorontalo is the holding of talk shows broadcast on public radio hosted by regional and provincial government officials who talk with citizens. However, although significant levels of consensus are reached on developing the short-term development plan and government priorities, the translation of these priorities into realistic budget allocations remains weak, due to the lack of technical capacity of local government officials (World Bank, 2008b, p. 75).

4.1.2. Special allocation grants and potential on-granting impacts on accountabilities

Although there is no available research that specifically analyses the impact on accountabilities in Gorontalo of special allocation grants, described in sub-Section 3.3.1 above, research across Indonesia helps to raise issues that may point to limited positive accountability impacts and effectiveness of the on-granting mechanism.

In theory, the special allocation grants could improve accountability by shifting the responsibility for implementing the activities funded by the special allocation grants to the regional level, and therefore closer to citizens. Co-ordination should be improved, as regional governments must form an integrated team to manage the planning, implementation, reporting and monitoring of activities and ensure that they do not overlap with other development programmes (SMERU Institute, 2008, p. 14).[67] Promoting transparency, the regional executive should also issue a budget implementation statement for the special

allocation grants (SMERU Institute, 2008, p. 14). However, despite these regulatory requirements and significantly for the new on-granting mechanism, in practice the special allocation grants can have negative implications for accountability.

***a)* Lack of policy co-ordination and local ownership of priority sectors.** There is little horizontal accountability or policy coherence in relation to how special allocation grant funds are allocated. As a result, the funds tend to be scattered across many sectors and attempt to serve a variety of purposes, from general poverty-reduction activities to the achievement of specific standards of minimum service (World Bank, 2007, p. 123; SMERU Institute, 2008, p. iv).

Although regions are empowered by legislation to submit proposals for special allocation grant funds, regions in reality have little input into the allocation of special grants. Proposals that may be submitted by regional governments only relate to the overall special allocation grant for that region; they cannot propose specific activities (SMERU Institute, 2008, p. 19) and, in any event, regions would have limited ability to develop proposals before they know the amount of their allocation. A provincial government official stated that regions "have little influence over DAK [special allocation grant] allocations, as these are pre-determined at the central level" (World Bank, 2008b, p. 68). Others say that, even where proposals are sent to central line agencies, there are no mechanisms in place to consider them (SMERU Institute, 2008, p. 10). Central government officials have said that the bottom-up mechanism of proposals being received from regional governments was trialled, but the proposals were overly ambitious and poorly justified, so the central government reverted to the top-down approach where the grant allocations are centrally determined (SMERU Institute, 2008, p. 37). Despite this centralised approach, the Ministry of Planning has found that special allocation grant-funded activities have rarely conformed to the annual government work plan (although this situation is reported to be improving; SMERU Institute, 2008, p. 12).

It could be predicted that the weakness of policy co-ordination evident at both the central and regional level with respect to the special allocation grant and the lack of regional government ownership are likely to cause similar problems for the accountability of the on-granting mechanism. Proposals relating to the on-granting mechanism could be similarly ignored and the process could become centrally dominated.

***b)* Lack of transparency.** Other government officials state that the process of allocating funds is not transparent[68] and that regions lobby Jakarta to receive larger special allocation grants (SMERU Institute, 2008, pp. iv, 36). Bargaining between central agencies and regional government officials is said to occur. One region even admits to hiring a company to lobby Jakarta for the special allocation grant in the maritime affairs and fisheries sector in return for a fee equivalent to the value of 10% of the grant allocated (SMERU Institute, 2008, p. 39). Parliamentarians are also said to broker allocation deals in the interests of their electorates (SMERU Institute, 2008, p. 37). Given the power of the central government to determine which regions receive what foreign funds and to cancel grants made under the on-granting mechanism, and given the general lack of transparency in the budget process (discussed in sub-Section 3.2.2 above), the avenues for lobbying and corruption are potentially even greater than is reportedly the case for the special allocation grants. As an integral component of accountability, lack of transparency will have negative implications for accountability.

***c)* Undermining the aims of decentralisation.** Despite the provision of substantial special allocation grants to certain sectors, the expenditure and development outcomes achieved by regional governments in those sectors continue to be weak (SMERU Institute, 2008, p. 34). As the number of sectors to which the grants have been provided have increased in line with expanding development priorities of the central government, the regions have correspondingly lost authority in those sectors as they continue to be fiscally dependent on central government grants. This has had negative implications for the progress of the decentralisation policy and regional governments' vertical accountability for results to their citizens (SMERU Institute, 2008, p. 34).

Further restraining vertical accountability gains of decentralisation, the authority of regional governments could be reduced further under the on-granting mechanism as they have considerably less control over the allocation of funds, which are essentially agreed between the donor and the central government. The President's plan of priorities is set at the central level, but it is at the regional level that policies and programmes are implemented. This disconnect would reduce regional government ownership of the policies, impacting negatively on accountabilities and development outcomes (Alonso *et al.*, 2006, p. 168). This problem may be magnified in Gorontalo where the regional governments' ownership of policies in key sectors crucial for development has already been eroded by the high levels of deconcentrated funds. Adverse incentives and targeting are likely to result, as is apparent with existing grants as funds are not necessarily expended on areas set as high priorities by the regional government.

***d)* Creating further delays and administrative costs.** In relation to horizontal accountability, given the power struggles and weak co-ordination between agencies and the cumbersome budget process described above, delays frequently occur in the central government's allocation processes that can cause delays in regional budget processes (see sub-Section 3.2.2 above). Due to the complicated and opaque calculation process, it is difficult for regions to estimate the allocation they may receive, which means that regions often need to resubmit the agreed budget to the regional parliament, with significant resource implications (SMERU Institute, 2008, pp. 19, 23). Adding other layers to the approval process with the on-granting mechanism – namely the donor government's domestic budget process and the negotiation of the two agreements – would likely increase delays and problems for regional governments' planning and timely expenditure and programme implementation.

***e)* Lack of oversight and evaluation.** Reflecting the general lack of reporting of financial information discussed above (see sub-Section 3.2.2), regions rarely report back to the central government on their use of the special allocation funds (SMERU Institute, 2008, p. iv)[69] – even though this is required by regulation and the distribution of funds to regions can be deferred until a region fulfils its reporting requirements.[70] Where regions do send reports on activity progress to the Ministry of Finance, they rarely receive any feedback or follow up (SMERU Institute, 2008, p. 45). There is no reason to be confident that compliance with the reporting, monitoring and evaluation requirements for on-grant funded activities would be any better than for special allocation grants; in fact, demand from the central government for compliance with these regulations may be weaker, as the funds are not their own. This situation would support neither vertical nor horizontal accountabilities.

***f)* Undermining public financial management reforms.** With respect to vertical accountability, as the special allocation grant is part of a region's budget, the government must go through the regional budget process outlined above. The *musrenbang* process encourages community participation in the development process even though critics say that in practice the *musrenbang* tend to be elite-dominated and that women's voices in particular are often excluded (SMERU Institute, 2008, p. 35). More fundamentally, the determination of the special allocation grants is not linked to the *musrenbang* process, but rather to criteria stipulated by the central government (SMERU Institute, 2008, p. 35). Similarly, even though the on-granted funds should be managed in the same way as other on-budget funds, the central government dominated nature of the on-granting mechanism means that these funds and activities would essentially be outside the *musrenbang* process. This situation is particularly crucial for Gorontalo, a province that has made notable gains in community participation processes that risk being undermined by the on-granting mechanism.

5. Lessons for the provision of budget support to a regional government in Indonesia

5.1. *Ongoing understanding of local political, economic and social dynamics is crucial*

The above discussion of the complex nature of the accountabilities present in a decentralised environment indicates that it would be near impossible to predict how the delivery of development assistance through budget support would impact on the local accountability structures and political dynamics in Gorontalo without a thorough analysis of existing governance structures. Without this understanding, the provision of budget support could lack effectiveness, such as by not contributing to development outcomes with poor priority setting and policy co-ordination, or could inadvertently work to undermine functioning accountability structures, such as implementation of the decentralisation policy, budget reforms and community consultation mechanisms, or could promote avenues for corruption. Although some of these problems could be overcome with good design, others may require broader change, such as revisions to the on-granting mechanism.

It must also be recognised that provision of budget support to Indonesia would inevitably shift political balances of power, for example by increasing the power of the Ministry of Finance at the expense of the line ministries and decreasing incentives for the latter to be vertically accountable for poverty-reduction outcomes (Koeberle and Stavreski, 2006, p. 14). This imbalance could cause tensions between ministries, at least in the short term (Development Information Services, 2006, p. 108). Accordingly, analysis of local dynamics must continue after the provision of budget support has commenced in order to monitor impacts on accountabilities so that programme design can be adjusted where necessary to avoid negative impacts.

Recognising that budget support occurs in a political context, donors must also acknowledge that the context can change rapidly. As budget support uses the government's own systems, these programmes are clearly identified with the government of the day. In this way, the support can be politically vulnerable as the donor is closely identified with the government. Upon a change of administration, not only must the relationship of partnership and trust be rebuilt, but the donor or its programmes may be terminated as the new government stamps its own brand on popular development programmes (DFID, 2007c, p. 31, paragraph S57). This risk is heightened when donor

support has been publicly identified with a high-profile government programme.[71] Accordingly, donors should also consider alternative avenues of support, such as to civil society organisations.

5.2. *A relationship of trust should be developed between the donor and the regional government*

Budget support has been found to be more effective where there is a relationship of trust between representatives of the donor and the partner government (Mosley and Abrar, 2006, p. 311). Trust is encouraged from the experience of negotiating (Mosley and Abrar, 2006, p. 312). However, in the case of Indonesia's on-granting mechanism, the negotiation is two-fold – between the donor and the central government on the one hand, and between the central and local governments on the other – reducing the likelihood of the trust relationship developing between the donor and the recipient of the funds.

Further challenging the building of relationships of trust, the choices of regions to fund are always political (Devarajan and Shah, 2006, p. 387). Such choices may result in competition between regions[72] for on-granted funds, which may encourage regions to accelerate reforms in public financial management as has been achieved in Gorontalo. However, the choice of where to focus scarce development resources will likely reflect the political priorities of the central government and possibly even the donor country in preference to considering the relevant local dynamics and needs of target regions. Central-level co-ordination and determination of national priorities are clearly important, but donors should be mindful of these political dynamics and also seek to develop an effective relationship of trust directly with the partner government at the regional level.

5.3. *Lack of attention to the demand side is likely to limit accountability benefits*

Prior to a decision to design a programme to provide budget support, not only the supply side of the public financial management system should be analysed but attention must also be paid to analysis of the demand side.[73] Details of how citizens access and process information and express their voices must be researched and analysed. Making budget information publicly available does not mean that the information will automatically be accessed and analysed. It is important to provide support to develop the capacity of external stakeholders, such as the regional parliaments, the media or civil society more broadly, to access and analyse available information and to lobby and monitor implementation of government programmes (Development Information Services, 2006, p. 116).[74]

By placing so much support in government systems to provide budget support, it may be politically difficult for budget support donors to fund some civil society organisations or other stakeholders who could criticise the government and its budget process.[75] In this way, it is foreseeable that the desire to build trust between the partner government and the donor may actually discourage support for other elements that are vital to an accountable regional government budget process. However, without support to the demand side of vertical accountability, gains made on the supply side may not be capitalised upon to the full extent possible.

5.4. *Revenue-raising ability is also important*

Failing to adequately address the equitable and effective revenue-raising capacity of regions will also limit the benefits of any improvement in accountabilities brought by budget support. Providing foreign funds through the on-granting mechanism is likely to

exacerbate the existing disincentives for regions to source and collect their own revenues resulting from high levels of central government support leading to regional budget surpluses. This situation encourages regions to be fiscally dependent on funds from the central government or donors which, as discussed above, is contrary to the aims of decentralisation to make local government more accountable to its citizens.

"The exercise of citizen influence over state revenue and expenditure lies at the heart of effective democracy" (Moore, 1998, p. 85). Supplying funds by budget support may have the potential, when implemented in ideal circumstances, to promote accountability in spending priorities between the people and the government – certainly more so than donors directly funding projects and bypassing the government's own budget processes. However, governments should also be accountable to the people regarding the origin of the funds. By placing funds on budget, the source of revenue is made public and the government is required to disclose the source of funds provided through the on-granting mechanism. However, where a government derives revenue from development assistance, it is likely to have privileged information about the funds and how they are to be used, channelled and accounted for. Citizens may not have access to all this information, and the government can use its privileged position to control the policy agenda.

> Members of the legislature and the public have little opportunity to acquire or develop knowledge about public finance because so many decisions are taken in closed, privileged arenas where leading representatives of the state negotiate with major income providers (Moore, 1998, p. 98).[76]

Significantly, research indicates that on a continuum between revenue that is earned (for example, through imposing and collecting income taxes) and revenue that is unearned (for example, grants from donor countries), where most revenue comes from earned sources, the government is more likely to be accountable and responsive to the people (Moore, 1998, pp. 85, 94). This makes intuitive sense – people are more concerned about the effective use of their own money than someone else's, for example foreign donor funds. It follows that budget support programmes should include a strategy as to how regional governments will be able to overcome disincentives to raise this revenue themselves.

These arguments raising potential issues with budget support are far more significant where the amount of assistance provided is a high proportion of a regional government's budget, as the problems above are magnified. Yet even where funds provided through budget support would be a small percentage of a region's budget, donor governments should not only look to create incentives on the expenditure side, but should also assist partner governments to develop their capacity on the revenue side (Moore, 1998, p. 110). Poor people pay informal fees for many public services that would be more accountable if channelled through the formal tax system and the budget. This is where external accountabilities come into play, as donor-funded programmes to support revenue raising in developing countries could easily be misconstrued as increasing taxes on the poor – and therefore disadvantaging them – even though these revenues are more likely to be used for public services that should favour the poor.

It could be said that the extension of this argument is that all development assistance creates dependence at some level and should be ceased in favour of partner governments "going it alone". However, this article does not argue that developed countries should not assist developing countries. Huge inequalities in income across the world mandate the need for funds and technical assistance to flow from rich to poor countries. However, this

article has shown that budget support alone, while an improvement on project-based aid, will not necessarily have positive impacts on accountability and hence improve development outcomes. Gains in vertical accountabilities through budget support may be limited where corresponding attention is not paid to the development of regional government autonomy on the own-source revenue side. If this is taken seriously, it may have challenging consequences for donor countries that may need to take a more honest look at how the systems of international trade, labour mobility and incentives for foreign direct investment impact on the revenues of developing countries.

6. Conclusion

In theory, providing development assistance through budget support has the potential to improve accountabilities and to result in more sustainable development outcomes than is the case with more traditional project-based forms of aid. Policy co-ordination and ownership by the partner government should improve, with expenditure priorities set by partner governments rather than dictated by external accountability to donor countries. Vertical accountabilities, particularly in a decentralised country, should be strengthened as the partner government is directly responsible to citizens for expenditure outcomes.

However, the above examination of the provision of grants to the province of Gorontalo shows that the potential impact of budget support on accountabilities must be interpreted in the particular political and fiscal context of the target area, whether a country or a region of a country. In Gorontalo, it is foreseeable that funds provided through the on-granting mechanism, if they do not take its peculiarities into account, could undermine the region's initiatives in public financial management reform and authority over service delivery and revenue raising, thereby weakening the decentralisation process and vertical accountabilities.

Increasing accountability is not a straightforward aim, as choices to strengthen certain lines of accountability over others are political and must be deliberated in full consideration of all the relevant political and fiscal dynamics. Donors must not succumb to a decision to provide assistance via budget support just because it presents a simpler way to deliver more development funds without a commensurate increase in administrative costs, because evaluations of some examples of budget support have had positive impacts on accountabilities, or to assuage guilt over the inequalities of the global system. Accountabilities are highly political and context specific, and the provision of budget support must be carefully examined on a case-by-case basis.

As well as ensuring that no harm is done, context-specific analysis could be used to promote some positive impacts on accountabilities from providing budget support. However, there are inherent limitations in budget support programmes that donors must address in order to more effectively promote accountabilities. Donors may need to consider providing assistance in more politically sensitive areas. For example, robust support to civil society to challenge the government's financial management processes and assistance to improve regional governments' revenue collection capacity may need to complement budget support programmes in order to promote accountabilities and lead to the attainment of more sustainable development outcomes.

Notes

1. Many different terms are used to describe countries, including "poor", "Third World", "South" and "developing" on the one hand, and "rich", "First World", "West", "North" and "developed" on the other. This article will use the terms "developing" and "partner" countries. The first choice is not an endorsement of modernisation theory, nor any other. The second, used to refer to the recipient of foreign funds, reflects a movement in development circles away from post-colonial language to language denoting aims to reflect more equal relationships. It should also be noted that the concept and definition of development is subject to much debate, which is beyond the scope of this article. "Partner government" is used to refer to the recipient of foreign assistance and could be used to refer to the central or local level.
2. The recurrent budget captures ongoing revenues (such as taxes) and expenditures (such as wages and rent) necessary to keep the economy going.
3. The capital budget consists of the government's spending on non-recurring items such as infrastructure.
4. Contrast with a SWAP which provides budget support earmarked to activities in a particular sector.
5. International Conference on Financing for Development (Monterrey Consensus), Mexico (2002) at paragraph 42, although the target has been affirmed in many international agreements since it was first set by a United Nations General Assembly Resolution in 1970.
6. Civil society organisations can include non-government organisations, media, community-based groups, etc. Civil society is not inherently inclusive and representative and, just as occurs in developed countries, these groups can also represent narrow special interests in developing countries.
7. Indonesia has three main tiers of government: central level, provincial level and regional level (the latter called *kabupaten* and *kota*). Accountability between different levels of government also has aspects of vertical accountability, as decentralisation can boost or detract from the vertical accountability between the central or regional government on the one hand, and citizens on the other.
8. Sometimes called "upwards accountability", but this can be confusing in a decentralised environment so "external accountability" will be used.
9. Specifically, under the "Accra Agenda for Action" (Third High-Level Forum on Aid Effectiveness, 2-4 September 2008, paragraph 15[e]), donor members agreed to aim to channel 50% of assistance through partner countries' fiduciary systems.
10. Interesting empirical research indicates that the tension between accountability to a donor's country's constituents and partner country beneficiaries is affected by the quality of vertical accountability mechanisms **within** donor countries. These mechanisms have been found to be an important factor in the delivery of effective development assistance. Where political institutions are democratic and transparent in a donor country, the government tends to be more orientated to society's interests. This also extends to external interests – a donor country is also interested in stable, democratic and prosperous neighbours – so donors with strong domestic vertical accountability mechanisms are more likely to deliver quality development assistance. Poor development assistance is often blamed on pressures from narrow domestic interest groups such as the aid or trade industries. In a vibrant democracy of the donor country, the power of particular special interests groups is reduced, so improved democratic accountabilities tend to encourage more effective foreign development policies and priorities. See Faust, 2008, pp. 383-384.
11. One way to manage this last tension is to use joint monitoring and evaluation systems, led by the partner government but supported by technical assistance from the donor country. However, this presents further difficulties for budget support modalities, as the number of donors and the partner government contributing to a broader pool of budget funds make it hard to attribute a particular outcome to a particular donor government's funds.
12. It must be acknowledged that measuring the impact of development assistance on accountabilities and development outcomes is a hugely difficult task.
13. Indonesia is also one of the most electorally competitive countries in the world, evidenced by the fact that 43% of incumbents in provincial and regional elections lose their positions when running for re-election (MacIntyre and Ramage, 2008, p. 10).
14. Describing the horizontal accountability mechanisms promoted by budget support over other development assistance modalities: "Finance ministries should demand that sector ministries deliver sustainable development results, line ministries have an interest in receiving adequate

funds on a regular basis, supreme audit authorities monitor the proper use of public funds, and parliaments can hold governments accountable for delivering on their promises" (Koeberle and Stavreski, 2006, p. 21).

15. The Paris Declaration warns against the imposition of parallel systems, such as separate monitoring and evaluation systems (High-Level Forum on Aid Effectiveness, 2005, paragraphs 17 and 45). Also see Koeberle and Stavreski, 2006, p. 8.
16. Law No. 22 of 1999 on Regional Governance (later replaced with Law No. 32 of 2004) and Law No. 25 of 1999 on Fiscal Balance between Central and Regional Government (later replaced with Law No. 33 of 2004).
17. This has not been borne out in practice yet, but it is still early.
18. Administrative decentralisation is defined as "the transfer of power from the higher to lower hierarchy of the same organisation" (Alicias *et al.*, 2007, p. 60).
19. Law No. 32 of 2004 on Regional Governance and Law No. 33 of 2004 on Fiscal Balance.
20. Provincial governments have little power but do form a co-ordination role for regions in their jurisdiction.
21. Law No. 33 of 2004 on Fiscal Balance, Articles 4, 66, 67.
22. Law No. 22 of 1999 on Regional Governance, Article 16(2).
23. Law No. 25 of 2004 on National Development Planning Systems, Article 25; Law No. 17 of 2003 on State Finance, Article 12.
24. Law No. 17 of 2003 on State Finance, Article 15; World Bank, 2007, p. 100.
25. Law No. 17 of 2003 on State Finance, Article 15.
26. Law No. 17 of 2003 on State Finance.
27. The major regulations are outlined in World Bank, 2007, p. 125.
28. Law No. 25 of 2004 on National Development Planning Systems; the Ministry of Planning and the Ministry of Home Affairs issued Joint Circular No. 0259/M.PPN/I/2005.050/166/SJ on Technical Guidelines on the Organisation of Development Planning Community Consultative Meetings.
29. The central government continues to provide deconcentrated funds to regional governments but this is being phased out by law (Law No. 33 of 2004 on Fiscal Balance, Article 108). These funds will be instead channelled through the special allocation grants (World Bank, 2007, p. 123).
30. About half of this amount is lost to administrative costs (World Bank, 2007, p. 124). Most own-source revenue comes from hospitality and electricity taxes, and fees for building permits and use of health services and public markets (World Bank, 2007, p. 124).
31. Law No. 32 of 2004 on Regional Governance.
32. In fact regional governments tend to significantly underspend their budgets (and of the money spent, on average more than 30% is spent on government administrative costs as opposed to public services).
33. Law No. 33 of 2004 on Fiscal Balance, Article 41.
34. Law No. 32 of 2004 on Regional Governance and Law No. 33 of 2004 on Fiscal Balance; World Bank, 2008b, p. 26; SMERU Institute, 2008, p. 1.
35. Under the new country strategy agreed between Australia and Indonesia, development assistance will focus on regions in five of the poorest provinces (Commonwealth of Australia, 2008, p. 6).
36. The way the mechanism may work in practice may not follow the letter of the law.
37. Presidential Regulation No. 2 of 2006 on the Provision of Loans and Grants and On-granting.
38. Presidential Regulation No. 2 of 2006 on the Provision of Loans and Grants and On-granting, Article 7.
39. Ministry of Finance Regulation No. 168 of 2008 on Regional Grants, Article 10.
40. Presidential Regulation No. 2 of 2006 on the Provision of Loans and Grants and On-granting, Article 9 and Article 7 elucidation.
41. Presidential Regulation No. 2 of 2006 on the Provision of Loans and Grants and On-granting, Article 11. Or, where a region has a proposal which has received a funding commitment from a foreign donor, the regional government can submit the proposal to the Ministry of Finance requesting it be included in the regional activity plan (Article 16[2]).

42. Presidential Regulation No. 2 of 2006 on the Provision of Loans and Grants and On-granting, Article 11.
43. Presidential Regulation No. 2 of 2006 on the Provision of Loans and Grants and On-granting, Article 14 and its elucidation.
44. Presidential Regulation No. 2 of 2006 on the Provision of Loans and Grants and On-granting, Article 17.
45. Presidential Regulation No. 2 of 2006 on the Provision of Loans and Grants and On-granting, Article 18.
46. Presidential Regulation No. 2 of 2006 on the Provision of Loans and Grants and On-granting, Article 21.
47. Ministry of Finance Regulation No. 168 of 2008 on Regional Grants, Article 14.
48. Presidential Regulation No. 2 of 2006 on the Provision of Loans and Grants and On-granting, Article 22.
49. Details of the flow of funds are included in Ministry of Finance Regulation No. 168 of 2008 on Regional Grants and Ministry of Finance Regulation No. 169 of 2008 on the System for Channelling Grants to Regional Governments.
50. Ministry of Finance Regulation No. 168 of 2008 on Regional Grants, Article 22.
51. Ministry of Finance Regulation No. 168 of 2008 on Regional Grants, Article 18.
52. Ministry of Finance Regulation No. 168 of 2008 on Regional Grants, Articles 13, 14.
53. Presidential Regulation No. 2 of 2006 on the Provision of Loans and Grants and On-granting, Article 23; Ministry of Finance Regulation No. 168 of 2008 on Regional Grants, Article 25.
54. Presidential Regulation No. 2 of 2006 on the Provision of Loans and Grants and On-granting, Article 24.
55. Presidential Regulation No. 2 of 2006 on the Provision of Loans and Grants and On-granting, Article 25.
56. Presidential Regulation No. 2 of 2006 on the Provision of Loans and Grants and On-granting, Article 27; Ministry of Finance Regulation No. 168 of 2008 on Regional Grants, Articles 13, 14.
57. Notably, it is very hard for the public to access laws passed by most regional parliaments.
58. In 2007, the Minister of Finance established a new agency, the Directorate General of Fiscal Balance, with one of its tasks being to manage the on-granting mechanism. New regulations are progressively being issued by the Ministry of Finance to provide further clarification of the process.
59. Law No. 38 of 2000 Establishing Gorontalo as a New Province.
60. For example, junior secondary education enrolment rates in some regions are only 44% and the infant mortality rate is high at 77 deaths per 1 000 live births.
61. Interestingly and somewhat unusually for Indonesia, Gorontalo has a woman head of the regional planning department.
62. Similarly, health – like education, an area for regional government responsibility under decentralisation – is over 70% funded by deconcentrated spending (World Bank, 2008b, p. 65).
63. This percentage should decrease with these funds being channelled through special allocation grants, the relative importance of which is expected to increase from their current proportion of budgeted fiscal revenue of 10% (World Bank, 2008b, p. 23).
64. As decreed in Law No. 33 of 2004 on Fiscal Balance.
65. The provincial budget has been audited by the State Audit Agency every year since 2002 and the financial statement is published in the local press (World Bank, 2008b, p. 76).
66. Internal audits at the provincial and regional levels have revealed nearly 1 000 administrative cases regarding the misuse of budget funds or incorrect administrative procedures over five years. The majority of these cases were resolved at the provincial level, although only around 15% were followed up at the regional level (World Bank, 2008b, p. 79).
67. However, co-ordination in most regions is weak and management is dominated by the sectoral regional agencies, with the Regional Ministries of Planning playing a very limited role (SMERU Institute, 2008, p. 46).
68. Even to know what the real process is within the central government is very confusing. Officials from the Ministry of Finance, the Ministry of Planning, the Ministry of Home Affairs and sectoral agencies give different responses as to where power lies in this process. See interesting accounts in SMERU Institute, 2008, pp. 37-38.

69. Most regions do not provide their final budgets and execution reports to the central government on time (IMF, 2006, p. 23).

70. Law No. 33 of 2004 on Fiscal Balance, Article 102. Monitoring and evaluation for development activities implemented by regional governments generally are woefully inadequate. Particularly for the special allocation grants, neither the regional nor the central government allocates any budget for monitoring and evaluation. Regions are required to submit quarterly progress reports for the special allocation grant-funded activities to the central and provincial governments, but most do not do so (SMERU Institute, 2008, p. 44; Government Regulation No. 55 of 2005).

71. For example, the government of Indonesia is implementing a new National Programme for Community Empowerment, which is a programme that delivers annual block grants of USD 8 400 to the village level. The programme will gradually be "up-scaled" until it is provided to all of Indonesia's over 70 000 villages by 2010. The grants are reflected in the regional-level budget but the activities are determined through a competitive proposal process decided at the sub-district level. In the initial stages, donors who wish to assist the programme can earmark their support, for example to assist particular districts, but by 2010 all support must be un-earmarked and on budget. The Programme is closely associated with the current President, Susilo Bambang Yudhuyono. There is a risk that the national elections in 2009 will see a change in government and the programme could be cancelled. Thus donors may have to start over to develop new mechanisms through which to deliver assistance ("Program Nasional Pemberdayaan Masyarakat" [National Community Empowerment Program], *Quarterly Update* newspaper, November 2007).

72. An opposing argument is that providing budget support to regions promotes equity because funds are allocated transparently (DFID, 2007c, p. 91).

73. For the importance of the demand side for accountabilities see Sections 2.1 and 2.2.

74. For the value in checks and balances on the demand side for vertical accountability see Section 2.2 above.

75. Similarly, it may be difficult to support the private sector to provide services in place of the government, even though the private sector is a significant driver of growth and poverty reduction (DFID, 2007c, p. 28, paragraph S43).

76. In Indonesia, even though the foreign grants would be on budget, the extent of public involvement or disclosure around the agreements made between the donor and the central government – and the central government and the public – is unclear, as discussed above in sub-Section 3.3.2.b.

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