



OECD Journal on Budgeting

Special features

- The budget as contract
- Independent fiscal institutions
- Fiscal stimulus in China
- Performance frameworks in Australia

OECD Journal

OECD Journal on Budgeting

Volume 2011/3

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



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

This document and any map included herein are without prejudice to the status of or sovereignty over any territory, to the delimitation of international frontiers and boundaries and to the name of any territory, city or area.

Series: *OECD Journal on Budgeting*, Volume 2011 Issue 3
ISSN 1608-7143 (print)
ISSN 1681-2336 (online)
<http://dx.doi.org/10.1787/budget-v11-3-en>

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

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

© OECD 2011

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

Foreword

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

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

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

The Editors

Public Governance and Territorial Development Directorate, OECD

Rolf Alter

Director

Jón R. Blöndal

Head of Budgeting and Public Expenditures Division

Andrea Uhrhammer

Head of Communications

OECD Journal on Budgeting

Jón R. Blöndal

Editor-in-Chief

Board of Advisors

Gerhard Steger (Chair)

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

Barry Anderson

Former Deputy Director, Congressional Budget Office, United States

Richard Emery

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

Mike Joyce

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

Joanne Kelly

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

Mogens Pedersen

Deputy Permanent Secretary, Ministry of Finance, Denmark

Table of Contents

Repairing the Budget Contract between Citizens and the State by Allen Schick	7
Independent Fiscal Institutions: Developing Good Practices by George Kopits	35
The Fiscal Stimulus Programme and Public Governance Issues in China by Christine Wong	53
The Performance Framework of the Australian Government, 1987 to 2011 by Keith Mackay	75

Repairing the Budget Contract between Citizens and the State

by
Allen Schick*

This article argues that the budget is essentially a contract between citizens and the state, and that the contract is in a great state of disrepair. The ongoing debate and action in OECD countries should focus on post-crisis revenue and expenditure policies in order to repair this contract. The combination of fiscal stress, high expectations and citizen mistrust, however, greatly complicates the task.

JEL classification: A130, H500, H600

Keywords: budget as contract, citizen expectations, citizen participation in government, trust in government, sustainable revenue and expenditure policies, accountability

* Allen Schick is Distinguished University Professor, University of Maryland, United States.

This article views budgets as contracts that establish rights, obligations and expectations, assign roles and stabilise relationships among participants, promote continuity in policies and allocations from one budget cycle to the next, and reduce both the volume of decisions and the intensity of conflict. The idea of a budget as a contract is not new, but it may have renewed salience in post-crisis countries. The Great Recession has impaired both explicit and implicit budget contracts in many OECD countries, compelling the most impacted ones to abandon established policies and to seek political support for sustainable revenue and expenditure policies. Countries that have escaped financial destabilisation may nevertheless have to reconsider existing budget policies in order to cope with the financial burdens of ageing populations.

Viewing the budget as a contract has several advantages:

- The budget *qua* contract has to be achievable at the time it is negotiated. A contract that provides for parties to the agreement to perform impossible feats is not enforceable in law or achievable in politics.
- The notion of contract injects reciprocity into budget decisions. Rather than viewing the budget solely as a matter of what the government spends and does, a contract is built on the fundamental idea that all parties, including citizens, have mutual obligations.
- As a contract, the parties participate in negotiating the budget's terms. Rather than being bystanders, citizens have a role in influencing what is decided and how public money is spent.
- Finally, contracts have means of enforcement, and these means include accountability for fulfilling its terms and consequences for failing to do so.

As the title of this article indicates, repairing the budget contract is a key challenge facing contemporary governments. Few have the option of going back to pre-crisis conditions, but few have fully charted a sustainable post-crisis course. Defining future budget directions would be facilitated by considering how the budget functions as a contract and the terms that would be appropriate for aligning citizen expectations and government financial capacity.

At first glance, it may appear appropriate to examine how commercial contracts work and contribute to economic growth and stability. There are, however, obvious differences between private contracts and budgets, including their legal status and remedies in case of breach. Some of the differences are discussed in Section 1 which distinguishes four types of budget contracts: fiscal, social, performance and relational contracts. Section 2 examines fiscal contracts, which pertain to key budget aggregates: total revenues and expenditures, the financial balance and public debt. Section 3 turns to social contracts which entitle citizens to a broad swath of cash transfers and other benefits, and which claim more than half of national spending in most OECD countries. Section 4 covers performance contracts which are funded through annual appropriations and finance agency operations and the provision of public services. Section 5 broadens the discussion to the relationship between citizens and the state, including the role of citizens and groups in allocative decisions. The

concluding section reflects on whether integrating contract post-crisis-like features into budgeting may help restore public trust and stabilise public finance.

1. The budget as a contract

In his most influential work, *The Politics of the Budgetary Process*, published almost half a century ago, Aaron Wildavsky characterised the United States budget as:

... a contract. Congress and the President promise to supply funds under specified conditions, and the agencies agree to spend them in ways that have been agreed upon [...] Whether or not the contract is enforceable, or whether or not the parties actually agree about what the contract purportedly stipulates, is a matter for inquiry. To the extent the budget is carried out, however, it imposes a set of mutual obligations and controls upon the contracting parties [...] A budget thus becomes a web of social as well as of legal relationships in which commitments are made by all the parties, and where sanctions may be invoked (though not necessarily equally) by all.

(Wildavsky, 1964, p. 2)

Although applied specifically to the United States, the notion that the budget establishes contract-like commitments, obligations and controls certainly fits parliamentary regimes where party discipline and/or coalition agreements bind the legislature and government to common budget policies. Contract-like controls are especially important during implementation of the budget to ensure that administrative units use appropriated funds in the amounts and for the purposes prescribed in the budget and supporting documents. When the budget is not regarded as a contract, there may be little correspondence between the numbers in it and actual expenditures. When, however, actual spending deviates significantly from authorised amounts, it is not only the budget contract that is impaired but democratic accountability as well.

As used here, is the word “contract” only a figure of speech, a fanciful metaphor that does not quite fit reality? The question arises both from Wildavsky’s words and from governmental practice. Wildavsky labels the budget a contract whether or not it is enforceable, an agreement even when the relevant parties differ on what they have agreed. Apparently, the traditional budget is less than a full-fledged contract, but more than a wish list. It is both an *ex ante* specification of what participants in the process are required to do or barred from doing, and an *ex post* record of what they have actually done.

There are two main reasons why budgets are not conventionally regarded as contracts. One is that budgets perform other functions in addition to authorising expenditures. A government’s budget is a political appeal to voters, a statement of its programme ambitions, a guide to economic policy, a means of organising the work and activities of public agencies, a communication link within government, an opportunity for parliament to express its preferences and concerns, a ritual for legitimising public expenditure, an accounting of past decisions and actions, and a means of financing ongoing programmes and operations. Wildavsky concludes that “the purposes of budgets are as varied as the purposes of men [...] Nothing is gained, therefore, by insisting that it is only one of those things when it may be all of them or many other things as well” (Wildavsky, 1964, p. 4). By being more than a contract, the budget becomes less of a contract. Its decisions carry significant weight, but not always or everywhere to the same degree. The budget demands both compliance and discretion, and fidelity to its terms, along with flexibility to deal with matters that arise during the year, including shifts in economic conditions or in political circumstances.

The second reason why budgets are not conventionally regarded as contracts is that public budgets are not legally enforceable and often not politically enforceable either. If, for example, a school fails to educate students or does not offer all the services promised in the budget, the government may not be able to sanction it by reducing financial resources. Doing so would likely disadvantage children and would not improve educational services or outcomes.

The school example points to another characteristic of public budgets. They are agreements within government, typically between an administrative entity and its parent ministry or between a sectoral ministry and the finance ministry. Taxpayers and other stakeholders do not directly participate in setting the budget's terms. As internal contracts, budgets do not change citizen-government relations, nor do they give impacted persons means of redress if public agencies breach budget commitments.

Budgets take on genuine characteristics of contracts when they are transformed from internal processes and agreements into spending and policy commitments between the government and the people. In view of the overriding need for political support and administrative flexibility at key stages of the process, budgets cannot always be treated as full contracts. Yet, it is feasible to inject more contract-like characteristics into budgeting by giving explicit consideration to impacts on citizens.

An initial step in reshaping budgets into quasi-contracts is to recognise that they produce different types of commitments. In all OECD countries, the budget's numerous decisions take three distinguishable forms:

- Explicit decisions on fiscal aggregates, such as total spending, deficits or debt, expressed in nominal terms or as proportions of GDP. These are the basic elements of fiscal contracts.
- Statutory obligations for government to make periodic payments to eligible recipients. These obligations, which typically are written into permanent law that continues from one budget cycle to the next, form the backbone of social contracts.
- Annual appropriations for the provision of authorised services. During stable times, appropriated amounts change only incrementally from one cycle to the next. This stability speaks to the contract-like characteristic of performance contracts.

The three types of contracts are established through different processes, have different means of enforcement, and often have different time frames as well. Moreover, the three types generally correspond to the widely used typology for analysing the objectives of public expenditures: fiscal discipline, effective allocation, and operational efficiency.¹

2. The fiscal contract

Every national government has a fiscal contract. Some governments set contract terms explicitly by establishing limits on total revenue, expenditure or public debt, or on the balance between revenue and expenditure. In others, the fiscal contract is implicit; fiscal aggregates derive from the revenue and spending decisions made in the budget, plus the effects of exogenous conditions such as the performance of the economy. When the fiscal contract is explicit, its parameters are fixed before the budget is decided; if it is implicit, the parameters emerge only after decisions have been taken. An explicit contract constrains budget decisions; an implicit contract accommodates them. An explicit contract usually has an enforcement mechanism, though not necessarily an effective one, whereas an implicit contract rarely has a means of enforcing the aggregates.

There is a pronounced trend toward explicit fiscal arrangements. Approximately 80 countries now constrain one or more fiscal aggregate before they formulate the annual budget. This trend has been spurred by the realisation that implicit fiscal contracts accommodate rather than constrain expenditure demands. Countries have taken different paths in adopting formal constraints. Some countries have limits that are fixed in national law or international agreements, while other countries have a “fiscal responsibility” process for setting the limits each year in advance of budget work. A few have built-in enforcement mechanisms, but most do not. In the absence of automatic enforcement procedures, a government has to act to keep the budget within bounds, typically by adjusting revenue and/or spending policies. Due to political and other pressures, enforcement is likely to be spotty when those who violate the fiscal contract are the ones called upon to repair it (see Anderson and Minarik, 2005; and IMF, 2009).

The Great Recession has severely damaged explicit fiscal contracts in the most heavily impacted countries, and less so in countries that suffered only mild economic dislocation. The key problem is that most of the preset limits devised before the crisis combine excessive rigidity and feeble enforcement. On the one hand, they do not flex with cyclical changes in economic conditions while, on the other hand, there are only weak sanctions or none when the limits are violated. The same rules apply when the economy is robust and when it is faltering, when stimulus is the appropriate fiscal response and when restraint is necessary. To put the issue within the framework proposed in this article, a pro-cyclical fiscal contract is not workable or enforceable; sooner or later, the parties to it – political leaders, in this case – will break the contract because they have no possibility of upholding it when economic conditions take a turn for the worse.

Citizens have a large stake in their country’s fiscal contract, but they rarely have a direct voice in setting its terms. Citizens can indirectly express their views on the government’s fiscal management at the ballot box, but they do not have seats at the table when fiscal policy is decided. Their exclusion may be a good thing, because opinion surveys in many countries show that citizens habitually prefer smaller governments and bigger programmes. Inviting citizens to actively participate in defining the government’s fiscal position might lead to no agreement or to one that inscribes their cross-pressures and inconsistencies in government policy. Yet contradictions in public opinion do play havoc with the fiscal contract, even when citizens lack a direct voice. The tension between the budget’s totals and parts explains why many governments have embraced explicit fiscal contracts, as well as why these contracts often succumb to political or economic *force majeure* (Schick, 2003a).

Arguably, however, the inherent fragility of fiscal contracts should impel governments to open the process to citizen participation. A strong case can be made that citizens hold contradictory opinions because they are not responsible for the fiscal consequences of their views. As long as the two sides of the question are separated, it is perfectly reasonable for citizens to want smaller government but more benefits from government. It is only when the two parts of the question are fused together, and when citizens are thus confronted with the arithmetic interactions between the parts and totals, that they have a sufficient basis to adopt internally consistent positions.

It is exceedingly difficult, though not impossible, to engage citizens in constructing their country’s fiscal contract. It is technically feasible to conduct a national plebiscite on fiscal options, including tax and spending policies, or to compel voters to choose among

revenue and spending alternatives that would reduce or increase budget deficits. Of course, it would be necessary to limit the number of choices, but voting results can indicate whether citizens favour bigger or smaller government, more or less spending on major programmes, and higher or lower tax burdens.

Although it is feasible to poll citizens on budget aggregates, the legitimacy of fiscal contracts does not rest on explicit endorsement by voters. Every fiscal contract is inherently a political covenant in which citizens entrust the government with authority to manage the public finances and the government commits to do so in a prudent manner. It is not specific revenue and spending policies, or even the sum of these policies, that bonds citizens and government, but the combination of trust and stewardship that empowers a government to set the country's fiscal course.

The issue of trust will be revisited in the concluding section of this article, but it is the stewardship component that runs afoul of the political pressures and contradictions mentioned earlier. Political leaders who get mixed messages from citizens may prefer to be stewards of public finance, but often end up promoting short-sighted, opportunistic policies that put the country's fiscal position at risk.

Distortions in political incentives get in the way of trust and stewardship. One distortion is the common resource pool problem: citizens with different interests and demands have incentive to draw as much as possible from the pool of public funds, even though they may be disadvantaged by the consequent destabilisation of public finance. Another problem is that political leaders have incentive to respond to today's voters at the expense of tomorrow's results, even when the likely result is future insolvency or austerity. Failure to recognise these mis-incentives dooms fiscal contracts. Instead of arming the government with trust, citizens besiege it with demands and, instead of acting as stewards, politicians behave as vote-seeking opportunists.

The remedy sought by contemporary governments is to adopt fiscal rules that restrain leaders from acting on the basis of mis-incentives. However, poorly constructed rules neither purge governments of budgetary myopia nor protect the common pool of public funds against political predation.

2.1. The fiscal contract should not harm citizens during adverse economic times

One advantage of viewing the budget as a fiscal contract is that it may sensitise the government to the impacts of fiscal policies on citizens. These impacts habitually are disregarded when national governments construct fiscal rules that ignore swings in underlying economic conditions and that therefore have pro-cyclical biases which deepen downturns when the economy is weak and spur governments to spend more or tax less when the economy is buoyant. Pro-cyclical rules – which include almost all of the rules adopted thus far – harm citizens when income supports and other programmes that benefit vulnerable persons are curtailed or terminated in order to keep within a fixed fiscal constraint.

It is much easier to devise rules that disregard economic cycles than those which seek to build counter-cyclical adjustments into fiscal targets. Fixed rules have constraints that do not vary with shifts in economic conditions and are, therefore, relatively easy to monitor and enforce; pliable rules do vary and depend on assumptions about potential output and other economic variables.

A fiscal responsibility process that enables the government to reset targets annually, or more frequently, when warranted by circumstances, is likely to be more counter-cyclical than

a rule that is established in law or international agreement. In setting annual or multi-year targets under a fiscal responsibility process, political leaders can take account of actual or projected economic conditions. While not as constrictive as fixed rules, a fiscal responsibility process may lead to more realistic targets and, consequently, to greater compliance.

A fixed rule can build cyclically adjusted targets into fiscal constraints. Chile has had considerable success with a structural rule, which it adjusted during the recent crisis, that requires a structural financial balance (as a proportion of GDP) but permits a nominal deficit when economic conditions deteriorate.

In designing cyclically adjusted rules, it may be useful to distinguish between the bulk of public expenditures that are not significantly sensitive to economic swings and those, such as unemployment benefits, that do vary. For example, Austria imposes a hard fiscal rule on non-cyclical expenditure and a flexible rule on cyclical components. An additional advantage of this approach is that it protects segments of the population that are injured by economic downturns against further harm from policy changes.

2.2. Fiscal rules should be framed within a medium-term horizon

Fiscal contracts generally span a single fiscal year, presumably because the country has annual budgets. Confining the contract to one year diminishes its utility, first because the fiscal policies implemented one year have consequences for subsequent years, second because short-term contracts invite practices that make the current year's fiscal position appear to be favourable at the expense of future years.

The obvious solution is to extend a fiscal contract to the medium term or beyond. But a rule covering multiple years can only be as sturdy as the framework within which it is housed. A fiscal framework is of little utility when, as often happens, the spending ceilings set one year are treated as floors for spending decisions the next year. To be effective, a framework must have an enforceable presumption that limits will not be reset whenever it is expedient to do so. There are, of course, legitimate reasons for resetting the targets in response to new conditions or information that was not available when limits were initially set for the fiscal year. Political commitment to uphold fiscal limits is a necessary but not always sufficiently effective safeguard against revising or ignoring the limits in order to accommodate popular demands for additional resources.

Some countries have introduced “claw back” rules to put public finance back on track when fiscal limits are breached because of economic or other circumstances. As part of new constitutional rules that will take effect in mid decade, Germany will require fiscal adjustments in subsequent years when one year's deficit limit is breached.

2.3. Fiscal rules are rarely self-enforcing

Fiscal rules require strong mechanisms for monitoring fiscal prospects and out-turns, and for taking appropriate corrective action. Rules limiting budget policies have been adopted by many countries because of concern that, without them, governments would take on more deficits and debt than is fiscally sustainable. Arguably, however, if the impulse to debt finance government activities is so powerful, mere rules may have only minor impact on fiscal behaviour. Rules that lack enforcement mechanisms can be easily brushed aside by cross-pressured politicians. The most direct tactic is to ignore, waive or modify fiscal limits that get in the way of coveted revenue or spending decisions. Even when rules establish preset limits, politicians may undermine them by manipulating

economic (and other) assumptions, changing the timing and recognition of revenues or expenditures, hiding the true deficit through off-budget manoeuvres, using one-off revenues such as income from asset sales, and other tactics.

Some governments have decided that the surest way to safeguard the country's fiscal position is to vest authority to issue economic projections and monitor budget out-turns in an independent entity. The United Kingdom's Office for Budget Responsibility, established in 2010, is modelled after similar organisations in other countries. Some observers believe that not only forecasts but fiscal policy as well should be entrusted to an independent agency.² The question of what to do in case of breach has stirred considerable controversy, especially with regard to the EU Stability and Growth Pact which was launched without effective means of enforcement.

Some of the most difficult enforcement issues arise during growth spurts when revenues are buoyant, deficits have been eliminated or significantly reduced, and politicians are pressured to cut taxes or boost spending. It is during these times that fiscal discipline falters, commitments extending well into the future are undertaken, and the seeds of future budgetary distress are sown. One of the lessons of the Great Recession is that if countries are not prudent during the good times, they risk paying a heavy price during bad times.

3. Social contracts

Income supports and other transfers prescribed by law are intergenerational covenants that bind current and future taxpayers to finance payments promised in the past. These covenants also commit governments to make required payments in a timely, accurate manner. They echo Edmund Burke's justly famous declaration that "society is indeed a contract. It is [...] a partnership not only between those who are living, but between those who are living, those who are dead, and those who are to be born" (Burke, 1790).

These entitlements are not fully binding contracts because a government can legislatively modify their terms, as quite a few OECD countries have done in anticipation of ageing populations or in response to financial crisis. With some notable exceptions, the adjustments have been marginal – such as raising the eligibility age for full benefits or recalibrating payment formulas – but the basic structure has remained intact. However, national governments may be impelled to legislate more far-reaching modifications in the future, especially in countries that already have high public debt burdens or have not made adequate provision to finance promised payments.

The prospect of future adjustments is heightened by several flaws in contracting for social transfers. One problem is that social contracts not only commit a government to future disbursements; they also inflate citizen expectations about what they will get in the future. With few exceptions, social contracts are open-ended commitments; they do not have fixed budgets or preset spending limits. They specify eligibility rules, benefit formulas and other relevant terms, but not the amounts to be spent during a specific fiscal period or during the lifetimes of a cohort of recipients. Not only is the amount to be paid to eligible persons open-ended, but many social contracts provide for upward adjustments as wages or prices rise or as individuals live longer, or in response to political pressure to enhance benefits. In many countries, the government's obligations increase in response to both favourable and adverse socio-economic conditions. To the extent that entitlement-fueled expectations beget still higher expectations, the social contracts on which contemporary

welfare states have been built are doomed to fall short. The social contracts are not adequately funded and they cannot be sustained. It is not the Great Recession that has imperiled many social contracts; rather, it has spotlighted their built-in deficiencies and prompted corrective action in some countries.

A related problem is that social contracts often are based on indifference to, or miscalculation of, downstream costs. Governments often lack timely and accurate projections of future liabilities, and politicians often have incentives to disregard or underestimate the long-term costs of new commitments. For their part, citizens routinely take it for granted that the government is giving back only what it took from them; they therefore feel cheated when the government trims promised payments. The fact that beneficiaries usually pay only a fraction of the cost does not sway public opinion, nor does it induce the parties to social contracts to exercise due diligence when they establish commitments that extend indefinitely into the future. To make matters worse, few countries set aside sufficient funds to cover projected future payments. From the outset, therefore, these contracts carry substantial risk that the government will not be able to fulfil the agreed terms.

Evidently, social contracts have been grounded on the premise of sustained economic growth, possibly interrupted by mild downturns but with the economy quickly reverting to its expansionary trajectory. In effect, neither party to the agreement – not the current government nor current or prospective beneficiaries – bears the full cost. Instead, a significant portion of the cost is deferred on the assumption that it will be financed by the dividends of future economic growth.

Inadequate growth is only one of the financial risks held by national governments. In fact, many OECD governments hold a broad portfolio of socio-economic risks. They are at risk when people live longer, when citizens experience bouts of illness or unemployment, when expensive medical technologies and treatments are developed, when natural or man-made disasters occur, when the yield on investments declines or interest rates rise, and much more. The economic crisis has shed light on the exposure of governments to asset bubbles and financial meltdowns, and to the enormous cost of restructuring banks and indemnifying depositors. These mega risks have destabilised public finance, but the cumulative costs of mini risks, such as income support for individuals during old age and for health care, also threaten government finance.

It is no exaggeration to say that modern social contracts massively shift risk from households and enterprises to governments and future taxpayers. This arrangement has one great virtue: it enables society to pool risks among its members, thereby spreading the cost and softening the financial loss borne by impacted households and firms. A strong case can be made for a government to assume socio-economic risks, for only it can organise insurance pools that are as inclusive as society itself. Serious problems arise, however, when the government fails to account for its exposure to risks or fails to allocate sufficient funds for future payouts, as well as when the shift in risks induces morally hazardous behaviour that adds to future costs.

Some fiscally prudent countries have moved to reduce their financial exposure by transferring some risks back to beneficiaries. For example, shifting from defined benefit to defined contribution pension schemes reduces the government's exposure to risk and future costs. Most changes have been driven by fiscal stress: pressure to reduce debt levels and fiscal deficits, and to calm financial markets by producing significant savings.

Ideally, renegotiating social contracts should give due consideration to the interests of stakeholders, should fairly allocate costs, and should stabilise government finances. The remaining paragraphs of this section suggest guideposts for post-crisis social contracts.

3.1. Governments should account for the risks embedded in social commitments and, to the extent feasible, the projected costs of these risks

Most social contracts expose a government to contingent liabilities – that is, to future payments if certain events occur. Some contingencies are predictable; others have a great deal of uncertainty. Governments can reliably project the future size of retirement cohorts, but not long-term price trends or investment returns of its pension funds. Two decades ago, not a single OECD country systematically listed its contingent liabilities; now a growing number annex statements of these liabilities to the budget or other financial reports (Bixi and Schick, 2002). Member countries should be encouraged to identify explicit direct and contingent liabilities that arise out of social commitments and to build future costs into the budget, the medium-term frameworks, and the long-term fiscal projections. Governments can apply simplified “value at risk” models to estimate future costs, and update these estimates annually as well as when major events significantly increase or decrease risks. Most importantly, governments should estimate prospective costs before taking on new social commitments.

Two big issues stand in the way of full recognition of contingent liabilities. One is that, in many countries, key parts of the social contract are embedded in expectations rather than in law. For example, in some countries, the government periodically adjusts pensions to price changes or to increases in the minimum wage, even when it is not legally required to do so, and it indemnifies bank deposits for losses above the legal limit. The presumption that the government will act in the expected manner is a core feature of social contracts, but recognising expectations as liabilities increases moral hazard and exposes the government to additional risks and costs.

The second problem is that accrual accounting standards generally do not require governments to recognise all social commitments. Governments have to expense pensions and other obligations for their own employees, but not the much costlier pensions and other benefits promised to the general population. The rationale for this distinction is that the former are legally contracted obligations, while the latter are established in laws that can be modified through new legislation. However, the fact that crisis-afflicted countries have curtailed pensions and other benefits for public employees calls this distinction into question.

3.2. Revised social contracts should not be short-term fixes that will have to be corrected through further adjustments

To strengthen trust in public institutions, new social contracts will have to constitute credible commitments that the government will provide promised benefits well into the future. Toward this end, governments should restructure social commitments so that: i) they are financially sustainable over an extended period, including cyclical variations in economic conditions; ii) they have assured sources of funding; and iii) they are in a form that restricts or inhibits unilateral changes by the government. They should also protect vulnerable persons against severe financial adversity, ideally in ways that do not generate moral hazard.

3.3. Social contracts should distinguish between risks that benefit recipients and those that adversely affect them

Governments bear contracted costs when workers lose their jobs or become disabled, as well as when people live longer and benefit from medical innovations. A strong case can be made that recipients should share some of the increased costs when they benefit from developments that improve their quality of life or enable them to live longer. Private insurers routinely adjust premiums and payouts to changes in life expectancy, and many households prudently adjust spending habits to guard against outliving their money. It is prudent for governments to make similar adjustments, but doing so is difficult because proposals that appear to reduce benefits trigger political conflict and often damage the government's electoral prospects, compelling it to settle instead for modest savings that do not remedy fundamental imbalances.

Some innovative governments have adjusted future payments to changes in life expectancy. For example, Sweden pioneered a novel approach in 1998 by adopting an automatic balance mechanism that ensures its pension system's financial viability at a constant payroll tax rate (Valdes-Prieto, 2002). One feature of this mechanism links the amount paid to changes in life spans. When a cohort of pensioners is projected to live longer, monthly payments automatically decline for that cohort, except for persons who voluntarily delay the start of benefits. The government has estimated that average benefits will be cut 14% by 2055 for those retiring at age 65 (Weaver, 2006). Sweden has effectively shifted the risk and pension cost of living longer from the state budget to pensioners. It has been motivated by a determination to preserve the social contract, not by a desire to dismantle fundamental social benefits. A major advantage of the automatic mechanism is that politicians do not have to vote to raise the retirement age or to adjust benefits. These changes are made administratively in accord with a predetermined formula.

3.4. Social contracts should withstand adverse economic swings and should be sustainable

Whether public or private, the value of financial rights conferred on one party depends on the capacity of the other party to pay obligated amounts. Many of the entitlements established during boom times assumed that the economy would continue to expand, and that it was therefore appropriate to assign workers and other beneficiaries a fair share of future growth. The financial crisis has undermined both this confident assumption and the policies that have derived from it. Nowadays, the key public finance issue facing governments is not how to allocate the incremental dividends of economic growth, but whether existing commitments can be sustained across generations. Even countries that have come out of the crisis in sound financial condition have had to re-examine their capacity to pay promised benefits over the next 30-50 years or longer.

Sweden's automatic balance mechanism has a formula that reduces pensions when liabilities exceed assets in notional accounts. (Notional accounts do not have cash flows; they are bookkeeping entries based on interest rates and incomes.) Payments are automatically restored when the deficit is liquidated and accounts are solvent. The mechanism was applied for the first time in 2010, but only after the formula was modified by the Swedish Parliament the previous year to avert steep pension cuts. Minimum guaranteed payments to low-income pensioners are exempt from the balance mechanism. The fact that Parliament has tinkered with the rules to delay reductions indicates that even automatic formulas do not escape political pressure.

Germany has taken a different approach to assure long-term sustainability. In 2004, it partly linked pensions to changes in the ratio of workers to pensioners. When this ratio, which is referred to as the “sustainability factor”, declines, the government makes adjustments to both the payroll tax and pensions. This is in contrast to Sweden’s mechanism which allocates the entire adjustment to pensions. Germany’s payroll tax rate has been projected to be four percentage points lower in 2040 than it would be without sustainability adjustments.

3.5. Governments should share risks and costs with stakeholders

A government that is the risk holder of last resort for society, as is the case in most OECD countries now, is almost certain to face intense fiscal pressures in the future, and in some countries possibly to the point of insolvency. Risk sharing is essential to reduce moral hazard and to protect governments against both catastrophic claims and the incessant rise in public expenditure, especially for health care. Co-pays, premiums, origination fees and deductibles are widely used means of shifting a portion of the cost to beneficiaries, but these often are set at levels that are too low to induce behavioural changes. Governments can also shift risk to third parties by purchasing reinsurance or catastrophe (CAT) bonds, or by selling a pool of risky assets and associated liabilities (for example, future premiums for medical care) to others. Regardless of the method, the objective should be to wean society away from the notion that the government is responsible for the entire cost, or almost all the cost, of major social risks.

The aim of these suggestions is to strengthen social contracts by protecting core citizen welfare while reducing the financial exposure of the government. Narrowing the reach and ambitions of social contracts by transforming them from open-ended, unrequited government commitments into reciprocal, limited obligations by both governments and citizens may lead to fewer benefits, but will make the contracts and the benefits they promise more viable.

4. Performance contracts

Performance contracts pertain to the portions of the budget that finance administrative operations and delivery of public services. Contracted performance is only implicit when the budget focuses on inputs, but is explicit when the budget is structured according to actual or projected results. Even though they classify expenditures by inputs, line-item budgets contain elements of performance contracts when they are supported by information on planned services and activities. The potential of input-based budgets to strengthen performance is evident when one examines the accomplishments of advanced democracies during the first 40-70 years of the 20th century. Despite line-item budgets, many developed countries made extraordinary progress in education, health care, transport, sanitation and other public services. These results suggest that commitment to perform may be more important than the format of the budget. When this commitment is absent or weak, stuffing the budget with performance indicators will not make much of a difference (Schick, 2003b).

If line items do not inevitably get in the way of results and output data do not assure results, what value is added by making the performance contract explicit? A related question is: how explicit should the budget be about results? Does it suffice to insert performance information into the budget, or should the government expressly link the amount spent with the volume of services and outputs? In addressing these questions, it is useful to regard the

budget as a contract for payment of authorised amounts in exchange for delivery of agreed services. In the same way that commercial contracts specify relevant terms because the parties have different, sometimes antagonistic, interests, a budget contract spells out what will be accomplished with public funds to prod the parties to fulfil their obligations. All contracts, whether public or private, benefit from trust between the parties, especially when some terms are fuzzy or circumstances change. When trust does not suffice, formal agreements can compensate. Agencies and staff that are committed to produce value for money can perform well even when the budget does not explicate the results to be achieved. But when this commitment is weak, a budget contract can compensate by giving public agencies and employees clear signals of what is expected of them.

Thinking about the budget as a contract for performance is hindered by the enormous variety of performance budgets (PBs). In many countries, within the OECD area and outside, the PB label is routinely applied to any budget that contains data on workload, activities, services, projects, programmes, outputs or outcomes, even when there is no indication that the data have influenced spending decisions. In a small number of countries, the PB label signifies that the government considers the changes that may ensue in results if budget resources are increased or decreased (OECD, 2007).

To clarify the concept of the budget as a contract for performance, it is useful to distinguish these budgets from those that merely provide performance-related information. There are numerous versions of performance budgets, but the important distinction is between the PB as a means of allocation and the PB as a container for information. The closer it is to the allocative model, the more the performance budget becomes a genuine contract for performance, but most countries that claim to have a PB use it principally or only as an information bucket.

What is it about PBs that spurs governments to compile performance-related information, but not to formally base allocations on results? Governments have invested substantial amounts to measure performance, yet they do not often connect these measures to expenditures. This pattern is so widespread and occurs in countries with such different political systems and administrative cultures that it appears to be functional, not random or accidental. Government agencies enthusiastically measure what they do and the outputs they produce, especially when they are the ones who decide how the information is compiled and used, but they are congenitally wary of using performance indicators to decide which administrative units or activities get more and which get less. The agencies covet information that bolsters their budget demands, but are cognizant that the same information might be used to reduce their budgets. They delight in showcasing good performance, but not when they are ranked in “league tables” that compare their results with those of other service providers. They generally are willing to compare results against targets, but only when they set the targets.

Despite these concerns and the failure of PBs to transform budgeting, this article opts for the allocative model because it reinforces the notion of budgets as contracts for performance. Moreover, shining a bright light on results might spur government entities to perform better.

4.1. Identifying and measuring performance

There are many ways to describe and quantify what government agencies do and the results they achieve. Competing approaches stir passion and conflict because they look at

government in different ways, and they sometimes generate different assessments of how government is performing. For the past two decades, outputs and outcomes – the goods and services produced by government agencies and the socio-economic impacts of public policies – have been the favoured terms. Older measures such as workloads, services and activities have receded in prominence. One explanation for this trend is that outputs are the language of markets and contracts, whereas services are the language of providers; and outcomes are the focus of policy, whereas activities are the focus of administrative units. It is feasible to describe and measure public outputs in market-like contracts that specify the amounts to be spent and produced. During the 1990s, New Zealand was probably the first and certainly the boldest country in structuring public management around a web of output-based contracts that included purchase agreements between ministers and departments and performance contracts between department heads and the government (see Schick, 1996).

Outputs are amenable to contractualisation because the parties to the agreement have effective control over the obligations they enter into. Outcomes, however, are a more difficult case because achieving them typically depends, at least in part, on matters beyond the effective control of the parties. For example, a school's success depends in significant part on family circumstances, peer influences and economic conditions. Despite their limitations, when they are voluntary and are treated as strategic signals rather than as binding commitments, outcome-based contracts can stimulate the government to review the effectiveness of established policies. In the school example, when measuring and assessing outcomes, policy makers should be mindful of conditions outside the classroom that affect what occurs inside.

Whether oriented to outputs or outcomes, performance contracts typically lack contestability and enforcement. When a government agency is the sole supplier of a public service, inscribing expected results in a contract does little to improve performance. And when failure to perform does not prejudice future budget allocations, and sometimes strengthens the case for more money, having a contract does not change behaviour or results. In these circumstances, government agencies have little commitment to achieve contract terms and do not bear any penalty when they do not achieve them.

4.2. Services and activities

Outputs and outcomes are a foreign language to most citizens, whose main concerns are the activities of the government and the services it provides. A citizen-centred education budget (or contract) would more likely focus on service measures such as class size, the types of courses offered and the number of guidance counsellors rather than on test scores and dropout rates. Does this suggest that governments should orient performance budgets to work and activities, rather than to outputs and results? The case for output/outcome-based PBs rests on the sensible notion that a government does not carry out activities for their own sake, but to produce social and economic good. A government does not operate schools just to offer courses in reading and arithmetic, but to give students skills that are essential for effective adulthood and productive employment. These end-purposes, the argument runs, should be the focus of performance-oriented budgets.

The counter-arguments do not deny the utility of output and outcome measures in assessing whether government policy is on the right course. It behooves all governments to probe whether the activities financed by the budget are achieving planned results and giving citizens value for money. Yet citizens know their government and form political

attitudes on the basis of the services they receive, or fail to receive. An actual performance contract between citizens and their government would almost certainly be organised around the services delivered by public agencies.³

Measuring outputs and outcomes need not crowd out attention to services and activities. The former are most useful, as just suggested, for evaluating programme effectiveness, the latter for comprehending how the government spends public funds. It is difficult to gauge whether a government is allocating the optimal amount of resources without decomposing programme or organisational expenditures into discrete activities and then calculating the inputs needed to carry out each activity. This is the rationale for activity-based costing, which has been widely applied in the business sector to estimate the financial effects of curtailing or expanding particular activities.⁴

The budget is not the only instrument for planning and assessing government performance. A government also needs robust analysis of policy options and systematic evaluation of programmes, but cramming these processes into the tense conditions and tight deadlines of the budget cycle is likely to yield less useful data and insights on performance than if analysis and evaluation were separated from the congested routines of budgeting. The further one moves from financial and operational decisions to strategic consideration of objectives and results, the stronger the case for output and outcome-based measures of performance. But in allocating money, services and activities are indispensable data entries; they are what participants in the budget dialogue discuss in deciding whether to spend more or less.

4.3. Specifying costs

To bind both providers and purchasers of public services, a performance contract should specify the volume and quality of services or outputs, and the amounts to be paid. However, the pervasive lack of data on the unit cost of services/outputs severs the link between resources and results. With the possible exception of trading entities that are self-financed by income from the sale of goods and services, national governments do not have robust cost accounting systems that enable them to distinguish between fixed and variable costs, and between marginal and average costs. Lacking this capacity, governments cannot reliably measure the incremental costs of producing an increment in services.

The failure of governments to invest in cost accounting is largely due to the notion of budgets and appropriations as legal limits on government expenditures. In all countries, government agencies receive a fixed appropriation for operating expenses and provision of services; this amount limits expenditures and does not vary if agencies produce more or less. (However, transfer payments, which are the main element of social contracts, generally are open-ended obligations that vary automatically with changes in the number of eligible recipients and in the payments to which they are entitled.) Historically, the overriding purpose of fixed appropriations has been to limit the amounts spent, not to buy public services. Of course, governments, political leaders and parliamentarians expect to receive services in exchange for authorising expenditures, but they do not formally connect the volume of services to the quantity of money. They rarely authorise agencies to spend more if they do more, or require them to cut spending if they produce less. Repeated waves of performance budgeting and other reforms have not weaned budgeting away from its roots as a control process.

Uprooting this orientation in order to link appropriations to performance would likely require a shift from fixed to variable budgets, in which the amount authorised to be spent depends on the volume of services. Although common in commercial enterprises, variable budgets (for administrative costs and services) are virtually unknown in government. Every variable budget is inherently a performance-based budget; every fixed budget is inherently one in which performance has limited influence, if any, on resource decisions. A variable budget effectively makes the budget into a performance contract, and transforms appropriations from limits on expenditure into indefinite allocations whose actual amounts are determined during implementation of the budget. Constructing a variable budget entails a series of connected steps:

- the disaggregation of services into standard units such as patient days and x-ray procedures in hospitals, and student days and courses in schools;
- cost accounting or allocation systems that enable governments to apportion the fixed costs that do not vary with the volume produced, and variable costs that do fluctuate with volume;
- computation of the marginal cost per unit – that is, the incremental cost of producing additional units; and
- administrative rules that empower managers to efficiently produce services and control costs.

Few member countries have the capacity to construct variable budgets; but even if they do not construct such a budget, investing in basic cost accounting systems will enable them to operate more efficiently and improve services (see Schick, 2007).

Variable budgets are not suitable for all government services and activities. Variable budgets are most appropriate when the government agency has no control over the demand for its services. For example, the agency responsible for issuing passports must process all applications; it cannot control workload by generating more demand or by refusing to handle applications. Inasmuch as the number of applications that will be processed during the next year is unknown, allocating a fixed amount for passport services is an inducement for inefficiency, poor services, or both. On the other hand, any administrative unit that exercises significant control over the volume of services should not be funded by variable appropriations. A variable budget would give it license to extract more money from government.

4.4. Performance as change

A performance contract (or budget) that strives to itemise all public services and activities would likely obscure the options that a government faces when it allocates resources. In all countries, and in most budget seasons, policy makers focus on the incremental differences between the current budget and the one proposed or adopted for the next year. The key question for each issue is whether to spend more or less than in the previous year. Injecting performance into the process broadens budget options to include the consideration of what more or less society will get by way of services, outputs, results, etc., if the government spends more or less. In other words, the central issue is what will change as a consequence of budget decisions.

To make informed budget decisions, governments require estimates of the incremental changes in results expected to flow from incremental changes in resources. This form of performance budgeting would be based on analysis of the marginal utility of

expenditures. Results that would occur regardless of changes in the amount of resources or in how they are managed would not be credited as performance.

Relevant changes come in many forms: efficiency of operations, waiting times and accessibility of public services, volume and quality of services, substantive outcomes, and so on. Ideally, agencies would bid for services by specifying expected changes in results if funding were forthcoming. Their bids would be supported by description and analysis of why the changes are sought and of how the funds are expected to produce the planned results.⁵

This type of performance budget would have essential characteristics of a contract, even if it were not formally styled as one. It would explicitly connect the money to be provided to the results to be produced. It would inform the producing party what it will be paid, and the paying party what it will receive.

5. Relational contracts: trusting government and repairing budgets

A contract specifies the rights and obligations of the parties to the agreement as well as remedies in case of failure to perform. But formal terms are only one feature of contracts, and not always the most important ones. No matter how detailed they are, most contracts are inherently incomplete – they cannot anticipate all the disagreements or misunderstandings that may arise in carrying out prescribed terms. Whether in markets or in government, incomplete contracts are vulnerable to opportunistic behaviour by self-interested parties who exploit gaps and ambiguities to gain untoward advantage. When the contract is discrete – namely, it is a one-time or occasional interaction – disputes often are settled through litigation because the parties lack incentive to maintain a trustworthy relationship. However, when the parties expect to interact on a continuing basis, they have incentive to maintain the relationship by resolving disagreements informally, without renegotiating the contract or drawing lawyers and courts into the dispute.⁶

Relational contracts are highly relevant to the theme of this article. The three types of contracts discussed thus far are built on political relationships, both within government and between citizens and the state. This is most evident in social contracts which deal with rights and obligations that span decades and sometimes generations; it is the relationship between citizens and the government that rationalises paying taxes today in expectation of benefits to be received 30-50 years hence. Performance contracts also have relational dimensions that pertain to the services citizens expect to receive from government agencies. Fiscal contracts establish a more generalised relationship, in which citizens entrust government with responsibility for managing the country's finances.

To illustrate the value of relational contracting in government, let us assume that budget decisions were made solely on an impersonal basis through the formal exchange of prescribed documents. Policies and rules issued by policy makers would flow downward along hierarchical pathways, and information on expenditures and activities of operating units would flow upward. In blueprint, central authorities (principally the finance ministry, the council of ministers and parliament) would obtain the information needed for intelligent allocations, and spending units would receive the optimal amount of funds for efficient operations. In practice, however, it is likely that budget decisions will be skewed by inadequate or misleading information because central policy makers are dependent on spenders who have both incentive and opportunity to withhold or distort information. Spenders often have the upper hand in this unbalanced relationship because they control critical information. They can misclassify public employees, record travel as training, pay

for one unit's activities out of another's account, count dropouts as students, and use dozens of ploys to misreport expenditures or activities. With inadequate or distorted information, policy makers unknowingly provide too much money or too little, or for the wrong purposes.

Thinking of the budget in relational terms explains why participants who have antagonistic interests nevertheless co-operate. The recurring character of budget work, with the same routines repeated year after year by the same role players, motivates each side to deal forthrightly with others engaged in the process. Spenders want their bids to have credibility and to be given due consideration by central budget allocators, and the budget office wants to produce a defensible budget that avoids political pitfalls by cutting some requested funds without impairing basic or popular services. For each side to get what it wants, both have to engage in conversations that often are more forthright than their formal exchanges. Although the relationship may appear to be adversarial, and friction often flares up during tense negotiations, beneath the surface abrasions of the process there usually is a reservoir of trust and co-operation.

Relations are vital at all stages of the process, not only when the budget is formulated. In countries where the national legislature has an active voice in amending the budget, parliamentarians and staff often establish stable, harmonious relations with counterparts in government. The relationship sometimes appears to be hostile, especially in countries which separate legislative and presidential powers; but even in these situations there are lively, trusting exchanges of views and information. After appropriations have been voted, informal relations introduce a measure of flexibility into what might otherwise be a rigid process. Situations frequently arise during implementation of the budget that make it necessary or desirable to modify expenditure plans. Virements often are arranged informally, through discussions between budget and sectoral officials or between them and parliamentarians (or legislative staff).

In both markets and governments, there are gains and losses from relying on relationships to supplement or substitute for formal contracts. The gains include reduced conflict and buildup of trust among persons who work with one another on an ongoing basis, lower transaction costs and less opportunistic behaviour, and greater confidence in and support for decisions emerging from the process. However, substituting informal relationships for formal procedures makes the budget less transparent and may open the door to misuse of public funds. In some countries, it may enable insiders to promote personal interests at the expense of the public interest, and may weaken the budget's status as an authoritative statement of financial policy.

Budgeting benefits from having both formal contracts that prescribe and limit government action, and relational contracts that promote political agreement and administrative efficiency. The balance between the two types of arrangements varies among countries and depends in part on political conditions and budget rules. Fiscally stressed countries that have itemised budgets are more likely to rely on informal, relationally sanctioned adjustments than countries that have comfortable budget margins and make broad allocations to programmes or administrative units.

5.1. A matter of trust

Relational contracts do not pertain only to exchanges within government, but to relations with citizens and the state as well. Within government, relationships can

mitigate conflict and de-rigidify budget actions. A very different dynamic is at work in contemporary citizen-state relations, for the impairment of fiscal, social and performance contracts has been exacerbated by declining trust and confidence in public institutions. Tables 1 to 3, drawn from recent Eurobarometer surveys, show low trust scores in approximately two-thirds of EU countries. Surveys conducted in other OECD countries and regions also reveal depressed levels of trust. Table 4, drawn from Trilateral Commission reports, indicates that the onset of declining trust occurred during the last decades of the 20th century.

Table 1. Trust in institutions: Government

Percentage who tend to trust

	November 2003	June 2005	May 2007	June 2009	June 2010
Austria	46	49	57	58	54
Belgium	38	44	62	35	22
Denmark	53	55	67	61	50
Finland	49	68	75	54	49
France	30	24	36	39	35
Germany	24	27	49	45	32
Greece	47	40	41	25	25
Hungary	n.a.	32	27	14	40
Ireland	31	40	41	20	21
Italy	27	29	37	25	25
Luxembourg	60	68	66	77	66
Netherlands	37	40	73	56	47
Portugal	39	33	46	28	20
Spain	42	40	52	34	20
Sweden	42	33	55	57	57
Turkey	n.a.	76	71	57	43
United Kingdom	24	34	34	21	26

Source: Eurobarometer.

Table 2. Trust in institutions: Parliament

Percentage who tend to trust

	November 2003	June 2005	May 2007	June 2009	June 2010
Austria	43	52	57	58	52
Belgium	40	49	66	41	28
Denmark	68	74	85	75	72
Finland	52	67	77	60	55
France	33	33	44	33	36
Germany	31	35	51	46	39
Greece	54	47	53	33	23
Hungary	n.a.	29	26	15	41
Ireland	34	40	43	23	22
Italy	33	35	39	27	26
Luxembourg	53	64	64	67	52
Netherlands	41	53	77	56	54
Portugal	46	40	49	36	28
Spain	41	37	52	32	21
Sweden	53	46	70	64	66
Turkey	76	73	74	58	46
United Kingdom	27	36	41	17	24

Source: Eurobarometer.

Table 3. Trust in institutions: Political parties
Percentage who tend to trust

	November 2003	June 2005	October 2007	June 2009	June 2010
Austria	19	31	30	40	40
Belgium	22	30	29	28	20
Denmark	39	51	40	58	49
Finland	19	37	26	32	30
France	12	14	17	13	14
Germany	12	18	18	24	19
Greece	20	22	21	15	9
Hungary	n.a.	16	8	10	29
Ireland	22	24	22	19	17
Italy	11	19	16	19	18
Luxembourg	26	46	30	50	40
Netherlands	26	35	35	41	45
Portugal	17	19	15	18	15
Spain	23	24	32	23	14
Sweden	18	22	25	36	37
Turkey	n.a.	28	23	26	24
United Kingdom	12	22	15	12	18

Source: Eurobarometer.

Table 4. Trends in confidence in parliament
Percentage*

	Early 1980s	Early 1990s
Belgium	40	44
Canada	43	37
Denmark	36	42
Finland	65	34
France	55	48
Germany (West)	51	50
Iceland	48	54
Ireland	52	50
Italy	30	30
Japan	28	29
Netherlands	45	53
Norway	77	59
Sweden	47	47
United Kingdom	40	44
United States	52	45

* The number reported here is the percentage of respondents who had “a great deal” or “quite a lot” of confidence in parliament.

Source: Pharr, S.J. and R.D. Putnam (2000), *Disaffected Democracies: What's Troubling the Trilateral Countries?*, Princeton University Press, Princeton, New Jersey, United States, Table 3.2.

Deterioration in citizen regard is not an isolated phenomenon nor a pattern that has occurred only in countries that have undergone political upheavals or scandals. “The convergence of results across Trilateral democracies is striking,” a team of prominent scholars concluded, “because each has experienced its own unique political events” (Pharr and Putnam, 2000). Some observers take comfort in the fact that citizens in OECD countries overwhelmingly favour democratic forms of governance.⁷ Their discontent appears to be directed at political institutions, particularly political parties and parliaments, not at the constitutional framework. Voters want competitive elections and the absolute right to

select government leaders, but they have distaste for the noise and cacophony generated by unfettered competition. A cynic might complain that they want democracy, but not the government that democracy gives them.

The inverse relationship between favouring democracy and disfavouring politicians has spurred some people to argue that democracy is strengthened by having an attentive, sceptical public. This argument ignores the fact that, in the not-so-distant past, citizens held much more favourable views of political institutions and processes. It is the down trend in civil attitudes, not the absolute scores, that troubles practitioners and scholars and eludes easy explanation. Moreover, declining trust and confidence have been accompanied by political demobilisation: less attention to political news and events, weaker party identification, and less engagement in political activity. Whatever the reasons, there certainly is negative feedback from citizen values to the capacity of government to take the tough decisions required to repair its budget contracts.

The timing of the down trend provides a clue to the withdrawal of trust. The post-war economic boom, which continued for approximately a quarter of a century in many OECD countries and was interrupted only by mild cyclical swings, petered out during the 1970s in the aftermath of oil price shocks and other disturbances. National economies across the OECD area continued to expand, but generally at lower rates and more haltingly than in the immediate post-war period.⁸ In the same way that governments and leaders previously took credit for robust growth, they now were blamed for disappointing economic growth. Worse yet, they no longer had sufficient growth dividends to distribute through expansionary budgets, but they were pressured to satisfy the financial commitments and expectations established during the boom years. In quite a few countries, politicians shifted from credit-taking to blame-avoidance and to tactics they hoped would shield them from the wrath of voters.⁹

However, although they are an important part of the story, economic trends do not provide a full explanation. For one thing, trust generally has not recovered when the economy has; the two variables have not moved in lockstep. For another, the concept of trust has cultural, normative, socio-political and other dimensions that need to be accounted for. Trust is not simply a referendum on the government of the day, but a statement concerning the relationship between citizens and the state. It is this relationship that has been impaired and that has to be rebuilt if budget contracts are to be repaired.

It is plausible to assume that adverse attitudinal trends are linked to deteriorating government performance, not just in a single year or activity, but over an extended period and across a broad swath of government responsibilities. There is little evidence, however, that governments are less efficient or productive than they once were, or that low performance is a cause of low trust. A team of senior World Bank researchers has examined the question of whether a performance budget that gives citizens a clear picture of how public money is spent might reverse the downward spiral in public regard. The team reviewed both public opinion surveys and various “drivers of trust” identified by prominent scholars. It concluded that “trust in government is not a simple function of perceived quality of service provision” (World Bank, 2010, p. 207). The team found a more complicated story, which it packaged into six pointed statements (World Bank, 2010, p. 203):

- Accountability matters more than performance in OECD countries.
- The effect of performance on trust erodes over time, even when performance itself remains constant.

- Improving performance matters most in services directly provided to citizens.
- The gain in trust due to improvements in performance and accountability can be squandered through perceived misdeeds.
- Overstated rhetoric can discredit performance results.
- Performance expectations matter.

A single theme runs through most of these conclusions. Except for accountability (the first item), all the findings deal directly or by implication with the alignment of expectations and results. Expectations are the building blocks of trust, and sometimes its undoing as well. Expectations and public trust rise when government expands, provides and promises more benefits, and improves performance. However, when benefits and performance are flat, expectations tend to remain elevated but trust is likely to decline. This is the contemporary version of the “what have you done for me lately” complaint of voters. The appealing but ultimately damaging response is for politicians to substitute promises for results – to proclaim, for example, that every child will be educated, everyone who wants to work will have a job, slums will be eradicated and the streets will be made safe, and so on down the roster of public responsibilities. Every promise pumps up expectations; every report that shows a shortfall in results deflates trust.

Though important, the gap between promised services and delivered results is only part of the disconnect between government and citizens. The trust problem is grounded as much in success as in failure, and probably as much in the functioning of modern society as in the performance of government. The great success of most OECD countries, which has roots in policies initiated decades before that Organisation was established, has been to liberate and empower the individual. Government programmes have been critical in universalising literacy, modernising transport, extending life expectancy, stabilising communities, boosting incomes, cushioning the financial effects of illness and unemployment, and enabling men and women to make their own financial and personal choices. Citizens have been made into consumers, armed with money to satisfy personal tastes and wants and with personal freedom to pursue their own interests. Obligations have been recast into rights that have been extended to once-limited or excluded persons – children, minorities, the handicapped and, in some countries, immigrants. The individualisation of expenditures by means of mandatory entitlements was vastly expanded during the first decades of the OECD, when governments were still in an expansionary mode and income transfers became the largest expense in national budgets.

The triumph of individualism has been assigned multiple labels which reflect its diverse impacts. From the perspective of public policy, it is the flowering of the liberal welfare state that invests citizens with personal freedom, political rights and financial means to satisfy their private wants. In Maslow’s famous hierarchy of needs, the apogees of individualism are “self-actualising” norms that elevate personal fulfilment above other values (Maslow, 1943). To some political sociologists, individualism has weakened group ties and drained countries of the social capital that undergirds democratic politics (see Putnam, 1995). From the vantage point of public finance, individualism is associated with the steep rise in mandatory entitlements and in the increased rigidification of national budgets. In the burgeoning literature on trust, individualism is often labelled post-materialism and is tagged as the principal reason for the withdrawal of citizen regard.¹⁰ The post-materialist individual is discomfited by all collective institutions and especially by the state which, no matter how open and democratic, is the most collectivist of all. The

paradox of collective institutions empowering and constraining individuals is at once the modern democratic state's greatest accomplishment and greatest challenge.

The post-materialist citizen has financial security – in significant part through the largess of the government – but wants something more and different, such as more leisure or liberty to do his/her own thing. A government has a confined role in supplying these non-material wants. It has a hierarchy of capacities that mirrors the individual's hierarchy of needs, beginning with providing physical protection and moving up the hierarchy to enabling services, such as education and transport, then to providing financial security. But there is not much that a government can do to self-actualise its citizens. Getting out of the way is one option, but this tactic, which is favoured by the more market-oriented OECD countries, does not garner much applause from citizens. The alternative favoured by more collectivist countries is to provide an enriched menu of public goods, such as environmental improvement, cultural pursuits and more leisure. The problem with this approach is that self-actualising wants are boundless: the more the government capacitates its citizens, the more they expect from it.

This predicament arises because post-materialists really are quite materialistic: they covet the goods, services and financial well-being provided or enabled by the government. They take these for granted, which is why they do not reward the government with trust when their wants are sated.

The expectation of getting ever more – glorified in modern times as progress, and enshrined in league tables and comparative ranking – is why today's citizens bite the public hand that feeds them. National budgets give citizens more reasons to be grateful than before. Not long ago, governments extracted taxes to finance their own operations; now, they spend public money principally to endow households and individuals with financial security. Citizen and state are financially tethered together but, rather than breeding trust, interdependence appears to have had the opposite effect.

If this argument is valid, it portends both good news and bad news. The good news is that low trust scores do not connote that the government is an uncaring services provider or a poor performer. In almost all OECD countries, social security benefits and other payments are distributed with clockwork efficiency, public services are accessible to an even broader range of citizens, and governments invest substantial resources to evaluate and report results. The bad news is that governments have limited scope to re-earn trust by being better performers. When they have the means, governments can bestow more benefits on citizens, but doing so might not suffice to turn the tide, at least not in the short run.

In assessing the relationship between government and the governed, low trust may be similar to a low-grade fever: at times bothersome, but rarely of consequence to do something about it. Then came the Great Recession, and in countries facing austere budgets, higher tax burdens and programme cutbacks, low trust has the potential to become more toxic and to greatly complicate the task of rebalancing public finance. In some countries, withdrawal of trust is no longer a low-grade fever.

5.2. Trust and budgets

In the framework of this article, the problem facing OECD countries is how to repair budget contracts and relationships when they cannot draw on a reservoir of trust to ease short-term pressures while securing long-term fiscal stability. The solution foreseen here is to reverse the connection between trust and budget policy. Rather than viewing trust as

enabling governments to repair tattered budget contracts, repairing these contracts is a pre-condition for boosting citizen regard of government. As long as citizens are disquieted by large fiscal imbalances, uncertain about whether promised social benefits will be forthcoming, and sceptical about government performance, they will distrust public institutions. The fundamental implication of this argument is that governments must make hard budget choices before citizens rally in support; in fact, the government of the day puts its political standing at risk by taking unpopular measures to stabilise public finance.

Although it might not suffice, a key to restoring public trust is to balance citizen expectations and government capacity. When citizens expect more from a government than it can effectively deliver, they cannot be confident that politicians and political institutions will fulfil their part of the bargain. Each country has to find its own way, consistent with its political orientation and economic condition, in aligning capacity and expectations. Some countries will aim to dampen expectations by reducing the footprint of the state and withdrawing from or curtailing some responsibilities; others will strive to upgrade government capacity by improving performance and expanding their revenue base. All will have to shift some risks and costs to households or enterprises; if they do not, new budget contracts will not be sustainable.

6. Restoring public trust and stabilising public finances

Each of the three types of budget contracts examined in this article requires distinct adjustments that were outlined earlier. But, regardless of the type of contract, all share several characteristics that are needed to repair relations between citizens and government.

- **Repaired contracts should aim for long-term sustainability, not only for short-term fixes.** In the aftermath of crisis, fiscally stressed countries have been tempted or pressured to make immediate policy changes that help stabilise public finance. While it is necessary to correct short-term imbalances, restoring trust is best facilitated by policy changes that can be sustained over a generation or longer. Bookkeeping tricks that defer expenditures or rely on one-off revenues will not restore budget balance or political confidence. False or temporary savings that compel a government to rewrite its budget contracts every few years will seed even more distrust among citizens who lack confidence that commitments and promises will survive the next political or economic cycle.
- **Governments should take account of downstream costs when they initiate or expand programmes.** The natural inclination of politicians is to use budgets to expand services or benefits. The process itself invites spending units to bid for additional resources and for the government to give them some fraction of what they requested. During boom times, groups and the media take it for granted that the budget will be a platform for programme expansion. Even when austerity is the order of the day, governments try to make some room in the budget for policy initiatives. They seek “sweeteners” that soften the cutbacks and enable them to claim that the government is doing good things and being responsive to citizen needs. One popular ploy is to “backload” spending increases by phasing them in over a period of years or having them take effect some years in the future. This tactic may buy political support and boost trust ratings but, sooner or later, the government will have to retreat from budget commitments, and trust will once again plummet.
- **Governments should reduce their exposure to financial and social risks.** Shifting large risks to governments helped boost economic output and personal well-being in OECD countries during the good times. But long before the Great Recession, fiscal

experts and social planners had warned that governments were overextended and would not be able to fully honour their financial commitments when populations age and escalating pension and health care obligations come due. The recession has hastened the day of reckoning in fiscally stressed countries, but other OECD countries are certain to feel the brunt of demographic and fiscal trends unless they act to shift some risks and costs off their books to families, households and enterprises.

The remedy applied by a few innovative countries, and recommended earlier in this article, is to have recipients share in the financial cost of “good news” such as improved health care and longer life. Health services and longevity are the two main drivers of unsustainable budget trends; any government intent about stabilising its fiscal future will have to deal with one or both of these factors. Countries that are currently in sound fiscal condition do not have to apply shock therapy to consolidate public finance. They can legislate changes in pension and health policies that have quite small effects at the start but cumulate to large savings 2-3 decades ahead. After all, advances in medical care and age expectancy inch ahead slowly; their large budgetary impacts are felt over time, not all at once.

- **Government budgets should more closely link resources and results.** Repairing budget contracts is inextricably linked to restoring public trust. There is no clear evidence that low trust scores are due to mal-performance by government; the rise of individualism, this article has argued, is the most prominent factor, though not the only one. Nevertheless, perceptions of performance take their toll in citizen attitudes and may have a greater impact than actual performance, especially with respect to critical public services such as education and health care. Budget procedures can make a modest contribution to aligning perceived and actual performance by explicitly linking the amounts allocated to the results produced or expected. Most performance-based budgets treat resources and results as separate entries that have no bearing on one another. These types of performance budget do not disclose changes in results that would ensue from spending more or less, or from reallocating funds from one activity to others.

Constructing a true performance budget requires major changes in information, costing and measurement systems. Reformatting budget documents to show workload or output data does not suffice; the key difference is to accurately inform citizens of how spending options or choices affect the services they receive from the government.

When all is said, this article argued earlier, it is the misalignment of expectations and capacity that has damaged budget contracts and citizen perceptions. Dampening expectations is exceedingly difficult in democratic societies that have been acculturated to expect progressive improvement in economic well-being and government-financed benefits. Rewriting budget contracts is only one of the adjustments needed to restore public trust by bringing citizen expectations and government capacity into balance. Changes in private and social structures and relationships may also be necessary, along with political reforms that make governments more accessible and transparent. But although it is only one facet of the solution, repairing the budget relationship will be a prominent element.

Notes

1. See Schick, 1998. For an application of this typology to budget practices, see Schick, 2001.
2. The case for independent fiscal institutions was presented in Gruen, 2001.

3. The Citizens' Charter, introduced by the United Kingdom in 1991 but discarded in 1997, is a prototype of a service-based contract between the government and citizens.
4. The concept was developed by Kaplan and Bruns, 1987.
5. For a practical application of marginal analysis in performance budgeting, see Friedman, 2005.
6. The concept of relational contracts was advanced by Macneil, 1974, p. 691.
7. In the 16 countries covered by the 1999 European Values Survey and the 2002 World Values Survey, between 87% and 98% of respondents approved the idea of democracy, and between 78% and 99% regarded democracy as the best form of government (see Dalton, 2004, Table 2.5, p. 42).
8. Late 20th century data (which were subsequently revised in later OECD publications) showed that real GDP growth in the OECD area averaged 5.1% during 1960-68 and 4.7% during 1968-73, but only 2.6% during 1973-79 and 2.2% during 1979-85 (OECD, 1987, Table 3.1).
9. This pattern was initially identified by Weaver, 1986.
10. Ronald Inglehart is the leading proponent of the post-materialist argument. See Inglehart, 1997.

References

- Anderson, B. and J. Minarik (2005), "Design Choices for Fiscal Policy Rules", *OECD Journal on Budgeting*, 5(4):159-208.
- Bixi, H.P. and A. Schick (eds.) (2002), *Government at Risk: Contingent Liabilities and Fiscal Risk*, The World Bank and Oxford University Press, Washington DC.
- Burke, E. (1790), *Reflections on the Revolution in France*, Penguin Classics.
- Dalton, R.J. (2004), *Democratic Challenges, Democratic Choices: The Erosion in Political Support in Advanced Industrial Democracies*, Oxford University Press, Oxford.
- Friedman, M. (2005), *Trying Hard is Not Good Enough*, Fiscal Policy Studies Institute, FPSI Publishing, Santa Fe, New Mexico, United States.
- Gruen, N. (2001), "Greater Independence for Fiscal Institutions", *OECD Journal on Budgeting*, 1(1):89-115.
- IMF (International Monetary Fund) (2009), *Fiscal Rules*, International Monetary Fund, Washington DC.
- Inglehart, R. (1997), "Postmaterialist Values and the Erosion of Institutional Authority", in J. Nye, P. Zelikow and D. King (eds.), *Why People Don't Trust Government*, Harvard University Press, Cambridge, Massachusetts, United States, pp. 217-236.
- Kaplan, R.S. and W.J. Bruns Jr. (eds.) (1987), *Accounting and Management: Field Study Perspectives*, Harvard Business School Press, Cambridge, Massachusetts, United States.
- Macneil, I.R. (1974), "The Many Futures of Contracts", *Southern California Law Review*, Vol. 47.
- Maslow, A. (1943), "A Theory of Human Motivation", *Psychology Review*, 50(4):370-396.
- OECD (1987), *OECD Economic Outlook: Historical Statistics 1960-1985*, OECD Publishing, Paris.
- OECD (2007), *Performance Budgeting in OECD Countries*, OECD Publishing, Paris.
- Pharr, S.J. and R.D. Putnam (2000), *Disaffected Democracies: What's Troubling the Trilateral Countries?*, Princeton University Press, Princeton, New Jersey, United States.
- Pharr, S.J., R.D. Putnam and R.J. Dalton (2000), "A Quarter-Century of Declining Confidence", *Journal of Democracy*, 11(2):5-25.
- Putnam, R. (1995), "Bowling Alone: America's Declining Social Capital", *Journal of Democracy*, 6(1):65-78.
- Schick, A. (1996), *The Spirit of Reform: Managing the New Zealand State Sector in a Time of Change*, New Zealand State Services Commission, Wellington.
- Schick, A. (1998), "A Contemporary Approach to Public Expenditure Management", The World Bank, Washington DC.
- Schick, A. (2001), "The Changing Role of the Central Budget Office", *OECD Journal on Budgeting*, 1(1):9-26.
- Schick, A. (2003a), "The Role of Fiscal Rules in Budgeting", *OECD Journal on Budgeting*, 3(3):7-34.
- Schick, A. (2003b), "The Performing State: Reflection on an Idea Whose Time Has Come but Whose Implementation Has Not", *OECD Journal on Budgeting*, 3(2):71-103.

- Schick, A. (2007), "Performance Budgeting and Accrual Budgeting: Decision Rules or Analytic Tools?", *OECD Journal on Budgeting*, 7(2):109-138.
- Valdes-Prieto, S. (2002), "The Financial Stability of Notional Account Pensions", *The Scandinavian Journal of Economics*, 102(3):395-417.
- Weaver, W.K. (1986), "The Politics of Blame Avoidance", *Journal of Public Policy*, pp. 371-398.
- Weaver, W.K. (2006), "Building Automatic Solvency into US Social Security: Insights from Sweden and Germany", The Brookings Institution, *Policy Brief*, No. 151, March.
- Wildavsky, A. (1964), *The Politics of the Budgetary Process*, Little, Brown and Company, Boston.
- World Bank (2010), "Results, Performance Budgeting and Trust in Government", The World Bank, Washington DC.

Independent Fiscal Institutions: Developing Good Practices

by
George Kopits*

This article presents an overview of independent fiscal institutions in OECD member countries, outlining their principal common features as well as country-specific attributes and functions, and flags the challenges they face in the surveillance of public finances. The case of the short-lived Fiscal Council in Hungary is discussed, with a comparison to the recently established Office for Budget Responsibility in the United Kingdom. The article draws upon the experience accumulated so far to propose internationally accepted good practices in this area.

JEL classification: H610, H680

Keywords: surveillance of public finances, independent fiscal institutions, fiscal council, parliamentary budget office, office for budget responsibility, oversight of fiscal policy, Hungary, United Kingdom

* George Kopits is senior scholar, Woodrow Wilson International Center for Scholars; former chair, Fiscal Council, Republic of Hungary; and former member, Monetary Council, National Bank of Hungary. An earlier version of this article was presented at the third annual meeting of Parliamentary Budget Officials in Stockholm, 28-29 April 2011. The article benefited from useful comments from Alan Budd, Balázs Romhányi, Eugene Steuerle, Coen Teulings, Lisa von Trapp, Simon Wren-Lewis, and participants at the meeting.

Although relatively few and novel worldwide, independent fiscal institutions have an important oversight role over fiscal policy-making in democratic societies, especially as they seek to restore public debt sustainability in the wake of the recent global financial crisis. This article presents an overview of these institutions in OECD member countries, outlining their principal common features as well as country-specific attributes and functions, and flags the challenges they face in the surveillance of public finances. In addition, it discusses in some depth the case of the short-lived Fiscal Council in Hungary, supplemented with a comparison to the recently established Office for Budget Responsibility in the United Kingdom as perceived in financial markets. Finally, on the basis of the experience accumulated so far, the article derives lessons with a view to formulating internationally accepted good practices in this area.

1. Evolution, experience and challenges

The first national independent fiscal institution entrusted with real-time surveillance of public finances (the United States Congressional Budget Office) was established in unique historical circumstances – almost accidentally – more than three decades ago. A couple of older institutions (the Central Planning Bureau in the Netherlands and the High Council of Finance in Belgium) began a similar fiscal watchdog function later and, eventually, a few other countries followed. More recently, in response to an unprecedented buildup in public sector indebtedness in the aftermath of the global financial crisis, an increasing number of countries have created, or are in the process of establishing, independent fiscal institutions.

These watchdogs differ markedly from other independent institutions that may have monitoring responsibilities too. In particular, they are not to be mistaken for public audit institutions that operate, with a long tradition, in more than 150 countries around the world. Although equally independent, the audit institution is responsible for conducting a detailed *ex post* inspection of the physical, financial and legal integrity of every public sector entity; in some countries, this task is complemented with performance audits. By contrast, the principal function of an independent fiscal institution (known under various names such as fiscal council, parliamentary budget office, or office for budget responsibility) is analysis and assessment of the budget bill or of any other legislative proposal in the fiscal area, including its consistency with fiscal rules (if any), prior to enactment. More specifically, an independent fiscal institution performs real-time costing and forecasting to ascertain the macro-fiscal consequences of the budget bill, over a short and medium term to a long-term horizon. In essence, its principal *raison d'être* is to maintain discipline and transparency in public finances during the policy-making process, which in turn helps bolster the credibility of government.

In other words, whereas the public audit institution discharges an indispensable backward-looking task, the independent fiscal institution has a forward-looking diagnostic task. In this division of complementary responsibilities, the former is comprised of a large

number of lawyers, auditors and accountants, whereas the latter is for the most part staffed with a relatively small group of economists. However, both institutions serve primarily the legislature and the public at large. Although in principle neither institution has a normative role, exceptionally in a few countries the independent fiscal institution has an advisory function (Sweden) or recommends budgetary targets (Belgium), but at the risk of forsaking non-partisanship.

In any case, the independent fiscal institution has no decision-making authority and, by implication, it cannot have legally binding enforcement power. Unlike monetary policy, fiscal policy by its very nature cannot be outsourced for two reasons. First, whereas monetary policy is assigned only the price stability goal, fiscal policy serves multiple objectives: stabilisation, allocative, distributional goals. Second, a democratically elected government cannot entrust fiscal policy to an unelected independent authority. By contrast, in most countries around the world, monetary policy is delegated to an independent monetary authority (monetary council, federal open market committee, etc.) predicated on a well-defined principal-agent relationship between the government and the monetary authority.

Moreover, the independent fiscal institution is to be distinguished from other advisory bodies, whether independent (Austria, Denmark, Germany) or attached to the executive arm of the government (for example, the United States Council of Economic Advisors), that do not perform a technical oversight function. Although accountable to the legislature, the independent fiscal institution is not part of it – not in the way that a budget or treasury committee is part of Parliament. The independent fiscal institution is a permanent entity, unlike periodically established review entities (finance commissions in India). Also, such an institution has a broad mandate mainly over the central government, as distinguished from a narrow monitoring task (United States Trustees of the Social Security and Medicare trust funds).¹

In all, there are more than half a dozen countries with independent fiscal institutions that meet the above characteristics. Yet, in each case there are features that are specific to each country's needs, legal traditions and initial historical context at the time of establishment. These features, of course, evolve over time, as the institution acquires experience.

As regards its organisational structure, the institution is headed either by an individual or by a council (or committee), appointed by the government or elected by a legislative committee or the legislature as a whole. More important, the system of government usually determines the institution's independence. While in a parliamentary system the institution should be independent from both the executive and the legislature, in a presidential system it is usually sufficient if the institution is independent from the executive.²

Typically, the head is a remunerated professional with no active political affiliation, who serves for a predetermined period spanning beyond the term of the government.³ In most cases, the institution has its own technical staff, with full access to all necessary data and information from the government. However, in Belgium and Sweden, it is supported by the staff of other public institutions⁴ with proven impartiality and analytical competence.

The terms of reference of independent fiscal institutions include the preparation of estimates and forecasts of the fiscal and macroeconomic consequences of proposed measures in time for consideration by Parliament during the legislative debate and before enactment. Prior to submission of the budget bill, in most countries, the institution produces short- and medium-term no-policy-change forecasts to serve as baselines for

subsequent forecasts that incorporate the proposed fiscal measures. In addition, periodically, it prepares quantitative long-term scenarios and sensitivity analyses for specific policy options, with clearly spelled out macroeconomic and demographic policy assumptions. The forecasts of the independent watchdog are not necessarily more accurate than other official or private forecasts but, unlike the latter, it reports publicly all underlying data and methodology. The goal is to assess the reliability of the government's estimates and forecasts, including the associated assumptions, with a view to determining the sustainability of sovereign debt and gauging the risks associated with the prospects. An additional function in the Netherlands consists of assessing the economic platform of major political parties, at their request, during electoral campaigns.

Table 1 summarises the structure and remit of the institution in selected countries. In addition to the organisational structure, the table indicates the remit in terms of five basic functions: monitoring compliance with fiscal rules or targets; macro-fiscal evaluation and forecasting; assessment of long-term debt sustainability; costing of legislative proposals; and formulating policy advice. The list excludes fiscal councils established in Romania and Slovenia and the recently downgraded council in Hungary, as none of them meet the characteristics identified above. In all three cases, the council is comprised of a non-remunerated part-time chair and members who periodically release opinions on broad fiscal trends and on the budgetary outlook, without any support from a technical staff.

Table 1. **Selected countries: Structure and functions of independent fiscal institutions**

	Effective date	Structure		Functions				
		Head	Staff	Compliance	Macro-fiscal	Sustainability	Costing	Advisory
United States: <i>Congressional Budget Office</i>	1975	Individual	X		X	X	X	
Netherlands: <i>Central Planning Bureau</i>	1986*	Individual	X	Rules	X	X	X	
Belgium: <i>High Council of Finance</i>	1989*	Collective	Other	Targets	X	X		X
Korea: <i>National Assembly Budget Office</i>	2003	Individual	X		X		X	
Sweden: <i>Fiscal Policy Council</i>	2007	Collective	Other	Rules	X	X		X
Canada: <i>Parliamentary Budget Officer</i>	2008	Individual	X	Targets	X		X	
Hungary: <i>former Fiscal Council</i>	2009	Collective	X	Rules	X	X	X	
United Kingdom: <i>Office for Budget Responsibility</i>	2010	Collective	X	Targets	X	X	X	

* These institutions were established in 1945 and 1936, respectively, but initially without a remit in fiscal policy.

A major issue that emerges in any discussion of independent fiscal institutions is their effectiveness in promoting transparency in public finances. Although in most countries the track record is rather short, on balance they appear to have had a positive impact on both counts. Any evaluation of their effectiveness is clouded by several considerations. Namely, the institution (along with fiscal rules) may be simply a formal manifestation of the government's political commitment, underpinned by the electorate's preference for discipline. In addition, it is difficult to ascertain a more subtle influence of the institution, as fiscal behaviour over time may be conditioned by the mere presence of the institution – whereby the government anticipates, and therefore averts, a potential confrontation by forgoing a more relaxed or opaque fiscal stance. In sum, the main difficulty lies in our inability to observe the counterfactual.⁵

Technical preparatory work and consensus building are under way in setting up independent fiscal institutions in Australia, Ireland, Portugal, Serbia and Slovak Republic.

In Chile, the creation of a formal fiscal council, on top of two existing panels of experts, is currently under consideration.

The International Monetary Fund and the European Union encourage the establishment of independent fiscal institutions.⁶ An ambitious initiative to create an EU-wide supranational watchdog to assess the budget bills of all member countries failed to materialise. A more effective alternative, for EU members, would be to establish minimum criteria to ensure the independence of these institutions at the national level, enforced by the Commission, much like the European Central Bank watches over central bank independence in member countries.⁷ A rather weak form of this option can be found in the draft European Council Directive on budgetary frameworks currently under consideration.⁸

The evolution of independent fiscal institutions has not occurred without stumbling blocks. Indeed, these institutions have had to face considerable challenges along the way. First, in the initial phase-in period which may last through as many as one or two changes in government, the institution has to prove its non-partisanship and technical competence. This was the case in the United States, where the Congressional Budget Office earned a reputation for impartiality well into the Carter administration, following the Nixon administration, only after it was able to display the same critical demeanour toward both governments. Second, the government may react to a critical assessment by reducing or threatening to reduce the appropriated budgetary funding to the institution, as has occurred in Canada and Sweden. Third, the government may be less than forthcoming in making data available to the institution, which happened in Canada. In these cases, the institution is likely to be protected primarily by public opinion and by financial markets, galvanised by alert and informative media.

However, in some instances the very existence of such a watchdog is under threat by a government that cannot tolerate critical assessment by independent institutions. The first institution to succumb was Venezuela's Congressional Budget Office – designed largely after the United States model – following three years of operation, terminated by President Hugo Chávez in 2000. More recently, Hungary's Fiscal Council was denied access to some official information and was threatened with a major cut in funding. Finally, the Council lost all funding, and its remit was significantly narrowed and its technical staff abolished under Prime Minister Viktor Orbán at the end of 2010 (discussed below).

2. The experience of Hungary

In many respects, the short-lived experience of Hungary's Fiscal Council illustrates in fast motion the range of challenges faced by an independent fiscal institution in an environment characterised by fiscal indulgence and low policy credibility. Following a rapid gestation period, the Fiscal Council was in operation for nearly two years before its demise and actual termination.⁹

2.1. Background

Hungary's public finances deteriorated markedly over the period 2000-06.¹⁰ Beset by both time inconsistency and common-pool problems, fiscal performance was dominated primarily by the electoral cycle rather than by macroeconomic fluctuations. From the bursting of the IT bubble at the beginning of the last decade until the global financial crisis, Hungary benefited from sizeable capital inflows to cover its wide external imbalances, driven by low private propensity to save and by large public sector dissaving. During the

so-called Great Moderation that experienced abundant global liquidity, these imbalances were facilitated by easy access to financing – especially in the lead up to EU membership. Under the assumption of an implicit guarantee conferred by EU membership, carry-trader investors were engaged in a moral hazard game, attracted by high yields on government paper. By 2006, the general government deficit peaked at nearly 10% of GDP, the highest among EU member countries.

Despite a fiscal correction as the global financial crisis unraveled, Hungary became exposed to a rapid loss of investor confidence. With a sudden stop in access to the secondary sovereign market, in October 2008, the authorities launched an adjustment programme supported by a stand-by arrangement with the International Monetary Fund and the European Union. Thus, in contrast with the rest of Europe, Hungary's expansionary fiscal stance was followed by the most contractionary stance during the financial crisis. In the meantime, public debt surged to over 80% by the end of 2010 from about 50% of GDP in 2001.

Apart from the destabilising effect on the economy reflected in output volatility and a contraction well below capacity, the greatest damage inflicted by reckless fiscal policy was the sharp erosion in credibility. Low credibility was rooted not only in an actual buildup of public indebtedness, but also in the opaque demeanour of the authorities. Less-than-transparent and incomplete reporting of public accounts (including abuses with PPP projects and delayed recognition of state-owned enterprise losses) and optimistic macro-fiscal projections became endemic practices.

2.2. Birth of the Fiscal Council

Faced with the deterioration in public finances in the spring of 2006, in the run-up to general elections, there was renewed interest in restraining fiscal indulgence through the introduction of permanent fiscal rules and an independent fiscal institution – in part drawing a parallel with the relatively well-functioning inflation-targeting regime, run by the Monetary Council of the National Bank of Hungary, that had been in operation since 2001. These initiatives, mostly from non-government quarters, were supported by some leading spokespersons of the main opposition party. In fact, it was only a year later that the government expressed interest in establishing a rules-based framework.

Proposed options for fiscal rules encompassed ceilings on public debt, on budget deficits and on expenditures. There were two main competing proposals for an independent fiscal watchdog. One was a fiscal council resembling the Swedish model, with technical support from the State Audit Office, presumably with a beefed-up staff to undertake fiscal analysis. The other option was an office with a relatively large staff, attached to Parliament, following the example of the United States Congressional Budget Office.

An additional contentious issue was whether to endow the institution with authority to enforce compliance with the rules. Some argued that it should have coercive power to reject a budget bill submitted to Parliament – entirely unusual in other countries – if it deemed the bill unrealistic and in violation of the fiscal rule; in the event, the bill would have to be modified accordingly or passed by a two-thirds majority of Parliament. Others argued that such legal authority might run counter to democratic principles or was not necessary, as the independent fiscal institution would have sufficient dissuasive power vis-à-vis the government through other means – as such institutions do elsewhere.

In the summer of 2007, the Hungarian Ministry of Finance unveiled draft legislation that called for the adoption of fiscal rules and of an independent parliamentary office. The

initiative was taken up by the President of the Republic who summoned legislative party leaders to reconcile their differences and enact the legislation. This was followed by 18 multi-party reconciliation meetings chaired by the then finance minister over a period of nearly a year, but with meagre tangible results. In November 2008, however – as part of the adjustment programme – Parliament passed the Fiscal Responsibility Law broadly based on the initial draft. Although the new law contained a number of compromises, it failed to gain the support of the main opposition party. Key features of the law, which amended the organic law on public finances as well, included the adoption of a set of policy rules, procedural rules and transparency standards. In addition, the law called for the establishment of the Fiscal Council, a collective body with its own technical staff (Office of the Fiscal Council) but without legal authority to enforce its assessments.

The Council was comprised of three members nominated by the President of the Republic, the Governor of the National Bank of Hungary, and the President of the State Audit Office. Following hearings in the Budget and Finance Committee, they had to be elected by a simple majority in Parliament. Actually, the Council members were supported by the Committee and elected unanimously on the floor – a rare occurrence in Hungary’s highly polarised political spectrum. This outcome was interpreted as a vote of confidence in the Council and, implicitly, as widespread support for the enabling legislation.

The Fiscal Council was scheduled to begin operating in the course of 2009, mostly on a pilot basis, in many respects shadowing its actual mandate that was to become effective in 2010. Instead, the Council decided to embark on an early start. As rapidly as legal and physical conditions permitted (hiring, procurement, etc.), preparations began to establish the Office of the Fiscal Council by the summer of 2009. Though still short of manpower, the Office issued the first baseline projection by mid-summer, in anticipation of the 2010 budget bill.

2.3. Goals

Given the economy’s continued vulnerability, the overarching goal of the Council from the outset was to restore the credibility of fiscal policy-making in the eyes of the electorate at home and of the financial markets abroad. For this purpose, the Council sought to enforce the new standards of transparency as enshrined in the law. The objective was to ensure public access to timely, comprehensive and understandable information on the state of public finances. This effort involved compelling the government to publish, with sufficient frequency and detail, updates of actual and estimated outcomes of public sector operations – above and beyond the requirements of Eurostat or the commitments under the stand-by arrangement.

Ultimately, the Council aimed at restoring public debt sustainability, in line with the mandate of the fiscal responsibility legislation. Apart from increased transparency, this required continuous surveillance of the reliability of macro-fiscal projections and compliance with the real debt rule and the pay-go rule (discussed in Sub-section 2.7 below), both designed for this purpose. Success would be reflected in a decline in sovereign risk premium. The resulting savings in the government’s annual interest bill would total well in excess of EUR 1 billion (more than one percentage point of GDP) if the risk premium declined to the average of Visegrád¹¹ countries, accompanied by a sizeable decline in interest costs in the private sector as well. More important, the benefits would further induce additional growth over time.

2.4. Basic modus operandi

The law provided the Hungarian Fiscal Council with a high degree of independence from both the government and Parliament. To be eligible to become members of the Council, the nominees must not have had any active party affiliation or held a political position in the previous four years. The members' non-renewable tenure was set at nine years – that is, spanning more than two four-year electoral cycles.

The Council was a creation of Parliament and, by the same token, could be abolished by a legislative act. Accordingly, its members were elected, and could be removed with cause, through simple majority vote, as spelled out in the Fiscal Responsibility Law. Parliament, its committees or members could invite the Council to express its opinions and for consultations; in this sense, Parliament was the Council's primary client. However, the Council was not an integral part of the legislature. Once in office, the Council was entirely independent from Parliament. The only exception was, of course, its annual budgetary appropriation which was in the hands of the legislature. Likewise, the Council was independent from the government and its agencies. The operations, procurement practices and financial activities of the Office of the Fiscal Council, as for any other public institution, were subject to review by the State Audit Office.

During its brief history, the independence of the Council was respected by Parliament and the government. There was no attempt to curtail or influence its activities directly or indirectly, including through its budgetary appropriation, except in the last few weeks of its existence (discussed below). The Council did not co-ordinate, or let alone negotiate, its analysis, forecasts or views with any public or private entity, domestic or foreign. In this respect, the Council could be regarded as a truly independent authority in public finances in Hungary.

Without forfeiting its independence, the Office of the Fiscal Council held technical consultations with the Ministry of Finance, line ministries, the National Bank of Hungary, the Treasury, the Tax and Financial Control Administration, the Government Debt Management Agency, the Central Statistical Office, and other public and private institutions when warranted by its analytical needs. In addition, public institutions were obliged by law to submit (within two weeks upon request) any data to the Council to perform its functions, including confidential data, as confidentiality requirements are binding on the Council as well. The modality of these consultations and data provision was formalised in bilateral agreements signed by the heads of the corresponding institutions. Consultations with the government and data submission by the government met with mixed success, and previously unavailable information was increasingly being released to the Council.

Whether dealing with domestic or foreign entities, the Council maintained an arm's-length distance, as all information released by the Council was being made available to all interested citizens. An exception to this guideline was that, before their official release to the public, all pertinent analyses and communiqués were transmitted by the Chair of the Council to key official counterparts.¹² In addition, the Chair met the counterparts periodically to inform them of the position of the Council on relevant fiscal policy issues. This practice helped remove unnecessary surprises in the flow of information and promote efficient policy making in economic and financial areas. This practice was particularly important in times of fiscal stress.

The law vested the Chair with decision-making authority in, and responsibility for, the Council, and as chief executive officer of the Office of the Fiscal Council. However, in practice, Council members had opted to take all decisions in consensus (other than

day-to-day operational and administrative decisions). This approach enhanced both the efficiency of the Council and the effectiveness of its statements.

2.5. Functions: evaluation

The law required the Council to evaluate the consequences of the budget bill as well as all other legislative proposals with potential repercussions on central government revenue or expenditure. At an aggregate level, the law instructed the Council to prepare macro-fiscal projections, excluding as well as incorporating the proposed measures – baseline and policy forecasts, respectively. At a disaggregate level, the Council was obliged to present quantitative assessments of the effect of each bill upon submission and before the final vote on mandatory central government revenues and expenditures.¹³ Although the law envisaged a phase-in of these and other functions in the first year of operation, the Council endeavoured to fulfil these responsibilities starting in 2009 to conform to the spirit of the law.

As a first step, at the aggregate level, the Council issued a set of medium-term baseline macro-fiscal projections in mid-August 2009, in anticipation of the budget bill scheduled for submission to Parliament in the following month. This was in essence a projection conditional on current legislation (including measures mandated by law but not yet effective) prevailing through a medium-term horizon. The baseline projection was to be updated by the end of March 2010, assuming implementation of the approved budget. This was in line with the schedule that calls for baseline projections to take place at the beginning of each semi-annual parliamentary season (usually late summer and early spring). The baseline projection provided a convenient benchmark for evaluating the effects of measures contained not only in the budget bill, but also in any other legislative proposal. In addition, the Council presented projections incorporating the effects of the budget bill immediately after submission of the bill to Parliament, in order to assist an informed legislative debate.

Macro-fiscal projections were accompanied by special analyses focused on timely policy issues. For instance, the August 2009 report contained a simulation of medium-term macroeconomic effects of the structural reform package enacted in early summer, consisting of changes in the tax system and social transfers. The March 2010 report included a sensitivity analysis estimating the effects of deviations from the projected path due to marginal changes in selected tax and expenditure categories.

The projections and the simulations were based on a dynamic stochastic general equilibrium (DSGE) model of the Hungarian economy, enhanced with a fiscal block. The model-based projections were built around trend estimates and, whenever warranted, modified with expert opinions. Although their use as a forecasting tool has been questioned, especially because of failure to anticipate the impact of the recent financial crisis on the real sector – absent a satisfactorily specified financial sector – DSGE models proved to be a robust and versatile basis for macro-fiscal projections and simulations, especially because of the explicit treatment of expectations.¹⁴

At a disaggregate level, the staff prepared real-time estimates of the budgetary effects of all mandatory expenditure programmes and tax categories. These estimates were consistent with the macroeconomic projections and, wherever possible, were supplemented by incorporating behavioural and technical parameters based on econometric estimates and expert opinion.¹⁵ All projections, estimates and underlying methodology were made promptly available to the public on the webpage of the Fiscal Council.

The Council found that the official budgetary forecasts contained in the budget bills were generally more realistic than those in previous years – though subject to a considerable risk margin – even when taking into account the world financial crisis and its impact on activity. The government's overall budgetary forecasts, as well as the underlying macroeconomic assumptions, were found to be broadly compatible with those of the Council. This can be attributed at least in part to the fact that forecasts and assumptions were subject to surveillance by the European Commission and the International Monetary Fund under the terms of the stand-by arrangement.

However, the medium-term projections released with the 2011 budget bill, submitted to Parliament in November 2010, were deemed by the Fiscal Council to be grossly optimistic, as they were based on an excessive official estimate of the supply-side impact of the introduction of the flat personal income tax rate. In addition, the Fiscal Council pointed to the lack of transparency in the allocation of the assets transferred from the government-mandated defined-contribution pension funds to the traditional defined-benefit public pension scheme.

2.6. Functions: compliance with standards and procedures

The Fiscal Responsibility Law of November 2008 constituted a significant step toward transparency in the public accounts and toward strengthening control over government expenditure, effective with the 2010 budget. These innovations included: consolidation of central government operations; reporting accrued losses and profits of majority state-owned enterprises; separation of mandatory budgetary components from discretionary categories; and significant reduction in the scope for expenditure overruns without supplementary appropriation. For the most part, these changes meant a stricter practice than ESA95 standards, with a view to restoring credibility in public finances.

The former Socialist government of Hungary made several attempts to dilute or remove the existing standards in the law. For one thing, the government ignored some of them in the 2010 budget bill. The Council repeatedly called attention to these departures from the law, urging the government to comply. Notwithstanding promises to withdraw some of these proposals, the budget bill was enacted untouched. Only during budget execution has the government shown some willingness to apply the law.

A much more serious breach was a proposed amendment to repeal the obligation to report periodically the losses and gains of state-owned enterprises, at a time when financial scandals were raging in public transport enterprises. The Council's protestations over this matter, which it regarded as totally unacceptable, prompted the Socialist government to rescind support for the proposal. The successor Fidesz¹⁶ government restored the proposed amendment and enacted it, disregarding the views of the Fiscal Council. In the same amendment, the government relaxed the threshold deficit that requires submission of a supplementary budget.

2.7. Functions: compliance with fiscal rules

The centrepiece of the fiscal responsibility legislation was to contain the rapid buildup of public indebtedness experienced over the past decade. This objective was to be pursued while preventing the continuation of a pro-cyclical stance that accentuated the volatility of the economic fluctuations. The three major rules are geared to: prevent a deficit-generating net impact for any single legislative proposal (pay-go rule) in the current and the subsequent year; limit the growth of primary expenditures (expenditure rule); and set

a permanent limit on the real stock of central government debt (debt rule). The debt rule limits the stock of central government liabilities, corrected for inflation. To this effect, starting three years in advance, the rule prescribes a two-step algorithm to derive a ceiling on the discretionary primary deficit which serves as the binding operational target, consistent with the *ex ante* debt limit.¹⁷

The law envisaged that compliance with the rules and surveillance would be phased in over time. However, the Council decided to apply the pay-go rule for the purposes of the 2010 budget bill debate. Of some 1 400 proposed amendments submitted by members of Parliament, the Office of the Fiscal Council selected some 300 proposals to examine whether they complied with the rule. Based on the disaggregate methodology being developed, the staff performed estimates (over a three-day interval) of the net budgetary impact and found that the overwhelming majority of the selected proposals violated the rule. A similar exercise was reiterated in connection with amendments to the 2011 budget bill. The estimates and the underlying calculations for each proposal were made available to each MP and to the public. The estimates received considerable media coverage.

Similarly, the Fiscal Council ascertained that both the 2010 and 2011 budget bills were consistent with the expenditure rule. Assessment of compliance with the debt rule was characterised by less than full co-operation from the government in supplying the appropriate information for the separation of mandatory and discretionary components of the budget forecasts. In any event, by flagging the need to comply with the rules, the Council played an early warning role, helping the government to focus on medium-term policy planning and on formulating the necessary fiscal reforms, consistent with the goal of debt sustainability.

2.8. Enforcement

As indicated above, during the preliminary debate over the fiscal responsibility bill, there was a clash of views on whether the Council should be endowed with a legally binding instrument of enforcement. In the final version, the law did not give any legally binding enforcement tool to the Council. In fact, the Council had to rely entirely on pressure generated by public opinion and financial markets, as in the case of practically all other existing independent fiscal institutions. Therefore, the primary tool of “enforcement” is communication and dissemination of Council views through various channels. The basic idea is to influence government behaviour through dissuasion rather than coercion.

A major channel of communication took the form of public and private contacts with Parliament and the government. In the fall of 2009, the Chair of the Fiscal Council was invited several times to Parliament. He presented the Council’s views on the 2011 budget bill at hearings of the Budget and Finance Committee, addressed the plenary session on the budget and, lastly, read a closing statement to the Committee prior to the final legislative action. In addition, the Chair met on a number of occasions with the President of the Republic, the Prime Minister, the finance minister and several members of Parliament. Also, he was asked to address a meeting of the parliamentary caucus of the opposition parties. In the course of 2010, the Chair again appeared in Parliament to express the Council’s analysis and opinion of the 2011 budget bill, including the medium-term fiscal outlook.

However, probably the most powerful communication channel was the media. The Chair and members of the Fiscal Council made themselves available to the media through periodic press conferences, interviews and statements posted on the Council’s webpage.

Also, they gave lectures at professional conferences and held meetings with representatives of civic groups and financial investors. While not actively seeking the limelight, the Council felt that public presence was necessary in order to reach out to Parliament as well as to the electorate, for both informational and pedagogical reasons.

Hypothetically, a formal binding enforcement could be triggered by the President of the Republic and, eventually, by the courts. In the first instance, the President could return a piece of proposed legislation enacted by Parliament on the grounds that it was inconsistent with existing legislation. The President has discretion in deciding the gravity of the inconsistency and in exercising this prerogative.¹⁸ Such action would oblige a new vote in Parliament on a modified version of the bill (at least slightly modified) for automatic passage thereafter.

2.9. Demise

Following general elections in May 2010, the Fiscal Council held a one-day seminar for newly elected members to familiarise them with the budgetary process and the role of the Council. However, apart from sporadic informal contacts with some members of government or of Parliament, and the invitation of the Council Chair to committee hearings and to address Parliament at the beginning of the budget debate, the Fidesz government avoided any mention of the Council or formal contacts with it.

The new government, elected by a two-thirds majority, viewed with disdain the preceding government and with suspicion all policies and institutions inherited from the past. But, more important, the government sought to mould existing institutional arrangements to suit its political preferences and did not tolerate any criticism inherent in checks and balances. Vacancies in both the presidency of the Republic and the presidency of the State Audit Office were filled with sitting members of Parliament loyal to the majority party. When the Constitutional Court struck down a confiscatory tax on severance pay, Parliament immediately limited the court's sphere of influence over cases involving fiscal issues. However, attempts to oust the governor of the central bank failed because of opposition by the European Central Bank, as they contravened the Maastricht Treaty.

In this context, it was not surprising that, following the Council's critical views of the lack of a coherent medium-term budgetary plan in the 2011 budget bill, a Fidesz member of Parliament proposed to cut funding for the Fiscal Council to an insignificant fraction of the original budget request. Ignoring widespread protests in the international and domestic press¹⁹ and in professional and academic circles, as well as adverse reaction in the financial markets, the government submitted a proposal to disband the Office of the Fiscal Council, change the composition of the Council, and radically narrow its remit. The official argument for these steps was budgetary saving – without regard to the value-for-money principle, evidenced by the interest cost associated with the risk premium paid for the government's low policy credibility. The dismissal of the Council was without cause and contradicted the unanimous vote of support by Parliament the preceding year. Given the government's overwhelming majority in Parliament (sufficient to enact constitutional amendments), probably only EU-mandated minimum criteria of independence – missing in the pending draft Council directive on budgetary frameworks, noted above – could have prevented the government's action.

Parliament amended the fiscal responsibility legislation accordingly, against the will of the much-weakened opposition parties. The composition of the modified Fiscal Council

is as follows: the Chair, appointed by the President of the Republic, who serves for six years on a non-remunerated part-time basis,²⁰ and two members who are *ex officio* the governor of the central bank and the president of the State Audit Office. Without a staff, the remit of the Council is limited by law to stating a broad opinion on the budget bill (excluding all other legislative proposals, regardless of their potential budgetary impact) and giving a recommendation to Parliament on whether to pass or reject the bill.²¹ Thus Hungary's Fiscal Council has been reduced to a part-time body much like the fiscal councils in Romania and Slovenia. More important, without resources and with its independence severely eroded, the Council no longer has any specific responsibility for applying criteria of fiscal transparency and sustainability, and for macro-fiscal forecasting or costing of legislative proposals.

3. Comparison with the United Kingdom

The *de facto* termination of Hungary's Fiscal Council was striking in light of the recent creation of the Office for Budget Responsibility (OBR) in the United Kingdom, particularly given their close resemblance in both structure and terms of reference.²² The demise of the former and the establishment of the latter provide an interesting illustration of the influence of policy signaling on market expectations. These contemporaneous episodes provide some stylised facts for this purpose, ignoring a myriad of attributes that differentiate the two countries. A feature in common to both countries was the concurrent election in 2010 of a centre-right government, succeeding a centre-left government notorious for fiscal indulgence over an extended period.

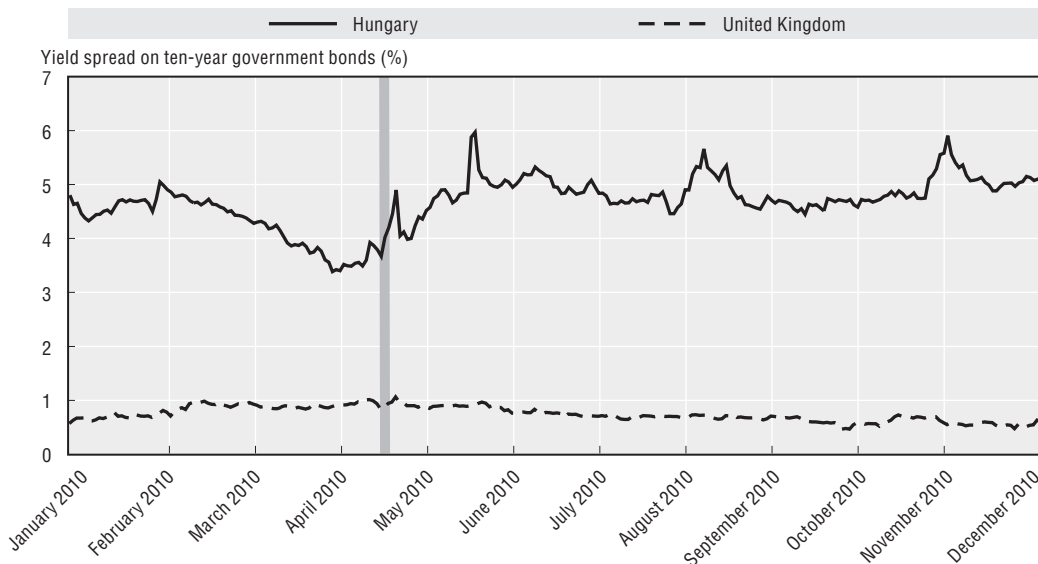
In the United Kingdom, shortly after assuming power in May 2010, the new coalition government set an ambitious structural balanced-budget target (called the fiscal mandate) for the end of its term. In addition, it immediately established an interim OBR, to be succeeded three months later by the permanent OBR headed by a three-member Committee for Budget Responsibility (appointed by the Chancellor of the Exchequer, but their appointment or attempted dismissal is subject to veto by the Treasury Committee of the House of Commons) and staffed by a team of economists and budget specialists, with a remit that includes real-time assessment of all legislative proposals in the fiscal area. The OBR is responsible for monitoring fulfilment of the mandate, preparing macro-fiscal forecasts (a task taken over from the Treasury) and analysing debt sustainability. In addition, as an initial step toward the mandate, the government introduced a number of tangible policy measures such as pruning welfare entitlements and raising the value-added tax rate.

The new government in Hungary, in command of a two-thirds parliamentary majority, inherited a rules-based fiscal framework which it chose to ignore. The government dismantled several modest structural measures introduced during the IMF/EU-supported adjustment programme, and imposed distortionary asset taxes on selected activities; these actions were followed by amalgamation of defined-contribution government-mandated private pension funds into the traditional defined-benefit pay-as-you-go system. None of these measures contributed to reducing the structural budget deficit. Further, as noted, the government weakened significantly the oversight of fiscal policy by independent institutions (the Constitutional Court, the State Audit Office and the Fiscal Council).

Although the above policy shift had no immediate consequence on macro-fiscal trends, the adopted measures influenced market expectations regarding the medium- to long-term fiscal outlook. Markets reacted promptly to the contrasting policy signals in the

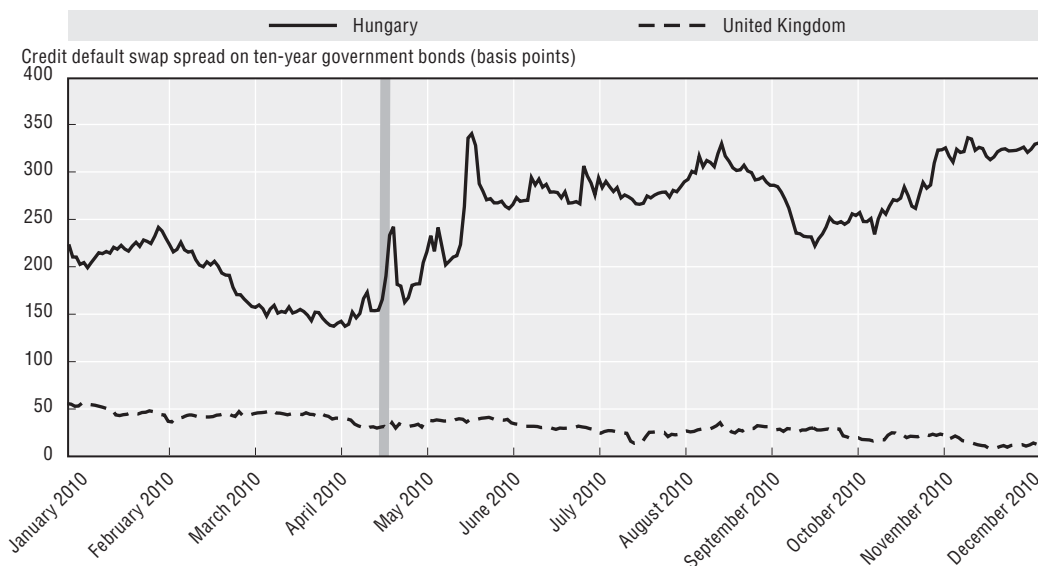
two countries, as reflected in long-term interest rate spreads on sovereign paper (Figure 1) which combine currency risk and default risk. In the United Kingdom, sovereign interest rate spreads declined steadily on all maturities. In contrast, in Hungary, following a pre-electoral decline in anticipation of the change in government which was expected to break with past behaviour, markets were disappointed, and spreads bounced back sharply to their level at the beginning of the year. The disparity in market perceptions of the credibility of the two governments was even more pronounced in the credit default swap spread on long-term government bonds (Figure 2), an indicator of sovereign default risk.

Figure 1. **Hungary and United Kingdom: Sovereign risk premium**



Source: Reuters.

Figure 2. **Hungary and United Kingdom: Sovereign default risk premium**



Source: Reuters.

4. Lessons for good practices

Independent fiscal institutions are relatively few and of recent vintage. Yet, at least on a tentative basis, the experience accumulated so far can be useful toward formulating an internationally accepted set of good practices. Admittedly, these institutions must be judged within their country-specific context. For this and other reasons, it would be far-fetched to promulgate best practices or absolute standards in this area. Subject to this caveat, the following good practices can be identified as being critical for the effectiveness of an independent fiscal institution.

First, the institution must be home-grown and home-owned in every respect. It must address local needs (in particular, lack of transparency and discipline in public finances); also, it must conform to the country's legal framework and political culture. It should not be adapted from abroad or established under pressure from an international or regional authority pursuant to an external commitment. In the event, the local authorities as well as the citizenry are likely to regard the institution as an externally imposed alien body. Indeed, credibility cannot be imported from abroad; it must be based on broad political consensus at home.

Second, the institution must be independent, non-partisan, technically competent, and accountable to the legislature. These characteristics are primarily determined by the professional standing of the leadership of the institution and the manner of its appointment (preferably elected by the legislature). Whereas in a parliamentary system the institution must be independent from both the executive and legislature, in a presidential system independence may be sufficient with respect to the executive branch alone. The governing body must be appropriately remunerated and free from any conflict of interest (both in substance and appearance) and, to strengthen its independence, its tenure should preferably cover more than an electoral cycle and not be renewable. The institution should exercise its independence to the fullest extent possible, as provided by law, and with an adequate level of resources. It should not be inhibited in openly expressing its differences with the government, though unnecessary conflict must be avoided at all times. Whether organisationally embedded in the legislature or not, the institution should stand ready to serve all legislators, but especially the members of the budget or treasury committee, in a non-partisan manner.

Third, the institution can only conduct meaningful surveillance of fiscal policy-making and fulfil its remit with the support of a skilled technical staff and with unlimited access to timely information from the government. The need for competent support staff and a strong mandate to secure access to information is higher if there is a greater degree of opacity in public accounts and official budgetary projections. The staff should be hired through open competition and should not have any links to other public or private institutions. There should not be any impediment in access to government information, though with appropriate safeguards (that is, security clearance for staff) for protection of state secrets in the areas of national defence and security.

Fourth, the core remit of the institution should consist of assessments of fiscal stance and debt sustainability – including monitoring compliance with fiscal rules or targets, if any – through real-time evaluation of the budgetary effects of all legislative proposals. This involves preparation of pre-budget baseline (no policy change) macro-fiscal forecasts, to be followed by forecasts upon submission of the budget bill, as well as costing of the effects of major legislative proposals. Periodically, this should be supplemented with computation of

numerical long-term scenarios, based on prudent macroeconomic and demographic assumptions. All quantitative estimates and forecasts should be made publicly available (in time for the legislative debate and well ahead of enactment), along with a full account of the underlying data and methodology. Surveillance by the institution should in no way overlap or duplicate the monitoring task of the national audit office; in fact, the tasks of the two institutions are complementary. Furthermore, the remit of the independent fiscal institution should preclude any policy-making or normative responsibility, and care should be taken in conducting any advisory role in a strictly non-partisan manner.

Fifth, a newly created independent fiscal institution must identify itself and start operating according to its terms of reference as soon as possible. This is the first and most important step toward establishing a reputation and gaining public support, because “cement dries quickly”. It cannot be taken for granted that the role and attributes of the new institution will be readily understood, its non-partisanship trusted, or its beneficial effects recognised without proof. Speed in implementation is all the more important since, in order to gain respectability and protection from threats to its existence, the institution’s non-partisanship must be tested over at least two electoral cycles, possibly covering governments of different political orientation.

Lastly, the institution must develop effective communication channels very early, especially with the media. Given that the institution can only have influence over fiscal policy-making through dissuasion (rather than through coercion by means of legal sanctions or other punitive measures), it must avail itself of media outlets which in turn can help foster an informed constituency (and financial markets) that will exercise timely pressure on the government to behave transparently and responsibly and thus build credibility. Ultimately, in a free society, the media are the closest allies and promoters of the institution.

Notes

1. In Belgium, however, the remit of the High Council of Finance extends explicitly to the regions and communities.
2. See Rivlin (forthcoming). Independence from the legislative branch is critical in a culture of strict party discipline, particularly when the party in power commands a strong majority in Parliament. Loose party discipline or coalition governments provide some inherent checks and balances.
3. From this perspective, Belgium’s High Council of Finance appears to be the least independent, as the finance minister chairs *ex officio* the Council.
4. In Sweden, the National Institute of Economic Research and the National Financial Management Authority are responsible for preparing short- and medium-term macro-fiscal forecasts. In Belgium, this task is performed by the National Accounts Institute, while the Secretariat of the Council (consisting of finance ministry personnel) drafts analytical reports for the High Council of Finance.
5. An attempt by Debrun and Kumar (2007) to measure the effectiveness of fiscal institutions through econometric estimates on cross-country EU data, although methodologically rigorous, is highly questionable in substance. Notably, the underlying “fiscal council index” based on a survey by the European Commission (2006) covers a large number of entities that are not comparable across countries, are not amenable to quantification, and do not conform to the characteristics discussed above.
6. In a recent report, the Van Rompuy Task Force (2010) recommends explicitly the establishment of independent fiscal institutions as part of national fiscal frameworks.
7. Such an approach was proposed in Kopits (2010).
8. The Council of the European Union (2011) draft directive on requirements for budgetary frameworks only contains ambiguous references to “arrangements for independent monitoring

and analysis to enhance the transparency of elements of the budget process” and “effective and timely monitoring of compliance with the [numerical fiscal] rules based on reliable and independent analysis carried out by independent bodies or bodies endowed with functional autonomy vis-à-vis the fiscal authorities of member states.”

9. For a detailed discussion of the Hungarian experience, see Kopits and Romhányi (forthcoming).
10. See Berger, Kopits and Székely (2007) for an analysis of fiscal indulgence in Central Europe prior to EU accession.
11. The Visegrád Group, or Visegrád Four (V4), are the Czech Republic, Hungary, Poland and the Slovak Republic. Originally, these four countries entered into an agreement in 1991 to co-ordinate their policies with a view to apply for membership in the EU.
12. These official counterparts are the President of the Republic, the Prime Minister, the Minister of Finance, the Governor of the National Bank of Hungary, and the Chair of Parliament's Budget and Finance Committee.
13. Actually, assessment of the effects of any legislative proposal – including motions for amendment – on discretionary items is an option rather than an obligation. However, as a means of protecting local governments from unfunded mandates imposed by the central government, constrained by the new set of fiscal rules, the Council was required to assess the impact of legislative proposals on the fiscal position of local governments.
14. The importance of expectations cannot be overstated in an analysis of the effects of fiscal policy. It is well known that the same fiscal measure can even have opposite effects if agents expect them to prevail permanently or only transitorily. In the presence of fiscal rules, the effects depend crucially on public expectations about the actual nature and time path of the authorities' fiscal and monetary reaction functions.
15. In essence, this is tantamount to so-called dynamic scoring (see Auerbach, 2004).
16. Fidesz (Fiatl Demokraták Szövetsége) is a major right-wing conservative party in Hungary, founded in 1988.
17. Whereas the ultimate targets under policy rules are often understood easily by interested citizens, the actual linkage to operational targets is not always obvious. In this regard, some fiscal rules, particularly the debt rule, are comparable to prevailing monetary rules. For instance, in an inflation-targeting regime, the target inflation rate is widely understood, and the difference between the target and the actual rate is tracked by the non-specialised media, but the transmission mechanism between the base interest rate and the inflation target can be followed only by a specialist in monetary economics.
18. Absent a precedent and because of the fragile economic situation, the President of the Republic decided not to exercise this option for the 2010 budget bill, even though the latter contravened the Fiscal Responsibility Law, as discussed.
19. In addition to exhortations in the press, the heads of independent fiscal institutions in Sweden, the United Kingdom and the Netherlands (Calmfors, Chote and Teulings, 2010) signed a letter urging the Hungarian government not to weaken the Council. In Hungary, more than 700 university faculty, researchers and public figures signed a petition to withdraw the government proposal.
20. Given his close affiliation to the Fidesz party and as head of an insurance company, the non-partisanship of the current Chair is questionable on conflict-of-interest grounds.
21. Oddly enough, the new constitution instructs the Council to ascertain whether the budget bill is in compliance with a new rule limiting public debt to one-half of GDP. Further, it authorises the Constitutional Court to reject the budget law if it fails to approximate this ceiling – at a time when public debt exceeds 80% of GDP.
22. There were a number of contacts regarding the establishment of the Office for Budget Responsibility between Hungary's Fiscal Council and the United Kingdom authorities, both in Budapest (including during a visit by 14 members of the Treasury Committee of the House of Commons in December 2009) and in London, culminating in a request for submission of evidence by the Chair of the Fiscal Council (see House of Commons, 2010).

References

- Auerbach, A.J. (2004), "Dynamic Scoring: An Introduction to the Issues", unpublished, University of California, Berkeley, <http://elsa.berkeley.edu/~auerbach/dynamscor.pdf>.
- Berger, H., G. Kopits and I. Székely (2007), "Fiscal Indulgence in Central Europe: Loss of the External Anchor?", *Scottish Journal of Political Economy*, 54(1):116-135, February.
- Calmfors, L., R. Chote and C. Teulings (2010), "Hungary's Fiscal Council Must Stay Independent", *Financial Times*, 6 December.
- Council of the European Union (2011), "Draft Council Directive on Requirements for Budgetary Frameworks of the Member States – Annex", 11478/2/11, 21 June, Brussels.
- Debrun, X. and M.S. Kumar (2007), "Fiscal Rules, Fiscal Councils and All That: Commitment Devices, Signalling Tools or Smokescreens?", in *Fiscal Policy: Current Issues and Challenges*, pp. 479-512, Banca d'Italia, Rome.
- European Commission (2006), "Public Finances in EMU – 2006", *European Economy*, No. 3, Directorate-General for Economic and Financial Affairs, European Commission, Brussels.
- House of Commons, Treasury Committee (2010), *Office for Budget Responsibility, Fourth Report of Session 2010-11*, Vol. I and II, The Stationery Office, London.
- Kopits, G. (2010), "Brussels Can't Monitor 27 Budgets", *Wall Street Journal*, 11 October.
- Kopits, G. and B. Romhányi (forthcoming), "Hungary: A Short-Lived Fiscal Watchdog", in G. Kopits (ed.), *Restoring Public Debt Sustainability: The Role of Independent Fiscal Institutions*, Oxford University Press, Oxford, United Kingdom.
- Rivlin, A. (forthcoming), "Politics and Independent Fiscal Institutions", in G. Kopits (ed.), *Restoring Public Debt Sustainability: The Role of Independent Fiscal Institutions*, Oxford University Press, Oxford, United Kingdom.
- Van Rompuy Task Force (2010), "Strengthening Economic Governance in the EU: Report of the Task Force to the European Council", 21 October, Brussels, www.european-council.europa.eu/the-president/taskforce.aspx.

The Fiscal Stimulus Programme and Public Governance Issues in China

by
Christine Wong*

China introduced the largest stimulus package in the world in late 2008, in the wake of the global financial crisis. China was also the first major economy in the world to emerge from the crisis. After a brief though sharp downturn in 2008, the Chinese economy recovered and grew by 8.7% in 2009 and by 10.4% in 2010.

This article discusses the fiscal stimulus measures adopted in China in terms of their substantive composition, as well as the decision-making processes and implementation mechanisms. It also discusses some of the challenges encountered.

JEL classification: H540, H760

Keywords: fiscal stimulus measures, crisis response, financial sector, government expenditures, local government debt, local government investment corporations, state-owned enterprises, intergovernmental fiscal relations, macroeconomic management, China

* Christine Wong is Professor of Chinese Public Finance and Director of Chinese Studies in the School of Interdisciplinary Area Studies at the University of Oxford, United Kingdom. The financial support of the OECD/Korea Policy Center is gratefully acknowledged.

1. Introduction

China was the first major economy to emerge from the global financial crisis, and it did so in spectacular fashion. After a brief – though sharp – downturn in 2008, the Chinese economy grew by 8.7% in 2009 and by 10.4% in 2010, and the robust growth in China helped a host of resource-rich countries avoid the economic downturn. A big factor behind this enviable success was the massive stimulus programme introduced in the fourth quarter of 2008 and implemented through 2009 and 2010. The initial programme that was announced totalled 4 trillion yuan renminbi (CNY) (USD 586.68 billion), comprising CNY 1.18 trillion in central government funding plus local government inputs and bank credit. The package amounted to 12.5% of China's GDP in 2008, to be spent over 27 months. In relative terms, this was the biggest stimulus package in the world, equal to three times the size of the United States effort.¹

Following Premier Wen Jiabao's call to make the stimulus "big, fast and effective", the programme was implemented with great force and in record time. Along with the huge fiscal injection, state-owned banks opened their spigots, and total credit grew by more than one-third in 2009. Local government inputs also far surpassed expectations. Altogether the total stimulus grew to an estimated 27% of GDP, with an injection of 19% in 2009 alone.

One obvious inference to draw from this bold stimulus programme and the economy's quick recovery is that China has a strong, rich and effective public sector. This was indeed the one described by George Soros, who said admiringly at a network meeting of his Soros Foundation-supported Open Society Institute in mid-2010 that "the Chinese government works better than ours (in the United States)".

This assessment is incontrovertible if the metric used is solely that of economic growth and of how quickly China returned to its high growth path; but the performance through the crisis looks weaker when a broader metric is used. First of all, once unleashed, the stimulus appeared to spin quickly out of control. Investment in fixed assets jumped to 66% of GDP in 2009, and infrastructure investment leaped to more than 18% of GDP, raising immediate concerns about the economy's absorptive capacity and the care with which projects were selected and implemented.

Indeed, by mid-2009 many policy makers and observers in China had begun to worry about the nature of the growth brought by the stimulus programme and its by-products. The big ramp-up in easy credit, for example, helped to fuel an asset bubble that sent prices of land and housing steeply upward, more than doubling in some big cities during 2009. The heavy pace of local investment was causing worries about rising local government debt. By early 2010, the government was sufficiently alarmed to call for an immediate freeze and audit of local government investment corporations, and by year-end the urgent problem for macro management had shifted decisively to slowing growth and tamping down inflationary pressures. At this writing in mid-2011, controlling inflation is now the top priority task for the government this year.

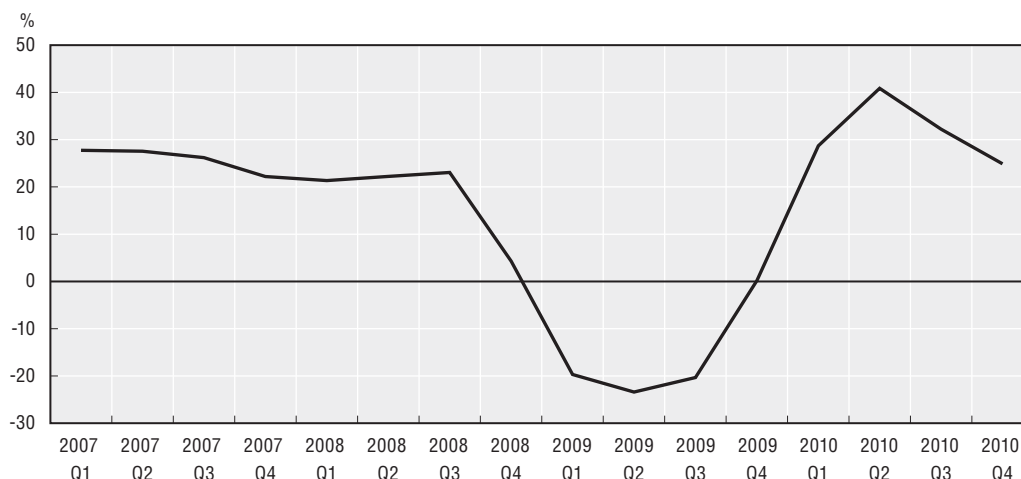
This article analyses the fiscal stimulus and related measures applied in the People's Republic of China in the wake of the global economic and financial crisis, and links them to issues of governance to draw some insight on China's reform needs going forward. Section 2 starts with a "scene setter" discussion of the fiscal and economic situation in China prior to the onset of the economic and financial crisis and of how the government shaped the crisis response. Section 3 provides a comprehensive overview of the fiscal stimulus measures applied. Section 4 reviews the implementation of the fiscal stimulus measures through 2010, and examines the responses of local governments on the demand side, and the financial sector on the supply side, to explain the overheated outcome. Section 5 concludes with observations on China's exit strategy and on the reform challenges ahead for strengthening macro management in China.

2. Backdrop to the stimulus: the economic and fiscal situation

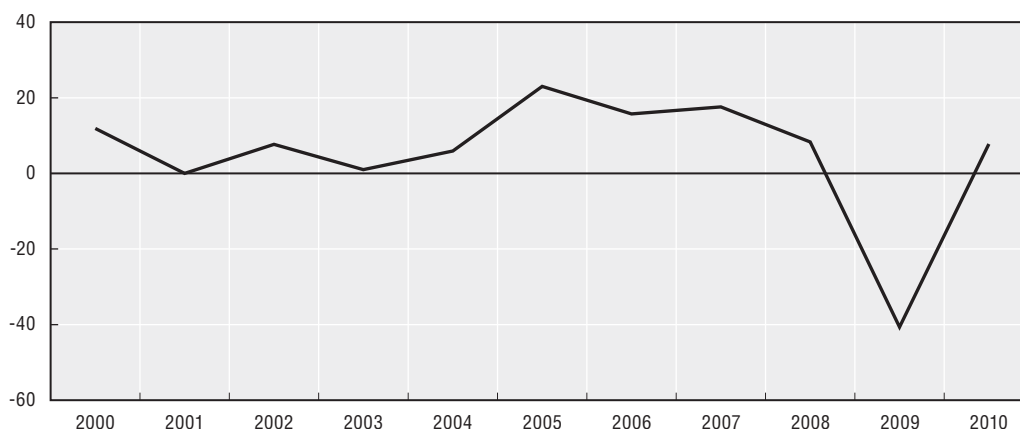
Through its transition to a market economy, China has achieved a remarkably long and sustained growth, and has emerged over the past few years as a global economic power. In 2009, it surpassed Germany to become the largest exporting nation, and in 2010 it passed Japan to become the second-largest economy in the world. These achievements came perhaps earlier than expected, partly as a result of the global economic slowdown that began in 2007 and ensnared virtually all countries, but from which China's remarkably quick recovery helped propel it past the others.

But China did not escape being hit hard by the economic crisis. The effect was first felt in the export sector, when world markets collapsed and exports fell precipitously. This downturn can be seen in the quarterly statistics on export growth (Figure 1): China's export growth plummeted from the fourth quarter of 2008 through 2009. Factories closed seemingly overnight, and workers were laid off. In the coastal export enclave of Dongguan in Guangdong province, so many workers had been sent home by mid-2009 that huge industrial parks resembled ghost towns. Given that exports had comprised one-third of GDP in value, the sharp downturn in exports exerted a drag on GDP growth that was a stunning -41% in 2009 (Figure 2).

Figure 1. **Growth in exports (quarter on quarter)**

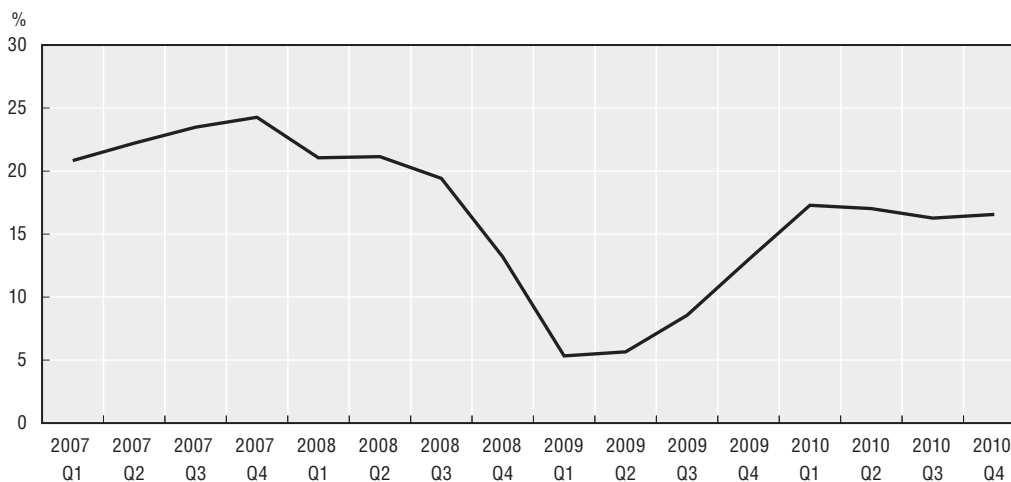


Source: General Administration of Customs of China.

Figure 2. **Contribution of net exports to growth (per cent)**

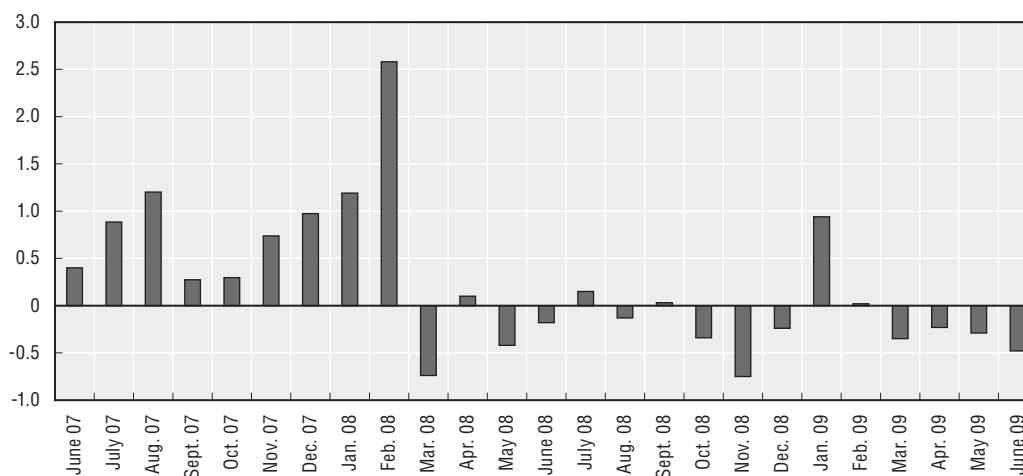
Source: China Statistical Yearbook.

Ironically, in China the government had actually begun to implement contractionary policies in November 2007 to tamp down the heavy pace of growth and accompanying inflationary pressures that had been building since 2003. As late as June 2008, the central bank raised the commercial bank reserve requirement twice (by a half percentage point on 15 June and another half point on 25 June) to further restrain monetary growth. The quick reversal of economic fortunes during the year is reflected in quarterly GDP growth rates (Figure 3), and shocked policy makers watched as the spreading global crisis turned the growth moderation into what looked like a free fall. Even more threatening was the deflation that was appearing to take hold, as month-on-month changes in the consumer price index dipped into negative territory in mid-2008 and stayed there through the rest of the year (Figure 4).

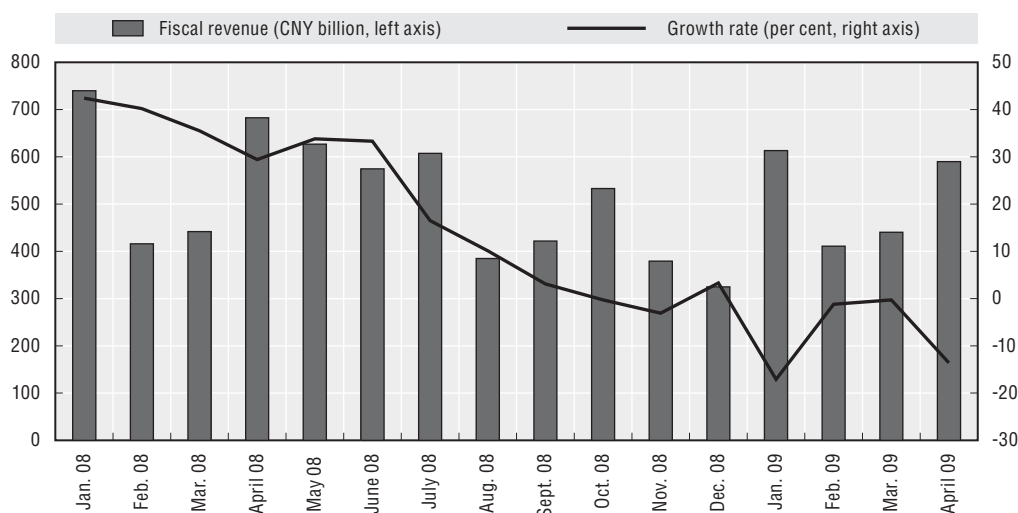
Figure 3. **GDP growth (quarter on quarter), nominal GDP**

Source: National Bureau of Statistics of China.

Monthly growth in government revenues had already been declining throughout 2008, but turned steeply downward during the second half of the year, ending in negative growth at year-end (Figure 5). By January 2009, the Minister of Finance was warning of “a very

Figure 4. **Change in consumer price index (month on month), per cent**

Source: China Economic Monthly Indicator.

Figure 5. **Monthly fiscal revenue (year-on-year growth)**

Sources: China Data Online; Ministry of Finance website.

tough year” ahead, as government revenues plunged 17.1% that month from a year earlier (Xinhua, 2009). Given the importance for government legitimacy of maintaining high rates of growth, policy makers became alarmed and determined to do everything necessary to reverse the trend.

2.1. The fiscal cushion

Against this backdrop, the government’s determination to move decisively to counteract the effects of global economic slowdown was emboldened by two considerations. First, in 1998 it had intervened with a fiscal stimulus programme that was widely credited with success in helping China stave off contagion in the Asian financial crisis (World Bank, 1999). Second, unlike the first time – when the fiscal stimulus was rolled out while government finances were still fragile – China’s fiscal status was far stronger in 2008.² Since the 1994 fiscal reform, China has rebuilt its revenue mechanism, and the

new tax system has proven quite buoyant. With rapid economic growth bringing in robust revenues, government coffers were overflowing, with the budget controlling a bigger share of a much larger GDP. Moreover, throughout the transition period, the government has managed its fiscal stance prudently, keeping budget deficits to less than 1% of GDP in most years. On the eve of the global financial crisis, the national debt was small (about 19% of GDP), leaving the government plenty of scope for decisive action.

3. The stimulus package

Although most of the public attention has been focused on the “CNY 4 trillion stimulus programme”, the total package of stimulus measures actually comprised four main components: an investment programme, accommodative monetary policies, tax cuts, and measures to ease the burden on state-owned enterprises.

3.1. The investment programme

The CNY 4 trillion “programme” refers to the investment component, which was officially announced by Premier Wen Jiabao on 5 November 2008 as a set of investments totaling CNY 4 trillion, to be spent over 27 months from the fourth quarter of 2008 through 2010. The programme would be focused on seven priority areas:

1. Transport and power infrastructure (railroads, roads, airports, electricity grids).
2. Earthquake reconstruction.
3. Rural village infrastructure.
4. Environment, energy efficiency and carbon emission reduction.
5. Affordable housing.
6. Technological innovation and restructuring.
7. Health and education.

The weighting of these components went through some adjustments during the first months of implementation. Their final distribution is presented in Table 1. These investments represent new budgetary spending, although some were already planned – such as the CNY 1 trillion on post-earthquake reconstruction, whose implementation would be accelerated under the stimulus programme.

Table 1. Sectoral composition of stimulus investment

March 2009 plan, as a per cent of total

Transport and power infrastructure (railroads, roads, airports, electricity grids)	37.5
Post-earthquake reconstruction	25.0
Rural village infrastructure	9.3
Environmental investment	5.3
Affordable housing	10.0
Technological innovation and structural adjustment	9.3
Health and education	3.8

Source: Website of the NDRC (National Development and Reform Commission), China.

For these investments, the central government committed at the outset to funding CNY 1.18 trillion from the budget, with the remaining CNY 2.8 trillion to be financed by local governments, enterprises and banks.

3.2. Accommodative monetary policies

In 2008, China was in the second year of a contractionary monetary policy regime aimed at slowing the 11-12% rate of growth over the previous years and reining in inflationary pressures. Faced with the sudden global economic meltdown and the threat of contagion to China, policy makers made an abrupt shift during the second half of 2008, to ease into an increasingly accommodative policy regime. In September, the central bank reduced the one-year lending rate from 7.47% to 5.58% (*China Daily*, 2008). In the period from September through December, interest rates were cut five times, with a cut of 108 basis points on 26 November 2008 (Aredy, 2008). To give an added boost to the financial sector, in December the State Council released a nine-step plan for financial reform. The package included new credit mechanisms for small to medium-sized enterprises (SMEs), a broader scope for issuing corporate bonds, and new regulations for the creation of real estate investment trust funds (REITs) and private equity (PE) funds (Li *et al.*, 2008). Also in December 2008, the State Council issued a document authorising a loan allocation of an additional CNY 100 billion to the policy banks. Commercial banks were urged to increase lending. The credit quota was abolished, and a call was issued to strive for increasing total lending by CNY 4 trillion in 2008 (State Council Office, 2008). As will be seen below, these liberalising steps together created the conditions for an overwhelming response to the call to stimulate the economy.

3.3. Tax cuts

In addition, the government cut taxes, sometimes through accelerating the rollout of some planned reforms. These included: increasing VAT rebates on exports; reducing taxes on small firms by cutting the tax rate from 6% to 3%; and raising the threshold for the tax levy on monthly income from CNY 5 000 to CNY 10 000. The conversion of the value-added tax from an investment-type VAT to a consumption-type VAT, which had been “forthcoming” for much of a decade,³ was finally rolled out on 1 January 2009. With this reform, firms can now deduct purchases for investment as well as for current operations. Given the high proportion of investment in GDP, this change represented a significant cut in VAT revenues, by perhaps CNY 150 billion.⁴

3.4. Bailing out and easing up on state-owned enterprises

To help state-owned enterprises (SOEs) weather the crisis, the government began to provide subsidies to the weaker firms through the State-owned Assets Supervision and Administration Commission (SASAC) which has management responsibility over SOEs and collects dividends from them. In November, the SASAC at the central level injected funds into two airlines (China Southern and China Eastern) using its own funds.⁵ In addition, SASACs at all levels were encouraged to reduce remittance requirements from their subordinate SOEs, and bailouts were undoubtedly provided to other SOEs. No figures have been reported for the overall size of these changes, but Premier Wen Jiabao has said that the combination of reduced claims on profit of state-owned enterprises and reductions in taxes and fees would put CNY 500 billion into the hands of enterprises (Wen, 2008).

4. Implementation

Implementation began in the fourth quarter of 2008 under a sense of great urgency that pervaded the top policy circles and emanated from the top leaders on down.⁶ The CNY 4 trillion stimulus programme was announced with great fanfare and was quickly

followed by a Communist Party document that outlined policies to “further expand domestic demand and assure stable rapid growth”. The document called for an immediate injection of CNY 120 billion in investment funds during the final quarter of 2008, by accelerating approval of investments of CNY 100 billion in priority areas and moving forward CNY 20 billion of the planned earthquake reconstruction spending. With the instructions to abolish lending quotas and for commercial banks to support investment, the document expressed the hope that the CNY 120 billion of fiscal spending would be leveraged to achieve an increase in investment totaling CNY 400 billion before year-end (Chinese Communist Party, 2008).

The release of four tranches of the central government funding was announced: CNY 108 billion in 2008Q4, and CNY 130 billion, 70 billion and 80 billion, respectively, in 2009Q1-Q3 (figures from the website of the National Development and Reform Commission). The actual disbursements are presented in Table 2. From the start, the emphasis was on the timely and full disbursement of funds, and for all projects to start by the third quarter of 2009. With three-quarters of all investment projects assigned to local governments (see, for example, Xiao, 2009, and Huo *et al.*, 2009), the worry was whether local governments would be able to raise the co-financing needed to meet their counterpart funding requirements in a timely fashion. In 2010, the central government made an additional appropriation of CNY 572.2 billion – perhaps to offset the lagging local government inputs – to bring the disbursement to CNY 992.7 billion for the year (Li, 2010). Altogether, the central government input to the stimulus totaled CNY 1.6 trillion (36% larger than the CNY 1.18 trillion envisioned at the start).

Table 2. **Disbursement of central government stimulus spending, 2008-09**

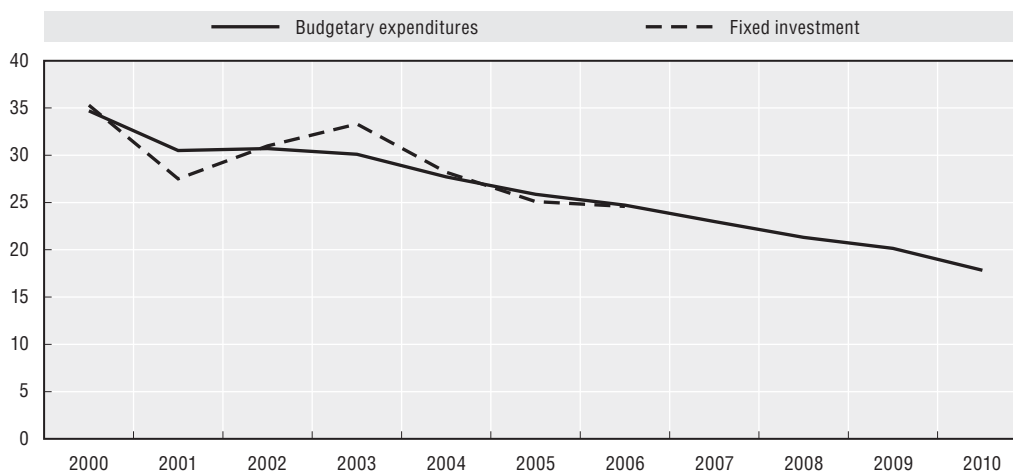
Disbursements	Period	Amount (CNY billion)
First tranche	2008Q4	108
Second tranche	2009Q1	130
Third tranche	2009Q2	70
Fourth tranche	2009Q3	80
Fifth tranche	2009Q4	223.8
Final year	2010	992.7
Total injection		1 604.5

Sources: Website of the NDRC (National Development and Reform Commission), China; Pumin Li (2010), “China will continue to implement the 2010 RMB 4 trillion investment plans”, *China News*, 7 March, www.chinanews.com.cn/cj/cj-gncj/news/2010/03-07/2155764.shtml, accessed 9 April 2011.

4.1. Response from local governments⁷

China’s fiscal system is highly decentralised (see, for example, World Bank, 2002, and Wong, 2007). The vast majority of responsibilities for providing public services are assigned to sub-national governments, and the central government accounts for less than one-fifth of national budgetary expenditures – a share that has fallen steeply over the past decade (Figure 6).⁸ The provision of infrastructure also mainly falls to local governments, and they have accounted for 70-75% of budgetary expenditures on fixed investment in recent years for which data are available.⁹

The fiscal stimulus programme was likewise to be largely implemented by local governments, and they embraced it with frenzied enthusiasm. Although the central government did not spell out in detail the division of responsibilities for undertaking and

Figure 6. **Central government share of expenditures (per cent of total)**

Source: China Statistical Yearbook.

financing the stimulus investments, anecdotal evidence indicates that the usual rules were applied both for the assignment of projects and for cost sharing between central and local governments (see, for example, Xiao, 2009, and Huo *et al.*, 2009).

Under the “normal process”, the National Development and Reform Commission (NDRC) is responsible for formulating the national investment plan and approving the list of projects to be included. With guidance from the NDRC on priority areas in which funding is available, local governments (and central ministries) prepare project lists to be submitted each year for inclusion in the national investment plan. Once chosen, a project becomes eligible for budgetary funding as well as bank credit, which is available only for approved projects.

While local governments and ministries compete for national investment funds, the competition is constrained by the availability of funding at localities, since virtually all projects implemented by local governments require counterpart funding, the proportions of which vary by sector and by region. For example, school construction requires a one-third contribution from local governments, and for low-cost housing the central input is a flat rate of CNY 300 per square metre for the central provinces and CNY 400 for the western provinces.¹⁰ Eligibility for application usually requires proof of funding availability from the local government. To be eligible for bank credit, the banks also require proof of requisite own funding in the form of equity or paid-in capital (usually 25-35%).

With the fiscal stimulus programme, the available pool of central funding was vastly expanded, but the goal for quick implementation of the ambitious investment programme required the NDRC to be especially vigilant in ensuring that projects would be allocated only to local governments that have sufficient funds to meet co-financing needs. From the outset, the worry was that with three-quarters of the projects assigned to localities, local governments would struggle to meet this burden of counterpart funding.

Under the climate of urgency that characterised the period from late 2008 through 2009, every effort was made to facilitate local government applications for projects. First, the government introduced several new measures to make it easier for local governments to meet the co-financing requirements. On 17 March 2009, the State Council approved a special CNY 200 billion treasury bond issue by the Ministry of Finance on behalf

of local governments, and stipulated an accelerated disbursement of the funds to the provinces (Han and Luo, 2009a). The ostensible purpose of this bond issue was to be a first step toward allowing local governments to raise debt for funding capital investments. Until an institutional framework is installed to monitor and control local debt issue, the government has chosen to issue the debt centrally, through the Ministry of Finance, but under the names of recipient provinces. Ministry spokespersons explained that these funds “should mainly be used in public infrastructural projects for the provision of public goods ... and not for enhancing recurrent expenditures” (Han and Luo, 2009b).

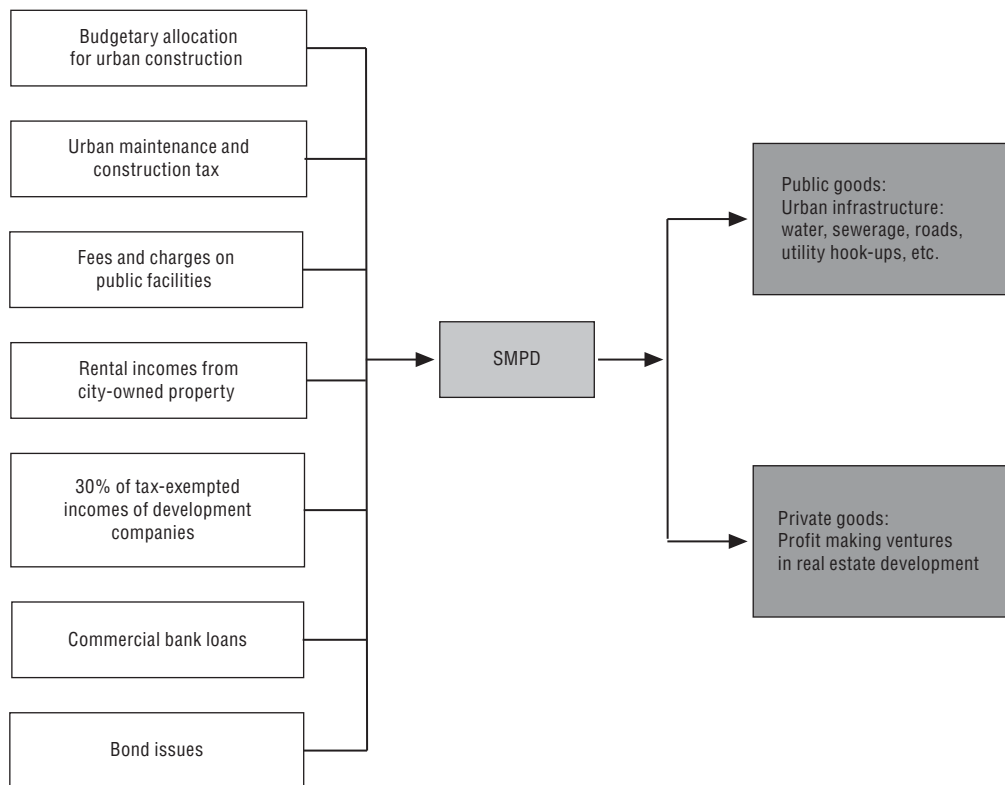
Second, in a more radical move, the government officially endorsed the use of local government financial platforms (see Box 1) and other means of raising debt. On 24 March 2009, a document was jointly issued by the People’s Bank of China and the China Banking Regulatory Commission, calling for “supporting localities with appropriate

Box 1. Local government investment corporations (LICs)

The local government financial platforms (*difang zhengfu rongzi pingtai*) referred to in the 2009 document jointly issued by the People’s Bank of China and the China Banking Regulatory Commission are commonly called local investment corporations (LICs). Since the late 1980s, local governments – mostly at the municipal and provincial levels – have been creating corporate entities to undertake the task of raising funds to finance public investment, and they are variously called urban development investment corporations (UDICs), highway or transport corporations, and the like. These corporations were an innovation to allow local governments to work around a central contradiction in the intergovernmental fiscal system in China, under which local governments are assigned the primary responsibility for the provision of public services including infrastructure but are not given the right to borrow, nor are they assigned enough revenues to take on this responsibility. LICs were initially created as financially independent, single-purpose entities often for the purpose of taking on loans from international financial institutions. Being financially independent restricted their undertakings to those with the capacity for debt servicing and repayment, and LICs were prevalent in the construction and operation of toll roads, power companies, water companies and utilities.

A breakthrough came in 1988, when Shanghai created the first broad-based investment corporation to undertake investment in urban infrastructure, the General Corporation of Shanghai Municipal Property (SMPD), and gave it the mission to co-ordinate and provide for the construction of facilities such as water supply, sewerage, roads, utility hook-ups, etc. To finance these tasks, the corporation was assigned earmarked revenues from the municipal budget and authorised to borrow from banks and to issue corporate bonds (see Figure 7 for a depiction of the corporation’s sources and use of funds). Its creation made possible a quantum leap in the financing available for investments in infrastructure to support urban renewal and expansion in Shanghai.

Over time, the model gradually spread to other municipalities, and LICs have come to play a key role in financing urbanisation in many localities. As they became more accepted, they have also evolved to be less strictly financially separated from government, and broadened in scope. Typically, the LICs raise and bundle together bank loans and other financing, using a variety of municipal assets including budgetary and off-budget revenues as equity and collateral. Increasingly, with urbanisation causing an increase in land values, land has become the principal asset backing LICs, and municipal governments have also increasingly relied on off-budget receipts from land lease sales to finance debt service in these LICs.

Figure 7. **General Corporation of Shanghai Municipal Property (SMPD)**

conditions to organise and build financial platforms, issue corporate debt and medium-term notes and other financial products, to broaden the channels of funding for providing counterpart funds for central government investment projects”.¹¹

Third, the Ministry of Finance relaxed the standards on what is eligible as counterpart funds to qualify for stimulus projects, specifying that local governments can use the following sources: budgetary resources, land revenues, proceeds from local bonds issued by the Ministry of Finance, funds raised by local financial platforms, and all other resources at the discretion of local governments (Ministry of Finance, 2009).

In fact, all of these changes had been outlined by Zhang Ping, Director of the NDRC, at a press conference during the National People’s Congress meetings in March 2009, signaling a consensus approval by policy makers at the highest level of government (Zhang, 2009). Altogether, these changes greatly expanded the space for local governments, and a dynamic was set up whereby local governments competed fiercely for stimulus investment projects, which represented an unprecedented windfall of funding opportunities for all manner of pet local projects. As a legacy of the planned economy, all local governments and line ministries have medium and long-term plans with project pipelines. Ready or not, many of these projects were quickly rolled out and brought forward, and new projects were hastily put together to meet the calls for new spending in environmental and green technology areas. Within less than a month of the announcement of the stimulus package, local governments, in aggregate, had proposed a staggering total of CNY 18 trillion in investment projects. Soon after, the figure rose further to CNY 25 trillion for the first 18 provinces reporting their plans (Huo *et al.*, 2009).

The central ministries, too, joined in the competition. Among the most aggressive was the Ministry of Railways, which grabbed an estimated CNY 1.5 trillion of the CNY 4 trillion investment approved by the NDRC. The Medium-Long Term Plan for the National Railway Network, set in 2004, had called for the network to reach 100 000 km of rails by 2020, including 12 000 km of high-speed lines. The Plan's centrepiece was the adoption of Chinese-made high-speed trains operating at or above 200 km/h. This was amended in 2008 to set targets of 120 000 km of total length (including 16 000 km of high-speed lines) and with train speeds raised to as much as 350 km/h (Liu et al., 2011).

4.2. Response from the financial sector

On the supply side, in answer to the calls from all quarters to support the stimulus effort, China's state-owned banks responded, also with frenzied enthusiasm. The State Council document issued in December 2008 (cited earlier) had called on the financial sector to support the government's industrial policy by increasing lending for investment in a long list of sectors, projects and conditions including public infrastructure, earthquake reconstruction, energy saving, technical renovation and technology upgrading, regional development, small and medium-sized enterprises, and rural projects. The document also encouraged banks to provide credit to support "financially sound enterprises that faced temporary difficulties". The document called, as well, for rolling out policies to expand consumer credit, to support mortgages for first-time buyers and for car purchases. It even specified quantitative targets for the expansion of bank credit, to strive to increase new lending by CNY 4 trillion in 2008, and for broad money supply to grow by 17%. The document also called for reducing restrictions on corporate bond issuance and expanding the range of financial products available for financing investment. In sum, the government was calling on the banks to pull out all the stops.

Bank officials were only too happy to oblige. After all, the directives from the government and political leaders effectively eliminated all personal responsibility for the lending decisions, and credit growth exploded. Especially favoured were projects backed by local governments. Net new credit grew by CNY 4.2 trillion in 2008 (Table 3) in a year when demand was sharply reduced by the economic slowdown. Net new credit had surpassed the average annual growth of CNY 3-4 trillion in the boom years of 2005-07, and even exceeded the government's target of CNY 4 trillion. In 2009, new lending more than doubled from the 2008 level, to CNY 9.6 trillion. In the first quarter alone, it expanded by CNY 4.6 trillion.

Table 3. **Fiscal and credit expansion (CNY billion)**

	2008	2009	2010
Fiscal deficit	111	950	650 ¹
New bank loans	4 178	9 622	7 932
New bond finance	502	935	-465
Total	4 791	11 506	8 117

1. This figure is equal to the reported deficit of CNY 1 trillion minus set-asides for the Budget Stabilisation Fund and rolled-over commitments.

Sources: China Statistical Yearbook; China Data Online; author's estimates.

4.3. The perfect storm

But now the stimulus was spinning out of control. Table 3 assembles available data on fiscal deficits, on growth in bank credit and on corporate bond issuance for 2008, 2009 and 2010. The huge fiscal injection was joined, and indeed dwarfed, by what some commentators have called “a tsunami of credit expansion”. Together, these sources brought new funds totaling CNY 4.8 trillion into the economy in 2008, and more than double that in 2009.

Table 4 estimates the size of the stimulus effort during the past three years. To derive the net effect of the stimulus programme, a distinction is made between the “normal” growth in credit that accompanies economic expansion and the extraordinary growth created by stimulus. Normal credit growth is estimated at CNY 3.93 trillion, 4.55 trillion and 6 trillion for 2008, 2009 and 2010, respectively, based on the average credit growth of 15% per annum during the period 2003-07. The normal credit growth for 2008, 2009 and 2010 are subtracted from total credit expansion for the three years, respectively, to derive the effect of the stimulus. For new bond finance, half of the new addition each year is taken, since it is not possible to define “normal” for such a nascent sector.¹² These figures show that, altogether, a conservative estimate would place the stimulus at CNY 9.5 trillion, or 27% of GDP, over the 27 months. This was 2.4 times the size of the announced stimulus package. In 2009 alone, it was CNY 6.5 trillion, or 19.3% of the current year GDP.

Table 4. **Estimated size and composition of stimulus**

	2008	2009	2010
Stimulus (CNY billion)			
Fiscal deficit	111	950	650
Net new bank loans	252	5 070	1 936
Net new bond finance	251	467	-232
Total	614	6 487	2 354
Stimulus (% GDP)			
Fiscal deficit	0.4%	2.8%	1.6%
Net new bank loans	0.8%	15.1%	4.9%
Net new bond finance	0.8%	1.4%	-0.6%
Total	2.0%	19.3%	5.9%

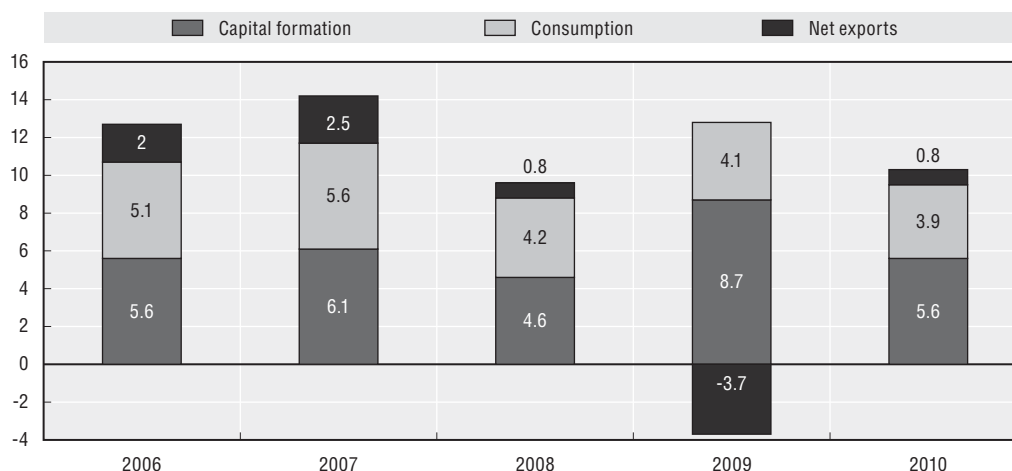
Sources: China Data Online; author's estimates.

This outcome was hardly surprising given the combination of the large fiscal injection, the relaxation of fiscal rules on local government debt, the substantial liberalisation of the financial sector and, especially, the politicisation of the whole stimulus effort. Altogether, these factors created an extraordinarily enabling environment, and it was welcomed by local governments (and ministries) whose incentives were all in favour of expansion.¹³ And they were aided by banks – especially state-owned banks that had been told by the government to open their spigots. Loan officers, too, were eager to expand their balance sheets, especially for investments that appear to be essentially risk-free since they are implicitly or explicitly guaranteed by the government.

5. The exit and post-mortem

The stimulus programme worked. It produced growth and jobs, the two ingredients for stability that the top leaders most urgently sought. Growth began to pick up in 2009, accelerating through the year. Quarterly growth rose from 5.3% in Q1 to 5.7% in Q2, 8.6% in Q3 and 13% in Q4 (Figure 3 above). For the whole year, it reached 8.7% – comfortably above the 8% that has long been considered the minimum required to keep economic problems from spilling over into social problems. This was an impressive achievement in the face of collapsing exports, which had contributed a shocking –3.7% to overall growth in 2009 (equal to –41% of total growth), after falling to 0.8% in 2008 from 2.5% in 2007 (Figure 8).

Figure 8. Sources of growth (per cent of GDP)



Sources: China Statistical Yearbook 2010; DragonWeek (March 2011).

Employment, too, grew robustly. The fear of massive unemployment among migrant workers never materialised, and indeed government officials estimated that aggregate employment grew by 8.5 million in the first three quarters of 2009 and could reach 12 million by year-end (Yang, 2009).

But the costs were high. First, all of the growth came from investment which jumped to 66% of GDP, and investment in infrastructure leaped to 18% of GDP. As seen in Figure 8, gross capital formation contributed 8.7% of GDP to growth, equal to total net growth in 2009. This was nearly double the 4.6% in 2008. More importantly, the 96% share of growth from capital formation was double the already high level of 48% during 2003-07, raising alarms about the efficiency of investment and project selection. It also set back the policy goal, pronounced annually since 2003/04 and enshrined in both the 11th and 12th five-year plans (2006-10 and 2011-15), to rebalance the economy toward more consumption and move away from the investment-driven growth model of the past.

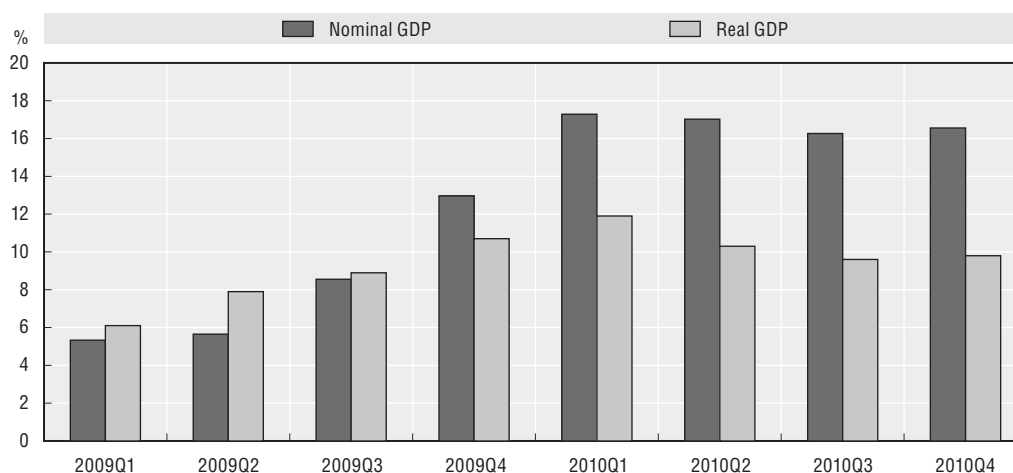
Second, in the rush to ensure quick implementation of the stimulus programme, the government went beyond pumping in new fiscal spending and easing monetary policy to changing fiscal rules and liberalising financial regulations. While these changes were on the whole consistent with market reforms, they were sometimes pushed too far and too fast amidst the campaign-style rhetoric coming from both the government and the party urging “support” for the stimulus programme. In the process, much painstaking progress on governance reform was reversed – building professionalism in the banking sector and

cleaning up balance sheets, improving budgeting and public investment management, refocusing local governments on public service provision rather than investment, etc. When combined with the huge spike in easy credit that allowed state-owned enterprises and government agencies (especially at the local levels) to extend their reach, the process has also seen the private sector being squeezed out in some industries and services, reversing the decades-long retreat of the state from economic activities.¹⁴

5.1. Exiting from fiscal and monetary expansion

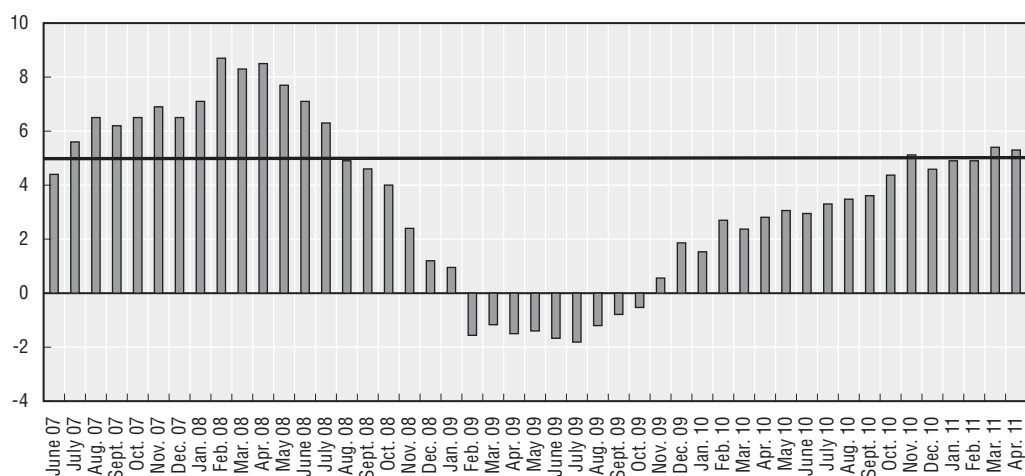
By the end of 2009, the economy showed firm signs of a rebound. Growth was accelerating quarter by quarter (Figure 9). After nearly a year of deflation, prices were trending gradually upward again (Figure 10). With worry about the stimulus programme growing through 2009, and with the popular economics press filled with talk of impending inflation, the government began to take measures in early 2010 to tamp down the growth momentum and slow credit creation.

Figure 9. **Growth recovery (quarter on quarter)**



Source: National Bureau of Statistics of China.

Figure 10. **Change in consumer price index (year on year), per cent**



Source: China Economic Monthly Indicator.

The fiscal stimulus had been scheduled to be completed by the end of 2010. In fact, even with the unexplained additional injection of CNY 572 billion during 2010, the deficit had fallen to CNY 650 billion (below 2% of GDP) due to strong revenue growth. The 2011 draft budget projects a deficit of CNY 900 billion, but it will be less if, once again, revenues exceed the budgeted amount.

The exit from financial stimulus was more protracted. On 7 January 2010, the central bank raised the discount rate by four basis points. A few days later, it raised the reserve ratio and began open market operations to repurchase CNY 30 billion of bonds over 91 days (Jingji Guanchabao, 2010). These signals, though, failed to reduce the pace of bank lending. In the first two weeks in January, new loans totaled CNY 1.1 trillion, equal to the frenetic pace of the blowout first quarter of 2009. An emergency meeting of the monetary policy committee was convened on 18 January, and administrative measures were reportedly adopted at a 22 January meeting of the leadership to enforce credit tightening (Sun et al., 2010). Although the government denied it, credit quotas were once again rumoured to be enforced. Even so, as seen in Table 3 above, credit expansion remained very high for the year, nearly CNY 8 trillion. Moreover, as banks tightened lending, there was a surge in the growth of off-balance-sheet financial products, including bankers' acceptances, designated loans, and loans issued by trust companies. The central bank estimated these to have more than doubled from CNY 1.6 trillion in 2009 to CNY 3.8 trillion (GaveKal-Dragonomics, 2011a, p. 2/3). In total, then, despite the government's efforts, credit expansion in 2010 stayed at roughly the same level as 2009.

Monetary tightening appears finally to be taking effect in 2011. New loans totaled CNY 2.2 trillion, compared to 2.6 trillion in the first quarter of 2010. At this pace, the policy is staying on track to meet the government's target of CNY 7.2 trillion. The government has cracked down on lending by trust companies, and this is finally slowing the growth of off-balance-sheet financing. However, designated loans reportedly more than doubled in the first quarter year on year, with large SOEs and listed companies profiting from high interest rate lending to property developers whose access to bank loans is being sharply curbed in the current tightening (GaveKal-Dragonomics, 2011b). Even so, monetary policy has moved toward normalisation, and the growth rate in investment and GDP have moderated somewhat since 2010, with recent reports indicating some easing of inflationary pressures (GaveKal-Dragonomics, 2011b; World Bank, 2011).

5.2. Managing local government debt

With the central government actively encouraging their creation, local government investment corporations (LICs) spread like wildfire under the stimulus programme and were on the front line in competing for investment funding and bank credit. With three-quarters of the stimulus investments made by local governments, the LICs played a leading role in investing in infrastructure and were, as a group, the biggest players. In the sea of liquidity and permissiveness, they proliferated and greatly expanded their scale of operation. According to the China Banking Regulatory Commission (CBRC), LICs grabbed nearly one-third of all new loans issued in 2009 and increased their total debt by CNY 3 trillion to CNY 7.38 trillion at year-end (*Investors Bulletin*, 2010). In the first quarter of 2010, LICs accounted for 40% of all new bank loans (*Investors Bulletin*, 2010; Wei, 2010). More recent estimates, based on findings by the National Audit Office and the central bank,

are that the total debt of LICs is likely to have reached CNY 10-14 trillion by year-end 2010 (Yang, 2011). It is the investment hunger of LICs/local governments that has helped inflate the stimulus programme and push the economy into overheating.

The super-sized stimulus programme has left in its wake a huge run-up in local government debt whose dimensions and potential effects are still not yet known. This is because China has no reliable national figures on local government debt despite a decade-long effort at building a debt-reporting system in the Ministry of Finance. A main reason is that, aside from the bonds issued by the Ministry of Finance on behalf of local governments, local government debt is primarily accumulated through LICs: investigators at the CBRC estimated that local government debt totalled CNY 11 trillion at the end of 2009, of which LIC debt accounted for CNY 7.38 trillion.

In aggregate terms, the implied level of local government debt (of CNY 15-20 trillion in total¹⁵), equal to around 40% of GDP in 2010, is not especially alarming. Servicing the debt, though, may pose problems for local governments, given how highly constrained their budgets are under the present intergovernmental fiscal system where they have no taxing powers and are already straining to meet growing expenditure needs. As a result, the UDIC/LIC model is heavily reliant on rising land valuations to supply investment funding and debt servicing, but such a revenue source is highly cyclical and volatile. In addition, some localities have taken on far larger debts, and they will be especially vulnerable. The central bank's Tianjin branch, for example, reported that the municipality's LICs doubled their debt in 2009 (Bateson, 2010).

Equally worrisome for the national government is the extent to which the banking sector is dependent on the LIC loans and their quality. Nation-wide, the People's Bank of China estimates that LICs account for "less than 30%" of all outstanding bank loans, but the degree of exposure varies greatly across banks and regions (Caixin net, 2011). This share is highest for the China Development Bank, which has had the longest history of lending to LICs and where LICs accounted for more than half of total loans in 2009. In Tianjin, LICs took 62.5% of all new loans issued in the city in 2009, and they were 17 of the 20 largest recipients of new loans during the year (Bateson, 2010).

LICs are not new. As noted in Box 1 above, they have been a fixture of municipal finance since the 1990s and have made substantial contributions to financing urbanisation in China. However, LICs operate in the interstices of China's mixed economic system, and no national agency has oversight over them – not the Ministry of Finance (MoF), nor the National Development and Reform Commission (NDRC), the Ministry of Construction (MoC) nor the China Banking Regulatory Commission. There are no reliable national statistics on LICs because there is no system in place that requires LICs to report on their activities or financial status. LICs are not under the purview of either the fiscal or the administrative planning systems. At present, the management of public investments is fragmented under the MoF, the NDRC, the State Science and Technology Commission and the MoC, and there is little co-ordination among them. Although the planning system still requires administrative approval for large projects that are above specified thresholds, it applies only to projects that are funded by public funds. Because LICs rely mainly on bank finance, there is no requirement for them to report on either their sources or their uses of funding.

Since mid-2009, the government has been engaged in a massive catching-up exercise, with several regulatory agencies undertaking investigations and surveys of LICs to collect information, including the CBRC, the Audit Office, the Ministry of Finance and the NDRC.

These agencies found numerous and serious problems with LIC loans. The most common were that fiscal guarantees were widely used as backing for the loans in lieu of collateral, and that when land was held as collateral, excessively optimistic valuations were placed on it. In Tianjin, the central bank found that loans backed by traditional collateral accounted for only 22% of the 2009 lending to LICs, while 71% were backed only by guarantees (Bateson, 2010). Nation-wide, the CBRC reported that 47% of all LIC debt was guaranteed by fiscal revenues, and it classified 26% of LIC debt as “high risk” at mid-year 2010 (GaveKal-Dragonomics, 2010).

5.3. Reform challenges for macroeconomic management in China

After more than three decades of market-oriented reform, the Chinese economy is highly decentralised, and the central government’s ability to direct national policy implementation is attenuated. The stimulus programme was intended to leverage fiscal inputs to produce a much larger effect through mobilising other “social” resources. However, a decentralised system of investment finance requires a financial sector that has the capacity for appraising the viability of projects and the credit-worthiness of the borrowers. These conditions were clearly absent when the majority of the borrowers were LICs whose financial relationships with local governments are often ambiguous, and when the LICs were allowed to borrow for “bundles” of projects. Moreover, local government finances are themselves extremely complex and non-transparent. Fiscal resources are scattered across several budgetary and extrabudgetary accounts, reporting is incomplete, and there is little co-ordination among them.

The stimulus programme has once again exposed the “Achilles’ heel” of China’s macroeconomic management: the tendency toward overinvestment that is rooted in the growth orientation and soft budget constraint of state sector agents, including local governments. Hardening the budget constraints requires a system with clearly defined responsibilities and accountability, which are lacking in the current intergovernmental fiscal system.

The stimulus programme, its implementation and exit have shown the extent to which the government continues to rely on administrative instruments, alongside indirect/market instruments, to manage the macro economy. The experience has shown both the advantages – quick results – and the disadvantages – inefficiencies and distortions. The use of administrative controls is both a cause and a symptom of the immaturity of markets. To rein in the build-up of local government debt, for example, the government will, in the short term, resort to instituting freezes and caps on LICs, to buy time for building up an appropriate institutional and legal framework for improving their governance.

The bigger challenge, though, is to strengthen governance for the whole public sector to improve the efficiency and effectiveness of public expenditures and public investment. Reforming the intergovernmental fiscal system will be a prerequisite to strengthening accountability for the whole sector.

Notes

1. The United States stimulus including temporary tax cuts and increased government spending was worth just over USD 700 billion, or about 5% of GDP, spread over two years.
2. In 1998, government revenues were less than 12% of GDP. In 2008, the level was 19.5%.

3. This consumption-type VAT was put under “pilot implementation” in the northeastern provinces of Liaoning, Jilin and Heilongjiang in 2004, and a nation-wide rollout was then expected to follow within 2-3 years.
4. The cost of this change in VAT was projected at CNY 120 billion but, as investment grew by 30% in 2009, the tax cut also grew in size.
5. For example, the central SASAC collected CNY 55 billion in dividends from firms under its supervision in 2009. These funds are normally kept by the SASACs.
6. Naughton (2009) has written vividly of the sense of urgency that permeated all levels of government in China during this period, from the central government to the provinces and downward.
7. Unless otherwise noted, “local government” in this article refers to all units of sub-national government, including provinces, municipalities, counties and townships.
8. In 2010, the central government's share was only 17.8% of total expenditures (budget report presented at the National People's Congress, March 2011).
9. Data on fixed investment end in 2006 because, with a change in budget classifications in 2007, capital spending is no longer reported in budget statistics.
10. These are lower income provinces that are the main recipients of intergovernmental transfers.
11. People's Bank of China and China Banking Regulatory Commission (2009), “Some guiding opinions on further strengthening the adjustment of credit structures to promote the stable and relatively rapid growth of the national economy”, 24 March, Beijing.
12. Bond issuance increased from CNY 9 billion in 2003 to CNY 396 billion in 2005, to CNY 648 billion in 2007, and to CNY 2 085 billion in 2009.
13. In the words of one commentator: “Who wants to be the mayor who reports that he did not get 8% GDP growth this year? Nobody wants to come forward with that... And if that's the easiest way to achieve growth, then you build.”
14. Through 2010, the press was filled with a rising chorus of complaints about *guojin mintui* (“the state advances and the people retreat”) with SOEs “consolidating” at the expense of private enterprises, especially in the coal and steel industries.
15. This is based on the assumption that LIC debt constitutes two-thirds of all local government debt, a proportion derived from CBRC estimates for 2009 (see *Investors Bulletin*, 2010).

References

- Areddy, James (2008), “China Cuts Interest Rates for Fifth Time Since September”, *Wall Street Journal*, 23 December, accessed 8 April 2011, http://online.wsj.com/article/SB122994387266426043.html?mod=todays_us_page_one.
- Bateson, Andrew (2010), “A window onto local government debt in Tianjin”, *Wall Street Journal*, 9 June, <http://blogs.wsj.com>, accessed 11 June 2010.
- Caixin net (2011), “Central Bank: (we should) pay attention to hidden liabilities of government”, 15 June, <http://economy.caing.com/2011-06-15/100269691.html>, accessed 27 June 2011.
- Cartledge, Simon (2008), “Missing links: poor transport networks are hampering China's evolution into an efficient place to do business”, *Financial Times Special Insert: Doing Business in China*, 20 October.
- China Daily (2008), “Central Bank's Zhou: Further interest rate cuts likely”, www.china.org.cn/business/news/2008-12/17/content_16962514.htm, 17 December, accessed 8 April 2011.
- Chinese Communist Party (2008), “Central Document No. 18 of 2008” (*Zhongfa* [2008] 18), Beijing.
- Cullinane, Kevin and Teng-Fei Wang (2007), “Devolution, Port Governance and Port Performance”, *Research in Transportation Economics*, Vol. 17, pp. 331-356.
- Fock, Achim and Christine Wong (2008), “Financing Rural Development for a Harmonious Society in China: Recent Reforms in Public Finance and Their Prospects”, *World Bank Policy Research Working Paper No. 4693*, August, The World Bank, Washington DC, <http://econ.worldbank.org/docsearch>.
- GaveKal-Dragonomics (2010), *DragonWeek*, 8 November.
- GaveKal-Dragonomics (2011a), *DragonWeek*, 28 February.

- GaveKal-Dragonomics (2011b), *China Economic Outlook*, April.
- Han, Jie and Sha Luo (2009a), "State Council agrees to issue 200 billion yuan bonds to enhance and expand local government matching funds in support of the implementation of proactive fiscal policies", *New China News*, http://news.xinhuanet.com/newscenter/2009-03/17/content_11028110.htm, accessed 5 May 2011.
- Han, Jie and Sha Luo (2009b), "Ministry of Finance: whether to issue local bonds next year will depend on the macroeconomic changes", *New China News*, accessed 5 May 2011, http://news.xinhuanet.com/newscenter/2009-03/17/content_11028131.htm.
- He, Jianwu and Louis Kuijs (2007), "Rebalancing China's Economy: Modeling a Policy Package", *World Bank China Research Paper No. 7*, September, The World Bank, Washington DC, www.worldbank.org/research/2007/09/8948435/rebalancing-chinas-economy-modeling-policy-package.
- Honohan, Patrick (2007), "Finance for Urban Centers" in Shahid Yusuf and Anthony Saich (eds.), *China Urbanizes: Consequences, Strategies and Policies*, The World Bank, Washington DC.
- Huo, Kan, Changyong Wang and Jing Wang (2009), "Can Stimulus Light China's Consumer Fire?", *Caijing Magazine*, 6 March, <http://english.caijing.com.cn/2009-03-06/110114349.html>, accessed 9 April 2011.
- Investors Bulletin (2010), "A Tight Hoop Should be Put on Local Government Financing Platforms", 6 June, <http://finance.ifeng.com/news/special/dfzwwj/20100606/2282325.shtml>, accessed 20 May 2011.
- Jiang, Yonghua (2008), *China's Tax Sharing System Reform* (in Chinese), China Financial and Economic Press, Beijing.
- Jingji Guanchabao (2010), "The Central Bank Sends Signals of Tightening", 22 January, <http://finance.ifeng.com/news/special/jshbzc/index.shtml>, accessed 21 May 2011.
- Li, Pumin (2010), "China will continue to implement the 2010 RMB 4 trillion investment plans", *China News*, 7 March, www.chinanews.com.cn/cj/cj-gncj/news/2010/03-07/2155764.shtml, accessed 9 April 2011.
- Li, Qing, Xiu Wen and Yuzhe Zhang (2008), "A nine-measure package broadened the government's economic stimulus plan to embrace REITs, PEs and other vehicles", *Caijing Magazine*, <http://english.caijing.com.cn/2008-12-09/110036510.html>, accessed 7 April 2011.
- Liu, Weixun, Yong Chen and Xiangdong Zhang (2011), "Gaotie yinji" (Secret Ills of High-Speed Rail), *Economic Observer Online* (in Chinese), 22 February.
- Ministry of Finance (2009), "On speeding up implementation of central fiscal stimulus investment projects: notification on issues of local counterpart funds", *MOF Construction Department Document No. 631*, 12 October, Beijing.
- Ministry of Finance (annual), *Finance Yearbook of China (zhongguo caizheng nianjian)*, Beijing.
- National Bureau of Statistics (2009), *New China 55 Years Statistical Compendium*, Beijing.
- National Bureau of Statistics (annual), *China Statistical Yearbook (CSY)*, Beijing.
- Naughton, Barry (2009), "The Scramble to Maintain Growth", *China Leadership Monitor*, No. 27 (Winter).
- People's Bank of China and China Banking Regulatory Commission (2009), "Some guiding opinions on further strengthening the adjustment of credit structures to promote the stable and relatively rapid growth of the national economy", 24 March, Beijing.
- State Council Office (2008), "Several Opinions of the State Council Office on Finance Stimulating Economic Development under Current Conditions", 13 December, *Guobanfa* [2008] No. 126, http://news.xinhuanet.com/newscenter/2008-12/13/content_10500530.htm, accessed 7 April 2011.
- Sun, Jianfang, Zhiyun Cheng and Rongping Hu (2010), "Clear signs of monetary tightening: the central bank returns to the use of administrative methods", *Jingji Guanchabao*, 22 January, <http://finance.ifeng.com/news/special/jshbzc/20100122/1747319.shtml>, accessed 21 May 2011.
- Walter, Carl and Fraser Howie (2010), *Red Capitalism: The Fragile Financial Foundation of China's Extraordinary Rise*, John Wiley and Sons, Hoboken, New Jersey, United States.
- Wei, Jianing (2010), "The causes and fixes of risks from local government financial platforms", mimeograph (in Chinese).
- Wen, Jiabao (2008), "We will consider further measures to stimulate the economy more directly", *Xinkuaibao*, 15 December, <http://finance.sina.com.cn/roll/20081215/01472572419.shtml>, accessed 7 April 2011.

- Wong, Christine (ed.) (1997), *Financing Local Government in the People's Republic of China*, Oxford University Press, Hong Kong.
- Wong, Christine (2001), "Converting Fees into Taxes: Reform of Extrabudgetary Funds and Intergovernmental Fiscal Relations in China" in Richard Bird, Robert Ebel and Christine Wallich (eds.), *Decentralization of the Socialist State: Intergovernmental Finance in Transition Economies*, The World Bank, Chinese edition: Central Translation Press, Beijing.
- Wong, Christine (2005), "Public Sector Budgeting Issues in China" in OECD, *Governance in China*, OECD Publishing, Paris.
- Wong, Christine (2007), "Can the Retreat from Equality Be Reversed? An Assessment of Redistributive Fiscal Policies from Deng Xiaoping to Wen Jiabao" in Vivienne Shue and Christine Wong (eds.), *Paying for Progress in China: Public Finance, Human Welfare and Changing Patterns of Inequality*, Routledge, London.
- Wong, Christine (2008), "Fiscal Management for a Harmonious Society: Assessing the Central Government's Capacity to Implement Policies" in Keun Lee, Joon-Han Kim and Wing T. Woo (eds.), *Power and Sustainability of the Chinese State*, Routledge, London.
- Wong, Christine (2009), "Rebuilding Government for the 21st Century: Can China Incrementally Reform the Public Sector?", *China Quarterly*, No. 200, December.
- Wong, Christine and Richard Bird (2008), "China's Fiscal System: A Work in Progress" in Loren Brandt and Thomas Rawski (eds.), *China's Great Transformation: Origins, Mechanism and Consequences of the Post-Reform Economic Boom*, Cambridge University Press, New York.
- World Bank (1999), *China: Weathering the Storm and Learning the Lessons*, Country Economic Memorandum, The World Bank, Washington DC.
- World Bank (2000), *China: Managing Public Expenditures for Better Results*, Report No. 20342-CHA, The World Bank, Washington DC.
- World Bank (2002), *China: National Development and Sub-national Finance, a Review of Provincial Expenditures*, Report No. 22951-CHA, April, The World Bank, Washington DC.
- World Bank (2007), *China: Public Services for Building the New Socialist Countryside*, Report No. 40221-CN, The World Bank, Washington DC, www.worldbank.org/research/2007/12/8945530/china-public-services-building-new-socialist-countryside.
- World Bank (2011), *China Quarterly Update*, April, The World Bank, Washington DC.
- Xiao, Liang (2009), "130 billion central investment plan has begun to be allocated; 95 billion will be allocated to localities", 21 Shiji Jingji Baodao, 3 February, <http://finance.sina.com.cn/roll/20090203/01305807294.shtml>, accessed 9 April 2011.
- Xinhua (2009), "China faces fiscal test as stimulus spending rises, tax revenues fall", 26 February, <http://english.eastday.com/e/0226/u1a4203833.html>, accessed 26 August 2011.
- Yang, Guchuan (2011), "Local government debt management reform proposals", *China Reform net*, 21 July, www.chinareform.net/show.php?id=1150, accessed 25 July 2011.
- Yang, Yiyong (2009), "The employment target for 2010 should be adjusted upwards", 21st Century Business Herald, 28 November, www.21cbh.com/HTML/2009-11-30/155834.html, accessed 18 May 2011.
- Zhang, Ping (2009), Press conference at the Second Session of the 11th National People's Congress, 6 March, www.ndrc.gov.cn/xwfb/t20090306_264932.htm, accessed 28 April 2011.
- Zhou, Yan (2006), "Comparing the Formal and Informal System of Provincial Government Investment in China", *Wuhan University Journal of Philosophy and Social Sciences*, Vol. 59, No. 6, pp. 811-818.

The Performance Framework of the Australian Government, 1987 to 2011

by
Keith Mackay*

This article analyses the performance frameworks adopted by successive Australian governments since 1987. One highlight was a formal evaluation strategy managed by the Department of Finance to support high-quality policy advice and budget decision making. The replacement of this strategy by a decentralised system of performance indicators is also discussed, together with the quality of government decision making. Lessons for other countries are also highlighted.

JEL classification: H110, H500, H700

Keywords: performance indicators, audit, evaluation strategy, government monitoring and review, budgetary decision making, government service delivery, public sector management, role of finance ministry, accountability, outcomes and outputs, intergovernmental relations, Australia.

* Keith Mackay is a consultant to the World Bank, where he was a Lead Evaluation Officer in its Independent Evaluation Group until his retirement in 2008. Valuable comments on an earlier draft were received from Manuel Fernando Castro, Nidhi Khattri, Philipp Krause, Steve O'Loughlin and Ximena Fernandez Ordonez.

1. Context

Australia has a population of 22.3 million people in a land area of 7.7 million square kilometres. The country has enjoyed continuous economic growth over the past 19 years, and was one of the few developed countries not to experience a recession during the global financial crisis. Its economic success in recent decades is widely attributed to a combination of structural reforms that started in the mid-1980s and a prolonged boom in the demand for raw material commodities, of which Australia is a principal world supplier. This economic prosperity has helped lead to considerable budget surpluses for the federal government over most of the past decade.

The federal system of government has three tiers. In addition to the national government there are six state and two territory governments. All of these are based on the Westminster model of government. And lastly, there are local governments. Each of these governments is elected separately. Federal spending in 2010-11 is projected to be AUD 355 billion (currently about USD 375 billion), or 25.2% of GDP. While the federal government collects the bulk of taxes, most public services are the responsibility of the states and territories – including education, health, welfare and community services, law and order, and infrastructure. The federal government provides considerable funding to the states and territories, in the form of block grants and tied funding. The federal government is responsible for social transfer payments to individuals, such as pensions.

The federal government is based in Canberra, and there were 164 600 public servants in June 2010. There are 20 government departments, and the three central co-ordinating departments are Finance and Deregulation (DoF), Prime Minister and Cabinet (PM&C), and the Treasury. The role of central departments in the budget process is described in Box 1.

Box 1. Central departments and the budget process

The Department of Finance and Deregulation (DoF) is essentially the central budget office; it co-ordinates the expenditure side of the budget. It oversees budget accounting, including the financial framework. The DoF also provides policy analysis of government outlays including all new policy proposals of line ministers; these DoF analyses accompany the spending proposals and are sent to the Cabinet committee that decides the budget (the Expenditure Review Committee). In addition, the DoF prepares savings options for achieving budget savings; line departments may prepare their own savings options. The Department of the Prime Minister and Cabinet (PM&C) focuses on the governments' policy objectives and on whole-of-government policy issues. The Treasury focuses on the taxation side of the budget and on macroeconomic issues. All three central departments have desk officers who shadow the line departments. All three, and especially the DoF, perform a "challenge" function, in terms of analysing and questioning the new policy spending proposals of line ministers.

2. First period: 1987 to 1996

2.1. *The priority for public sector reform*

A reformist Labor government was elected in 1983, and Bob Hawke became the Prime Minister.¹ The new government faced a difficult macroeconomic situation including very tight budgetary constraints. One measure of the government's success is that it was able to reduce the share of federal government outlays in GDP from 30% in 1984-85 to 23% in 1989-90; by international standards, this is a very significant reduction. The government achieved this by reducing its own spending as well as the grants it paid to the other levels of government. At the same time, the government was committed to implementing a substantial reorientation of public spending towards the poorer members of society, and to reducing "middle-class welfare". This crisis situation provided powerful incentives for fiscal discipline and for a series of microeconomic reforms. The reforms were intended to change Australia from a highly regulated and protected market-place to a much more flexible, open economy. The Australian dollar was floated, high tariffs were reduced, the financial sector was deregulated, and the flexibility of the labour market was increased. Many government business enterprises were privatised or made to compete with the private sector.

The new government was also determined to implement a series of public sector reforms with the objective of improving government performance significantly. One aspect of these reforms was the desire to provide much greater autonomy to government departments and agencies. This was a "let the managers manage" philosophy, and it involved the devolution of powers and responsibilities – encouraging better performance by providing much greater autonomy to managers. Departments were given autonomy in their spending of salaries and other administrative expenses, through a new system of consolidated running costs. There was also a major reduction in the number of government departments through amalgamation, with the objectives of achieving less balkanised policy advice and of encouraging the internal reallocation of resources through portfolio budgeting.

The budget system was changed very substantially. Australia led the world in introducing a medium-term expenditure framework in 1987, involving forward estimates of spending. The estimates provided a spending baseline and freed up the budget process from a detailed, line-item scrutiny of spending, to focus instead on changes in government policy and spending priorities. This simplified the budget process substantially, and it allowed a much more strategic approach to budget decision making (Keating and Holmes, 1990; Blöndal *et al.*, 2008). The forward estimates also provided departments with greater surety about future resource availability. As Thomas has noted:

The [Australian] government could be considered a leader among countries in terms of the early adoption and the range of reforms made to the design of public organisations, the delivery of programs and services and the introduction of new mechanisms of internal and external accountability... (Thomas, 2009, p. 374).

The government advocated the principles of programme management and budgeting, with a focus on the efficiency and effectiveness of government programmes – through sound management practices, the collection of performance information, and the regular conduct of programme evaluation. Guidance material on these principles was published by the Department of Finance (DoF) and the then Public Service Board, another central agency. And central departments also participated in programme effectiveness reviews and joint management reviews of programmes.

The departmental secretary of the DoF, Michael Keating, was a major architect of many of the government's public sector reforms.² The role of the DoF as budget co-ordinator and overseer of the spending of other departments also helped to ensure its influence on the reform agenda; the DoF enjoyed the powerful support of the other central departments for this agenda. The DoF was keen to get out of the detail of spending issues, where a traditional, zero-based budget process had meant that a substantial portion of its day-to-day work was narrowly focused on minor line-item spending bids and disputes with departments. The DoF wanted to focus much more on higher-level policy issues, as exemplified in its policy analysis and briefings prepared in support of the annual budget process. The streamlined budget process facilitated exactly this kind of high-level focus. The department's concern with budget spending encompassed not simply a priority on cutting government outlays, but also on finding ways to make spending more efficient and effective.

However, the DoF and other central agencies remained unhappy with the progress made by line departments in managing their performance, and so in 1987 the Minister for Finance was able to secure the Cabinet's agreement to a formal requirement that all budget spending proposals ("new policy proposals") should include a statement of objectives and performance measures as well as proposed arrangements for their future evaluation. Departments were also required to prepare plans for the systematic monitoring and evaluation (M&E) of their programmes, and to report these plans to the government. At the same time, the DoF expanded the advisory support it provided to line departments by provision of guidance material and a basic training course in evaluation.

By 1988, it had become evident to the DoF that departments' evaluation plans were often poor, and that a more fundamental review of their M&E practices was necessary. This in-depth review was headed by a senior official from a line department. The review found that:

- there was a lack of integration of evaluation into corporate and financial decision making;
- evaluations tended to focus on efficiency and process issues rather than on the more fundamental question of overall programme effectiveness – i.e. whether or not programmes were actually meeting their objectives;
- there was a poor level of evaluation skills and analytical capacity; and
- the role of central departments in evaluation, especially the DoF, was unclear.

2.2. The government's evaluation strategy³

The DoF concluded that "letting the managers manage" was insufficient; it was judged necessary to "make the managers manage" and to make departments plan and conduct evaluations (Keating and Holmes, 1990). Thus in late 1988, the Minister for Finance secured the Cabinet's agreement to a formal evaluation strategy whose underlying principle was that line departments would have the primary responsibility for determining evaluation priorities, preparing evaluation plans and conducting evaluations.

The strategy had three main objectives. The first, and arguably the most important, was that it provide fundamental information about programme performance to aid the Cabinet's decision making and prioritisation, particularly in the annual budget process when a large number of competing proposals are advocated by individual ministers. Second, it encouraged programme managers within departments to use evaluation for the improvement of their programmes' performance. Lastly, the strategy aimed to strengthen

accountability in a devolved environment by providing formal evidence of programme managers' oversight and management of programme resources. This emphasis on transparency is of considerable interest to the parliament, particularly in the senate's processes of budget scrutiny and approval. Line departments are also accountable to the Cabinet and, in a sense, to central agencies such as the Department of Finance.

The evaluation strategy to which the Cabinet agreed had four formal requirements for departments (Box 2).

Box 2. Evaluation strategy: formal requirements

- That every programme be evaluated every 3-5 years.
- That each portfolio (i.e. comprising a line department plus outrider agencies) prepare an annual portfolio evaluation plan (PEP), with a three-year forward coverage, and submit it to the DoF. These plans were to comprise major programme evaluations with substantial resource or policy implications.
- That ministers' new policy proposals include a statement of proposed arrangements for future evaluation.
- That completed evaluation reports should normally be published, unless there existed important policy sensitivity, national security or commercial-in-confidence considerations, and that the budget documentation which departments present in parliament each year should also report major evaluation findings.

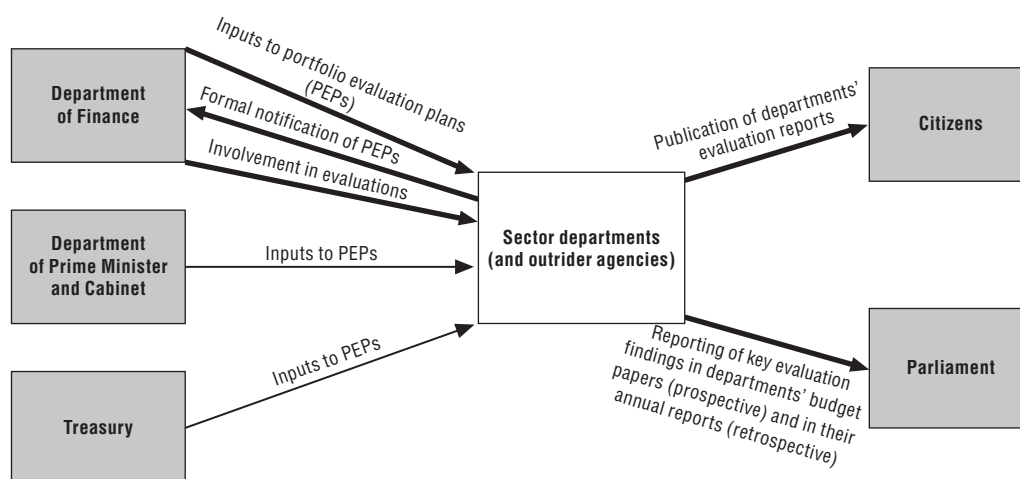
The Cabinet also agreed that the DoF would have the opportunity to make an input to portfolio evaluation plans (PEPs) and to the terms of reference of individual evaluations to ensure their consistency with government-wide policies and priorities, and that the DoF would be available to participate directly in selected evaluations, subject to negotiation between the DoF and the line department (or between their ministers if a dispute arose). The evaluations were to be conducted by the line departments (or agencies). The participation of the DoF desk officers in individual evaluations would typically involve their membership in the evaluation's steering committee, as well as their provision of comments on draft evaluation reports. The planning and reporting flows under the evaluation strategy are shown in Figure 1.

Line departments had expressed serious concerns with the planned role for the DoF, which they regarded as intrusive. Nevertheless, the Cabinet's agreement to the evaluation strategy was in the form of a formal Cabinet decision. An advantage of Westminster systems of government is that such decisions can be taken quickly; and for the federal government and its public servants, such decisions virtually have the force of a law. A disadvantage – compared, for example, with countries that have a Napoleonic system of government – is that such decisions can be easily reversed when there is a change in government.

While the evaluation strategy had three stated objectives, from the perspective of the DoF (which was the primary architect and overseer of the strategy) the objective to which it devoted most attention was to support the Cabinet's decision making during the budget process. The senior DoF management wanted to ensure that its line areas overseeing line departments were fully involved in the evaluation planning of departments and in the

conduct of major evaluations. The immediate objective was to ensure that DoF budget officials were highly familiar with the quality and any limitations of the evaluations, were fully aware of their findings and recommendations, and were thus able to use them in their policy analysis work. Involvement of these officials in the evaluations would also substantially increase their knowledge of the evaluated programme's objectives and the realities of its operating environment.

Figure 1. **Evaluation planning and reporting flows**



Achieving the necessary cultural change in the DoF was easier said than done. Its budget analysts were capable, but tough-minded and very conservative. Thus it was a challenge to change their mindset from focusing on detailed line-item costings to instead having much more of a high-level policy focus, concerned with the performance of government programmes. The necessary cultural change was achieved by a number of means. There was strong leadership and advocacy by successive DoF secretaries and their deputies. Staff turnover was also required, with more emphasis on analytical and research skills and less emphasis on accounting skills. There was also some focused recruitment, so that evaluation experience became one of the selection criteria in the annual recruitment rounds for section heads in the department.

In the years immediately after the Cabinet's agreement to the evaluation strategy, two government reports (from a parliamentary committee and from the Australian National Audit Office) noted the continuing unevenness in the coverage and scope of evaluation activity in line departments (Parliament of Australia, 1990; ANAO, 1991a). Both reports argued that the DoF should take a more active approach in encouraging departments to plan and undertake evaluations. The DoF then created a separate branch responsible for the provision of evaluation advice, support, training and encouragement to other departments and also within the DoF itself. This branch had nine evaluators capable of providing assistance, and it acted as a focal point and catalyst for evaluation throughout the Australian public service. It prepared detailed advice and handbooks on evaluation methodology, provided introductory evaluation training, identified and shared evaluation best practice, and promoted a community of evaluators within the federal public service.

Australia's monitoring and evaluation system (M&E) essentially stressed evaluation, which was viewed as providing the necessary in-depth, reliable information on the efficiency and effectiveness of government programmes. Performance information was understood to be important, but it was viewed as an issue for line departments to manage.

2.3. Other government monitoring, evaluation and review activities

Other evaluation and review activities pre-dated the evaluation strategy. One example is ANAO performance audits. By the mid-1990s, the ANAO was producing 35 performance audits each year. As discussed below, some of these audits focused on the evaluation activities of individual departments as well as on the government's overall evaluation strategy. The audit office's strong support for evaluation, which continues to the present day, has helped to highlight and provide additional legitimisation to evaluation. Another set of activities related to evaluation was undertaken by various government research bodies, such as the Bureau of Transport Economics, the Bureau of Industry Economics and the Industry Commission. Their work included research on microeconomic issues as well as policy analysis and some evaluations.

As already noted, one limitation of the government's evaluation strategy was that it paid insufficient attention to the regular collection, reporting and use of performance information, via tools such as management information systems and performance indicators (Mackay, 1998). However, it had been hoped that evaluation findings would lead to the improvement of performance indicators and the setting of performance targets. By the mid-1990s, the DoF was concerned about departments' poor progress in articulating clear and achievable objectives for their programmes, and in collecting and reporting meaningful performance information on a regular basis. These concerns were confirmed by two reviews which the DoF commissioned concerning departments' annual reports and their budget documentation. This situation might appear to be somewhat paradoxical, because evaluation can involve relatively sophisticated techniques, and by that time it was generally being done well, yet the setting of programme objectives and the collection of regular performance information are often conceptually easier, and they were being done poorly. One explanation is that evaluation had been mandated, while the collection of performance information had not.

Thus, in 1995 the DoF secured the Cabinet's agreement to a rolling series of comprehensive reviews, staggered over three years, of the programme objectives and performance information of all programmes in all departments (see, for example, DoF, 1996). These reviews were conducted jointly by the DoF and each line department, with the results reported to their respective ministers and to the Cabinet as a whole. The reviews laid the basis for a much greater focus on performance information after 1997 (discussed in Section 3 below).

A parallel focus on performance information was achieved by the publication of annual reports on service delivery by the federal, state and territory governments; as noted earlier, most government services are provided at the state and territory levels. The decision to prepare these reports was taken in 1993, and the first report was published in 1995 (SCRCSSP, 1995). This 700-page report covered AUD 38 billion in annual expenditure, or about 9% of GDP. It provided performance information on a range of government services, such as: public hospitals; schools and vocational training; public housing; and police, court administration and prisons. The purpose of these reports was to provide greater transparency of performance and accountability for it. In addition, it was

hoped that the reports would both support and spur improved performance by making comparisons across different jurisdictions – described as “yardstick competition” – and help to identify best practice. Further discussion of these reports, and their uses, is provided in Section 4 below.

2.4. How successful was the evaluation strategy?

2.4.1. Evaluation planning

Since 1987-88, all government departments had prepared annual portfolio evaluation plans (PEPs), and these were intended to comprise the major evaluations of the department and its out-lier agencies. By the mid-1990s, about 160 of these evaluations were under way at any given time. The bulk of these evaluations were major, in that the programmes had significant policy or spending implications; however, a significant minority of these evaluations, particularly for the smaller departments, concerned only minor programmes or only the efficiency aspects of large programmes. Line departments themselves decided which programmes should be included in their PEPs and also which issues the evaluation terms of reference would cover. However, the DoF would usually endeavour to influence the departments’ choice of evaluation priorities by making direct suggestions to them. In making these suggestions, the DoF would attempt both to anticipate and to help create the information needs of the Cabinet. Where the DoF had difficulty in persuading departments, it sometimes approached the Cabinet directly to seek its endorsement of proposed evaluation topics and also detailed terms of reference.

The Cabinet-endorsed, formal requirement under the evaluation strategy that portfolio evaluation plans be prepared and submitted to the DoF certainly provided a powerful incentive to line departments to prepare plans and to take them seriously. Another influential factor was the issuance by the DoF of formal guidelines to departments concerning the desirable content of these plans, together with follow-up monitoring and reminders to departments about the need for the plans. The evaluation branch of the DoF conducted internal reviews of the content and coverage of these evaluation plans, and provided feedback and prompting to departments as well as by identifying examples of good practice. The DoF secretary also used this information to informally pressure line departments to improve their evaluation activities. The DoF supported the creation of the Canberra Evaluation Forum which involves monthly meetings of the evaluation community to discuss topical evaluation issues. The meetings were organised by a steering group of departments and other interested parties; this forum still exists, and it attracts large audiences at its meetings.

In a number of performance audits and two “better practice” guides on programme evaluation and performance information, the Australian National Audit Office also repeatedly reminded departments about the importance of systematically planning their evaluation activity (ANAO, 1991a, 1991b, 1992a, 1992b, 1992c, 1993, 1996, 1997; ANAO/DoF, 1996).

2.4.2. Conduct of evaluation

The formal requirement that all programmes be evaluated every 3-5 years was influential in creating a climate of expectation that evaluation is the norm rather than the exception. The concept of regular, comprehensive coverage of programmes also encouraged a planned, staged approach to evaluation. This formal requirement should not be accepted at face value, however. It is very seldom the case that all aspects of a

programme are included in any single evaluation. Instead, it is usual that an evaluation will focus only on particular aspects of a programme or one of its sub-programmes. The challenge is to ensure that the evaluation addresses the main objectives or problem issues, and this is a role in which the DoF played an active part via persuasion concerning evaluation terms of reference and via direct involvement in individual evaluations.⁴ The DoF also provided guidelines on how to tailor the evaluation methodology according to the specific questions it was intended to address (DoF, 1994a). These questions would depend on the size and importance of the programme being evaluated, the maturity of the programme, and the funds available to conduct the evaluation.

The evaluations were managed and conducted (or contracted out) by line departments. The rigour, depth and types of evaluation conducted varied considerably, as did their cost. At one end of the spectrum, the evaluations comprised rapid reviews of programme performance, using whatever evidence was available and investigating specific issues such as programme efficiency, effectiveness or appropriateness. At the other end of the spectrum were rigorous impact evaluations using detailed data sets and complex statistical techniques. Evaluations also included cost-benefit analyses and performance audits, among others. All of these evaluations were subject to formal planning, terms of reference and reporting. No statistics are available concerning how many of each different type of evaluation were conducted. However, it is probably fair to say that the majority involved relatively rapid review. Of course, evaluations of major programmes would often be major undertakings involving a range of evaluation tools, methods and approaches. A sample of evaluations analysed by DoF ranged in cost (in 1993 prices) from AUD 56 000 to AUD 560 000 (DoF, 1993).⁵

Most departments chose to set up evaluation units to co-ordinate their formal evaluation planning. At their smallest, these units comprised two or three individuals who provided some advice and quality review, and perhaps some training. In some departments, such as the Department of Employment, Education and Training, there was a separate branch – a specialist evaluation unit – of 20-25 staff responsible for evaluation planning, provision of advice on evaluation methodology, participation in steering committees, and the conduct of a number of major evaluations, particularly in the area of labour market programmes.

There was no standard approach by departments as to how they chose to conduct evaluations. Some evaluations involved a wide array of external and internal stakeholders, either by their participation in an evaluation steering committee or, less commonly, by their participation in the actual evaluation team. Some evaluations were conducted by a central evaluation unit with participation by the line programme area, but it was more common for the responsibility for the conduct of evaluations to rest with the programme area. For the more important evaluations – those listed in portfolio evaluation plans – some external involvement would be typical, via provision of suggestions and comments on the terms of reference and proposed evaluation methodology, participation in the steering committee, and provision of comments on drafts of the evaluation report. But, again, there was no standard approach to this external involvement: it would be determined by the willingness of the line department to involve outsiders, and also by the interest and availability of outsiders such as central agencies to become involved. For programmes with major resource or policy implications, the DoF would usually be very keen to be involved and would apply whatever pressure it could to ensure its participation.

A National Audit Office survey found that, for evaluations conducted over the period 1995-97, about half examined the delivery of products or services to external clients, and a further 30% were associated with matters internal to the department. One-third of the evaluations examined the appropriateness of new or established programmes, and 15% were directed towards the development of policy advice for the government (ANAO, 1997).

The large number of evaluations under way at any time, and the fact that over 530 evaluation reports were published between 1993 and 1997, attest to the existence of extensive evaluation activity in the Australian government. The result was a large and rapidly growing “library” of evaluation findings. The DoF also published a register of published evaluation reports, and this also provided some quality assurance because the public availability of these reports exposed them to peer scrutiny. The ANAO survey found that 75% of evaluations conducted in 1995 and 1996 were either released to the public or were available on request.

2.4.3. Evaluation quality

The quality of evaluation reports is a much more difficult dimension to measure. The rigour of programme evaluations depends on the expertise and objectivity of the evaluators. The ANAO assessed the quality of a sample of evaluation reports in 1997 and found that over a third of them suffered from methodological weaknesses of one kind or another. These weaknesses included: failure to adhere to the terms of reference; use of inappropriate methodologies; a divergence between data and conclusions; and unfounded recommendations. It is certainly the case that some published evaluations were of low quality, and the suspicion is that some of these were produced for self-serving purposes, such as to provide a justification for the retention or expansion of the programme.

The perspective of the DoF was that the quality of evaluations can be expected to vary enormously. This variation would be a significant problem if the intended audience of an evaluation is the Cabinet (to aid its decision making) or the parliament (for accountability purposes). In such circumstances, the DoF would certainly be willing to inform the Cabinet that it considered an evaluation to be unreliable. Line departments would typically try hard to avoid such criticism, which would be virtually guaranteed to attract the anger and condemnation of the Cabinet.

The National Audit Office consistently argued that departments should set up central oversight procedures to achieve quality assurance of evaluations conducted by line areas within the department. There is certainly evidence from those few departments which followed this approach that it is an effective means of making available needed evaluation skills and expertise, and of ensuring evaluation quality. But most departments chose to rely on programme managers and their staff for the actual conduct of evaluations. This devolutionary approach helped ensure that the evaluations drew on the programme expertise of staff and that there was a high level of “ownership” of the evaluation findings; both of these elements may be difficult to achieve with external evaluations. The DoF philosophy was to try to achieve the benefits of self-evaluation while ensuring, via its involvement in the steering committees of major evaluations, that sufficient objectivity and rigour were achieved.

Some disadvantages of this devolved approach were a lack of evaluation skills in many programme areas and a lack of experience in conducting or in outsourcing evaluations. It seems highly likely that this skills shortage was a major contributor to the reduction in

quality of some evaluations. Basic training in evaluation skills was widely available in the Australian government – provided by the DoF in particular – and the DoF and departments also prepared guidance material such as evaluation handbooks (for example, DoF, 1991, 1994a, 1996). There is also a fairly large community of evaluation consultants in Canberra, including numerous academics with either subject area knowledge (*e.g.* health issues) or with specialist research and analysis skills. Nevertheless, the 1997 ANAO study also revealed that 20% of departments were concerned about the lack of available training in advanced evaluation techniques, and this was a weakness of the Australian evaluation system.

As noted above, some departments addressed the need for more advanced skills and experience by setting up a central evaluation unit to provide advice on methodology and to participate in evaluation steering committees. The then Department of Health pursued evaluation quality assurance in a devolved environment in a number of ways: selection of good quality officers to manage the evaluation; involvement of internal and external stakeholders; ensuring that technical advisory panels were available to help assess the work of consultants; having steering groups available to help manage consultants; and ensuring that sufficient resources were available for the evaluation. That department, like some others, also put a lot of effort into training its staff to enhance their analytical and research skills.

2.4.4. *Use of evaluation*

A bottom-line issue is the extent to which evaluation results are actually used. If their use is patchy or poor, then there really is little point in conducting evaluations. It is important to appreciate the realistic limits to the influence of evaluation on ministerial or Cabinet decision making. Banks has stated this well:

Policy decisions will typically be influenced by much more than objective evidence, or rational analysis. Values, interests, personalities – in short, democracy – determine what actually happens.

But evidence and analysis can nevertheless play a useful, even decisive, role in informing policy-makers' judgements. Importantly, they can also condition the political environment in which those judgements need to be made.

Without evidence, policy-makers must fall back on intuition, ideology, or conventional wisdom – or, at best, theory alone. (Banks, 2009a, p. 3)⁶

There is clear evidence that evaluations were used intensively in the budget process: they provided a substantial contribution to the development of policy options and their consideration by the Cabinet. The DoF conducted several surveys of the extent of influence of evaluation findings on the budget proposals that were initiated by line ministers, prepared by their department officials, and submitted to the Cabinet for its consideration (*e.g.* DoF, 1994b). The survey respondents were DoF officers who typically attended all Cabinet meetings concerned with budget issues, and their judgments were sought concerning the extent of influence of evaluation on the budget proposals of line ministers and on the final decisions of the Cabinet. The close familiarity of the DoF officers with these proposals, and also with any evaluations or reviews on which they might draw, gave them an insider's perspective on the extent of influence of evaluation.

In the 1990-91 budget, some AUD 230 million of new policy proposals submitted by line ministers was judged to have been directly or indirectly influenced by the findings of

an evaluation. By 1994-95 (the last year for which estimates were available), the amount involved had risen to AUD 2.3 billion.⁷ Measured in dollar terms, the proportion of new policy proposals influenced by evaluation rose from 23% to 77% over that period; and for most of these proposals, the influence of evaluation was judged by DoF officers to be both direct and major. These results indicate the importance that public servants, in their preparation of the details of new policy proposals, and ministers attached to having evaluation findings available. Ministers often expressed their view that it was valuable to them to have evaluation findings available for their Cabinet debates. Overall, it was very important to have had the active support of key Cabinet ministers in encouraging portfolios to plan and conduct high-quality evaluations. This support was also reflected in the many Cabinet decisions which called for evaluations of specific programmes or issues.

It is also the case that evaluation can have a significant influence on the “savings options” put forward by the DoF or by portfolios for Cabinet consideration in the budget process. (Savings options are areas of government expenditure which could be trimmed or abolished entirely.) In 1994-95, about AUD 500 million of savings options (or 65% of the total) were influenced by evaluation findings; again, the influence of evaluation on individual savings options was usually judged to be major. This emphasis on evaluation findings was encouraged by the nature of the budgetary system in the Australian government. Australia had a well-functioning policy decision-making mechanism which made transparent the costs of competing policies and encouraged debate and consultation among stakeholders within government. In this “market-place of ideas”, evaluation findings can provide a competitive advantage to those who rely on them.

DoF officers were also surveyed for their judgments on the extent to which evaluation had influenced the Cabinet’s final decisions – as distinct from the influence of evaluation on the proposals drafted by officials and submitted to the Cabinet – in the 1993-94 and 1994-95 budgets. While the evidence is mixed, it indicates that evaluation played a substantive role. In 1994-95, evaluation was assessed to have influenced the Cabinet’s decision in 68% of the AUD 3.74 billion of proposals considered (new policy proposals plus savings options).⁸ The corresponding proportion for the 1993-94 budget, however, was only 19% of proposals. One important reason for this difference was the substantial revision of labour market, industry, regional and aboriginal policies in the 1994-95 budget; the major policy review on which these decisions were based had been heavily influenced by a number of evaluations commissioned specifically to help guide the policy review (DoF, 1994b).

Campbell has observed that the DoF “functioned as the nerve center for Cabinet on how programs actually functioned. It spearheaded public service reform throughout the 1980s. Its signature initiatives were devolution of authority over running costs to departments and the promotion of an evaluation culture that allowed ministers to monitor and gauge the effectiveness with which departments employed such discretionary spending power” (Campbell, 2001, p. 275).

The observation of the Auditor-General is particularly noteworthy: “In my view, the success of evaluation at the federal level of government... was largely due to its full integration into the budget processes. Where there was a resource commitment, some form of evaluation was necessary to provide justification for virtually all budget bids”

(Barrett, 2001, p. 13). And in comparing the relative success of Australia's and Canada's approaches to incorporating evaluation into the budget process, Schick has stated that:

Canada organised a vast [evaluation] effort around the Comptroller General in the 1970s; Australia adopted an ambitious evaluation strategy in the late 1980s. Canada's effort bore little fruit; Australia's produced significant reallocation of budget resources. Canada is thought to have failed because it centralised evaluation, thereby dampening co-operation by spending departments which may have been adversely affected by the findings. Australia is thought to have succeeded because it gave affected departments a big stake in designing and using evaluations (Schick, 2002, pp. 23-24).

There is also clear evidence that evaluation findings were used by line departments in their ongoing operations and internal management. While there are no detailed statistics concerning the use of evaluation by line departments for their own, internal management purposes, the 1997 ANAO survey found a high level of utilisation of evaluation by line departments. The ANAO survey also found that the impact or use of evaluations by line departments was most significant with respect to improvements in operational efficiency, and to a lesser extent with respect to resource allocation decisions and the design of service quality improvements for the benefit of clients. This high level of utilisation reflected a strength of the Australian evaluation system: evaluation was essentially a collaborative effort involving the DoF, other central departments and line departments. Although responsibility for evaluation was largely devolved to line departments, the involvement of the central departments in the planning and oversight of major evaluations helped achieve broad ownership of the evaluations themselves and of their findings.

3. Second period: 1996 to 2007

3.1. Context

A conservative Coalition government was elected in March 1996, and John Howard became the new Prime Minister. The new government displayed a strong ideological preference for the private sector which it regarded as being inherently more efficient than the public sector. The government expressed considerable unhappiness with the federal public service, and considered it to be rule-bound and caught up in red tape. The government emphasised market testing and the outsourcing of government activities wherever possible – a preference for non-government service delivery. Thus the government significantly reduced the size of the public service, from 143 000 in 1996 to 113 000 in 1999, a reduction of over 20%.

3.2. Changes in public sector management

Over the eleven years that this government was in office, it implemented a number of major changes to public sector management, discussed below. Collectively, these changes resulted in a completely new performance framework; Table 1 provides a comparison of this framework with those in the two other periods analysed in this article. This framework embodied a mix of principles, expectations and formal requirements. Overall, the number and nature of formal requirements were simplified considerably from those of the previous government (Russell, 2003).

Table 1. **Australia's performance framework: key aspects**

	1987-96	1996-2007	2007-11
Australian Public Service (APS)	Cohesive public service; central rules and standards, <i>e.g.</i> pay, classifications, terms of employment.	Public service downsized and balkanised; individual employment contracts; heavy use of business consultants; departmental secretaries usually employed on three-year contracts.	Efforts to renovate public service, <i>e.g.</i> for policy skills; moves to recentralise some functions, <i>e.g.</i> procurement, pay grades.
Philosophy underlying public sector management	Substantial devolution to departments; central requirements, <i>e.g.</i> evaluation, to "make the managers manage".	Very high level of devolution ("let the managers manage"); reduction in red tape; much greater reliance on private sector.	Some recentralisation, with heavy emphasis on encouragement; "let the managers manage"; further reduction in red tape.
Policy cycle	Formalised, disciplined; heavy reliance on analysis by public service; Expenditure Review Committee (ERC) at centre of budget process.	Much less disciplined; greater reliance on non-APS policy advice; many policy/expenditure decisions taken in Prime Minister's Office; ERC relatively weak.	Decision making initially in hands of four key ministers; now greater reliance on budget/ERC processes; APS policy skills to be strengthened.
Role of the Department of Finance (DoF)	Powerful, respected, high level of policy skills; heavily involved in scrutinising new policy proposals – the "challenge" function; responsible for budget estimates; heavily involved in evaluation.	Severely downsized; small role in budget estimates and low financial management skills (until after 2002); low policy skills; little or no evaluation involvement; passive oversight of "Outcomes and Outputs Framework"; strategic reviews managed by the DoF (from 2006).	Increase in staff numbers; refurbished financial management skills; role in reducing regulation and red tape; strategic reviews, and prospect of a rejuvenated evaluation approach.
Evaluation	Formal strategy and requirements (from 1987); enforcement by the DoF; heavy utilisation in policy advice and by the ERC; evaluation use by line departments.	Evaluation deregulated; only a few remaining evaluation islands among departments/agencies; small number of strategic reviews (from 2006); no systematic use of evaluation in the budget process.	Flurry of reviews after 2007; continuation of strategic reviews; no systematic use of evaluation in budget process, and major investment decisions taken without benefit of evaluation; agency reviews to be conducted in future; possible rejuvenation of evaluation in near future.
Performance information (PI), programme objectives, accountability	Programme budgeting (from 1986 on); evaluations usually published; only late attention to performance indicators via reviews of PI, programme objectives (from 1994); federal/state reporting of service delivery performance (from 1995); formal reporting requirements (annual reports, portfolio budget statements).	Programme budgeting abolished (from 1999); new "Outcomes and Outputs Framework" for formal reporting, based on performance indicators (1999); principles-based, no quality control by the DoF; accrual accounting (1999); evaluations rarely published; federal/state reporting of service delivery performance.	"Outcomes and Programmes Reporting Framework", based on performance indicators, and now including programme budgeting; evaluations rarely published; federal/state reporting of service delivery performance; citizen surveys planned.

3.2.1. Role of departmental secretaries and the public service

Departmental secretaries had traditionally been career public servants who were expected to display apolitical professionalism and impartiality. The new government, however, expected secretaries (and the public service as a whole) to be much more responsive to their political priorities, and expected them not to question government policy decisions or preferred options too closely (Podger, 2005, quoted by Kelly, 2006, pp. 12-13; Podger, 2007). The government replaced six departmental secretaries and, by 2001, had put all departmental secretaries on three-year contracts.

Reflecting a private sector paradigm, departmental secretaries became chief executive officers (CEOs) held accountable for results rather than for bureaucratic processes; it was considered undesirable to constrain CEO actions by excessive administrative controls. Performance pay was introduced for departmental secretaries in 1999; the performance contract was between them and their minister.⁹

Departments and agencies were expected to operate on a much more business-like basis (Hawke, 2007); departmental services and outputs, and in particular the outcomes that they were expected to lead to, were viewed as being, in effect, purchased by the government via the annual budget. This outcomes-based, purchaser-provider model had its intellectual basis in the New Zealand public sector reforms.¹⁰ Accrual budgeting was introduced in 1999, and the government viewed it as “heralding a new ‘businesslike’ era in government ... [because it] would show the full cost of all programmes, not just the immediate cash outlays, and therefore make it easier to price and compare them with alternative private sector provision” (Blöndal *et al.*, 2008, p. 152).

To facilitate this *modus operandi*, departmental secretaries were given considerable autonomy over human resource decisions, including the pay of public servants in their departments; this led to a less centralised, less unified, and more balkanised public service. The government also chose to rely much more on alternative sources of policy advice, particularly business consultants as distinct from academics. These consulting companies have not only provided policy inputs but have even been asked to prepare detailed policies (Banks, 2009a). Thus, by the final year of the Howard government in 2007, the total expenditure on consultants was AUD 484 million, or about the same amount as the entire senior executive service in government which comprised some 2 700 staff.

These changes reflected what was, essentially, a “let the managers manage” philosophy. It was analogous to the one adopted in the early 1980s.

3.2.2. *The policy cycle and the role of the DoF*

The election of the Howard government in 1996 led to an environment in which there was greater contestability in policy advice and policy debates. The government diversified its sources of policy advice and policy preparation, including business consultants, think-tanks and academics. Indeed, the government displayed an ideological preference for advice from outside the public sector. At the same time, more and more policy and budget decisions came to be taken in the Prime Minister’s Office, with less reliance on the policy process. One respected commentator argued that:

Howard, like most Prime Ministers, wants research and advice to realise his aims. He would not be swayed, for example, by research suggesting that [his favourite policy options were] ineffective. ... In such a highly political environment the risk is that policy is more divorced from evidence-based research (Kelly, 2006, pp. 14-15).¹¹

For almost all of this period, Australia enjoyed considerable budget surpluses, and this was substantially due to a continuing strong economy. The need for budget discipline was thus reduced significantly and, as a result, the government often decided a large proportion of budget spending right at the end of the budget process (Blöndal *et al.*, 2008). These decisions were made outside of the formal budget (*i.e.* policy) process, and “controlling expenditure has become ever more difficult” (Blöndal *et al.*, 2008, p. 161). The lack of budget discipline meant that monitoring information and evaluation findings about the performance of government programmes became essentially irrelevant. It can thus be argued that the large budget surpluses from 1998-99 onwards eliminated a main driver of a performance orientation by government.

The DoF was an early casualty in this changed environment, and it went through a “traumatic” period in the late 1990s and early 2000s (Blöndal *et al.*, 2008). The government had appointed a new departmental secretary, Peter Boxall, to head the DoF in 1997, and he

was a key proponent of the Outcomes and Outputs Framework (discussed below). He disbanded the DoF unit responsible for advising on evaluation and public sector management reform issues, in order to focus the department more fully on accrual budgeting and the contracting out of government activities. Under its new leadership, the DoF wanted departments and agencies to take the main responsibility for budget estimates, including their forward estimates, as well as for reporting their performance under the Outcomes and Outputs Framework (Wanna and Bartos, 2003).

The then Department of Finance wanted agencies to assume still greater responsibility and saw its role then as akin to an investment bank that only needed the broadest of overviews... The number of analytical budget branches – the ones mirroring spending ministries – was reduced from 13 to 4, creating a vacuum at the centre. The Department lost much of its corporate knowledge of expenditure policy issues, such that it became difficult for it to exercise an effective budget “challenge” function *vis-à-vis* spending ministries and agencies (Blöndal et al., 2008, p. 143).

Campbell (2001) has provided evidence that the weakening of the policy formulation process started during the early part of this period as a result of the irregularity of Cabinet meetings and poor preparation for them, and that the DoF no longer served as a “nerve centre” for the Cabinet concerning the performance of government programmes. This evidence is based on a number of interviews of senior executives that Campbell conducted in the latter part of the 1990s.¹² Based on this evidence, he concluded that the policy process had been undermined due to “... the current government’s tendencies to operate less collegially and collectively than did the Labor government, to trust less and not include in decisions top officials, and to introduce a [DoF] budgeting technology which appears to focus on outputs – often even inputs – at the expense of attention to outcomes” (Campbell, 2001, pp. 278-279).

This situation led the normally diplomatic OECD to conclude that:

In Australia, the deregulation of the public service and the adoption of an arm’s-length posture by the central agencies allowed management freedom but is currently considered to have deprived the Finance Ministry of the information necessary for it to adequately advise the minister (OECD, 2002, p. 5).

For a finance ministry, with its traditionally leading role in the budget and related policy formulation processes of government, this criticism is fundamental.

Peter Boxall was replaced as DoF departmental secretary by Ian Watt in early 2002; most senior budget officials were also replaced at that time. A review of various Howard-era public sector management changes was conducted later that year, and it was decided to increase the number of staff in the DoF who had the financial skills necessary to monitor agencies’ financial performance, cash flows, financial management compliance, and ability to estimate expenditures (Hawke, 2007). These functions are normally the most basic ones for a department of finance, and it is a telling observation that even these had been degraded in the early years of the Howard era.

The number of staff in the budget branches has since risen to about the level that it was before 1996, although their focus was reportedly much more towards financial issues rather than on the provision of policy analysis and advice. It is somewhat ironic that, in an era when much greater attention was intended to be paid to government results,¹³ the central budget office had shifted its focus from a substantial emphasis on government

results and performance to a focus instead on financial inputs. This shift represents a much more old-fashioned conceptualisation of the role of a department of finance.

Policy capacities in the wider public service were also significantly degraded during this period. This led the Public Service Commissioner in 2005 to state her concern that: “For some time now I have been concerned that there has been an erosion of the capacity for sound research, evaluation and analysis in some areas of the [public] service” (Briggs, 2005, p. 10). She also noted that a number of senior public servants shared these concerns.

Similarly, the head of the Productivity Commission (the government’s principal adviser on microeconomic reform, including matters relating to Australia’s productivity and living standards) has repeatedly noted that, from 1996 until the present, continued funding cuts have resulted in a large decline in the number of public servants who are skilled in quantitative methods and other analytical tools, which he identified as exactly the types of skill needed for evidence-based policy making (Banks, 2009a).

3.2.3. *Abolition of the evaluation strategy*

There had been considerable opposition on the part of line department secretaries to the creation of the evaluation strategy in 1987, mainly on the grounds that they viewed it as an intrusion on their areas of responsibility. However, once the strategy had been established, there was little stated opposition to it during the following decade. All this changed after there was a change in government. With the advent of the Howard government in 1996, and consistent with the government’s push for less “red tape”, line departments pressed for less oversight by, and reporting to, the DoF. Line departments also took the opportunity to highlight the burden to them of planning and conducting evaluations. One particular concern was the requirement for preparation of portfolio evaluation plans (PEPs). Some of these had increased in size from a recommended 20 or 30 pages in length, to over 120 pages, with a concomitant increase in the administrative workload necessary to prepare them. A consensus had emerged within the bureaucracy that while it was important to have evaluation findings available to assist decision making by programme managers and by the Cabinet, detailed and elegantly worded plans were not necessary to achieve that objective.

These arguments immediately found a receptive audience with the new government, which therefore decided in 1997 to abolish the evaluation strategy, including its four formal requirements:

- That every programme be evaluated every 3-5 years.
- That portfolios prepare annual portfolio evaluation plans.
- That new policy proposals indicate how they would be evaluated.
- That evaluation reports should normally be published.

The current DoF departmental secretary has recently argued that the decision to abolish the evaluation strategy reflected a view that it was too cumbersome and too resource-intensive for all parties, and that there was a problem with obtaining suitable skills to undertake the evaluations (Tune, 2010).

In addition to the abolition of the formal strategy, the evaluation support which the Department of Finance – renamed the Department of Finance and Administration – had provided to line departments was essentially discontinued. The DoF still encouraged line departments to conduct evaluations of key policies and programmes, with a

recommendation that they be conducted on a five-year cycle, but there was no longer any formal requirement for this. This principles-based approach left the decision to departmental secretaries as to whether or not to conduct any evaluations.

Annual reports, which are presented in parliament, were meant to report the implications of any evaluations that have been conducted in the past year; however, a report by the Australian National Audit Office (ANAO, 2003) concluded that departments' annual reports often do not report evaluations or their findings.¹⁴ Portfolio budget statements (PBSs) were also meant to indicate any planned evaluations in the coming year. In addition, new policy proposals were required to report evaluation evidence, if any existed. But there was no requirement that all new policy proposals should include an evaluation plan if the proposal were accepted. Instead, the proposing minister was expected to present the "business case" for the proposal as well as the strategy for monitoring results; this terminology is indicative of the business-oriented mindset of the Howard government.

There was a new requirement to review "terminating programmes" (those with a defined end date) and "lapsing programmes" (those that were expected to continue but where funding would have to be reauthorised) and to report the findings to the Expenditure Review Committee of Cabinet (McPhee, 2008).¹⁵ These reviews were focused on asking if and how the government should continue to be involved in a programme. However, a team of OECD reviewers has concluded that these reviews "became a mechanical and ineffective exercise which rarely resulted in any significant changes to the programmes, despite an abundance of reviews – there were 149 lapsing reviews between the 2004/05 and 2006/07 budgets" (Blöndal et al., 2008, p. 151). This requirement has now been abolished.

The DoF has interpreted this new framework of performance information and evaluation as a devolved approach (Russell, 2003). The Australian Auditor-General characterised these reforms as a deregulation of evaluation (Barrett, 2001).

A former Public Service Commissioner and departmental secretary has summarised the situation thus:

One of the strengths of the Hawke/Keating governments was the more systematic gathering of performance information and evaluation of programs. Cabinet submissions were required to identify research and evaluation evidence in support of policy proposals and to set out how the proposed new policy would be evaluated. In a short-sighted attempt to reduce the size of submissions, the requirement was dropped in the late 1990s, and evaluation was no longer a mandated requirement. While performance reporting continues to contribute to "evidence-based" policy advising, loss of internal capacity and systematic evaluation, and the increasing reliance on chosen external consultants, has affected the capacity of departments to offer high-quality policy advice (Podger, 2009, pp. 79-80).

Towards the end of the Howard government era (1996-2007), another DoF departmental secretary, Ian Watt, was able to secure the Cabinet's agreement in October 2006 to create a "strategic review framework". The objective of these reviews – which continue to the present day – is to assess the efficiency, effectiveness and policy alignment of a limited number of government initiatives (DoF, 2007); however, the reviews are not intended to identify possible savings. Review topics are chosen by a Cabinet committee, based on advice from the DoF and the other central agencies. The topics are typically large, high-priority, complex and cross-agency in nature, such as the strategic

review of the Australian government's 62 climate change programmes (Wilkins, 2008). Five strategic reviews were conducted in 2009, for example.

These reviews are usually led by eminent persons, such as retired senior public servants, assisted by 4-6 staff seconded from various departments. Review teams are located in the DoF where there is a secretariat to manage the reviews. The current secretary of the DoF considers that some of the reviews have been of excellent quality, although other reviews have been hampered by lack of agency involvement and co-operation (DoF, 2010).

3.2.4. The “Outcomes and Outputs Framework”

The main formal performance-related innovation of the Howard government was its “Outcomes and Outputs Framework”, introduced in 1999 (Box 3). This framework was intended to further strengthen the shift in focus from inputs to results. It required departments to agree with their ministers on the outcomes – the government objectives – towards which they were working, and to also agree the departmental outputs – such as service delivery for specific target groups or for the community at large – that would be produced to help achieve these outcomes (DoF, 2000; Chan *et al.*, 2002; Russell, 2003). By 2004, for example, the 145 departments and agencies collectively had 199 outcomes, and usually between one and ten outputs each¹⁶ (McPhee, 2005; Blöndal *et al.*, 2008). CEOs were given the

Box 3. The Outcomes and Outputs Framework: objectives and potential benefits

The Outcomes and Outputs Framework had three principal objectives; these mirror the objectives of the earlier evaluation strategy:

- To support the government's policy development.
- To support and strengthen departments' internal management, including staff learning.
- To strengthen external reporting, for accountability purposes.

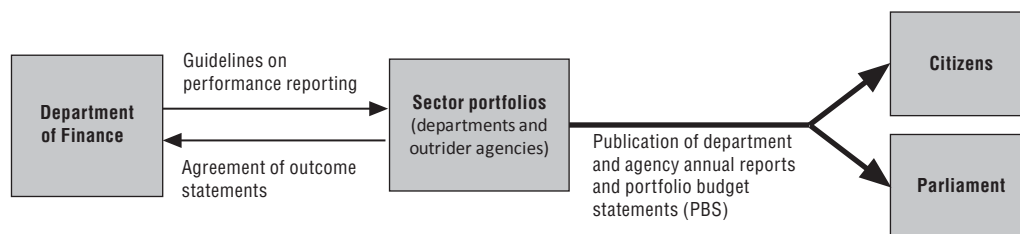
On paper at least, the framework also has the potential to:

- Clarify and ensure agreement among key stakeholders concerning objectives and expected standards of performance. This shared understanding is also crucial to ensure that purchaser-provider arrangements work well.
- Encourage departments to understand well the results chains underlying their work activities – i.e. the logical (and desirably evidence-based) links between departmental spending, their activities, their outputs, and their contribution to desired outcomes.
- Facilitate benchmarking comparisons across departments, and between the public and private sectors. This in turn would make it easier for the government to select least-cost providers, thus yielding efficiency gains. Accrual budgeting could be expected to facilitate considerably such an approach.
- Help departments to cope better with management complexity, particularly when the work of several departments jointly impinges on achievement of a particular outcome objective. This relates to the concept of “joined-up government”.*

* New Zealand has taken a more systematic approach than Australia in this regard, and has formulated a number of strategic results areas which transcend narrow departmental perspectives – see, for example, Schick, 1996. Incidentally, his critique of the New Zealand reforms includes a warning against their uncritical application to developing countries (Schick, 1998). Another critique of New Zealand's reforms appears in Campbell, 2001.

authority to allocate appropriations across different types of output to achieve the desired outcomes. The DoF provided guidance regarding performance management and performance reporting. However, the DoF did not enforce compliance with the framework; it did not specify minimum or mandatory requirements (ANAO, 2007). Thus the definition of individual outcomes and outputs was left to departments and agencies to decide. The reporting flows under this framework are shown in Figure 2.

Figure 2. **The Outcomes and Outputs Framework: performance reporting flows**



The framework required the formal reporting by departments of their performance in achieving these outcomes and outputs. This performance reporting relied on the publication of performance indicators that measure departments' outcomes and outputs – including their quantity, quality and prices – as well as departmental efficiency and effectiveness. Those departments and agencies that provide services directly to the public are required to have service charters, with actual levels of performance to be included in their reports to parliament. Some examples of outcome statements and performance indicators under the Outcomes and Outputs Framework are shown in Table 2.

Table 2. **Examples of outcome statements and performance indicators under the Outcomes and Outputs Framework (2006-07 budget)**

Portfolio	Example of an outcome	Examples of performance indicators
Communications, Information Technology and the Arts	Development of services and provision of a regulatory environment which encourages a stable and effective communications sector for the benefit of all Australians and an internationally competitive information economy and information and communications technology industry.	<ul style="list-style-type: none"> Qualitative evaluation, analysing the department's contribution to developing the ICT sector. High-quality programme administration as measured by: i) number (and trend) of funded grants and grants administered; ii) per cent and number of applications processed within agreed time frame; iii) per cent and number of key processes completed within target period (plus analysis where applicable).
Families, Community Services and Indigenous Affairs	Families and children have choices and opportunities.	<ul style="list-style-type: none"> Percentage of funded projects assessed as meeting the objectives set for the programme. Number of families assisted directly and indirectly. Percentage of care services outside school hours satisfactorily participating in quality assurance.
Immigration and Multicultural Affairs	Contributing to Australia's society and its economic advancement through the lawful and orderly entry and stay of people.	<ul style="list-style-type: none"> The extent to which the entry of migrants results in a positive impact on living standards as measured by models of the economic impact of migration. Number of onshore applications (persons) finalised. Performance against service standards (median processing times).
Transport and Regional Services	Assisting regions to manage their own futures.	<ul style="list-style-type: none"> Regions are assisted to manage their own futures. Information on Australian government programmes and services is available to all Australians. Australian government interests in all territories are managed.

Source: Portfolio budget statements (2006-07 budget) for each portfolio.

Ex post reporting is achieved via departmental annual reports that discuss actual spending and actual performance. ex ante reporting is achieved via portfolio budget statements that relate planned spending to promised performance. Both types of report are presented in parliament. The annual appropriations provided by the parliament are intended to allow the government to achieve its specified outcomes; indeed, the stated outcome objectives constitute the legal basis for appropriations. Each department and agency is able to specify its own outcomes and outputs, subject to the endorsement of its minister. With the introduction of this new framework in 1999, programme budgeting – which had been introduced in 1986 – was abolished.

3.3. The 1996-2007 performance framework: extent of success

3.3.1. The Outcomes and Outputs Framework

The core part of the government's performance framework was the formal Outcomes and Outputs Framework. This framework relied on the collection and reporting of performance information in order to aid policy development and departments' internal management, and for external reporting for accountability purposes.

One inherent limitation of a reliance on performance information for these purposes is that, while it can help provide a useful overview of programme and agency performance, it requires careful analysis for this to be achieved. Simple reporting of data is insufficient; it is typically necessary to supplement the data with qualitative information and especially sound analysis and interpretation. A very good example of this type of analysis is provided by the federal/state/territory performance comparisons for a wide range of government services, discussed in Section 2 above. Fortunately, these published comparisons continued uninterrupted during the Howard era.

Of course, while such analyses are useful in making cross-jurisdictional comparisons, and can help suggest some possible reasons for good or bad performance, they do not provide depth of understanding nor can they provide definitive explanations of causal factors that explain performance. Thus, while performance indicators can measure the different stages of a programme's results chain – inputs, processes, outputs, outcomes and their final impacts – they do not demonstrate causal relationships. Such understanding can only be provided by evaluation; hence there is a complementarity between performance information and evaluation.

Specific problems with the performance information presented in the two main reporting vehicles – annual reports and portfolio budget statements – became evident soon after the Outcomes and Outputs Framework was introduced. Similar problems were highlighted frequently in subsequent years but were never satisfactorily addressed during the Howard government (1996-2007). The role of the DoF in this situation is briefly discussed below.

The many problems with the framework have been identified by ANAO performance audits, speeches of the Auditor-General, reports of parliamentary enquiries, the OECD, and a range of academic observers and senior public servants; see, for example, ANAO, 2001a, 2003, 2007; Blöndal *et al.*, 2008; McPhee, 2005; Mulgan, 2008; Murray, 2008; Parliament of Australia, 2004, 2007; Podger, 2009; Thomas, 2009; and Webb, 2010. The problems that have been identified with the Outcomes and Outputs Framework are serious and fundamental (Box 4).¹⁷

Box 4. The Outcomes and Outputs Framework: significant problems

- “Outcomes” were usually defined in a single sentence, in very broad, aspirational terms, rather than trying to state in specific terms the desired impact of the government’s activity. There was a lack of performance information to tell if outcomes had been achieved or not (ANAO, 2001a, 2007; Parliament of Australia, 2007).
- ❖ One media commentator noted that “in the past, the ‘outcomes’ have been defined as vaguely being in line with the minister’s expectations, rather than clearly defining the target group of the spending, what activities would be undertaken with the funding, and the intended result” (Tingle, 2009, p. 17).
- ❖ Andrew Podger, a former Public Service Commissioner and departmental secretary, stated that “it is easy to be sucked into unrealistic outcomes approaches with meaningless outcomes statements and limited connections between the program activities and the claimed outcomes” (Podger, 2009, p. 81).
- There were about 200 outcomes for the government – and, for example, only three for the entire defence department – and so they had a high level of aggregation. In addition, departments and agencies did not have any shared outcomes; they each preferred to have their own outcomes, for which they alone were accountable (ANAO, 2007; AGRAGA, 2010).
- There were poor logical links between many outputs and outcomes (Podger, 2009).
- Targets or benchmarks were typically not specified for outputs (ANAO, 2003, 2007).
- Departments and agencies tended not to report unmet targets, and often did not discuss areas where performance was poor (ANAO, 2003; Parliament of Australia, 2004).
- There was insufficient performance information concerning efficiency and effectiveness, and too much focus on activities undertaken (ANAO, 2007).
- The majority of agencies with purchaser-provider arrangements did not include performance information on them in their portfolio budget statements (ANAO, 2007).
- The specification of outputs and outcomes differed between departments and agencies, making comparisons very difficult (Blöndal et al., 2008).
- Definitions continued to change over time, even a decade after the framework was introduced (Blöndal et al., 2008; Webb, 2010).
- Portfolio budget statements reported information on the forward estimates of spending, but presented no information concerning forward estimates of outputs or outcomes (ANAO, 2007).
- There was no “clear read” – i.e. there was a lack of corresponding and comparable performance information between the performance promised in portfolio budget statements and the performance actually delivered and reported in annual reports (Murray, 2008).
- The Senate, which has responsibility for approving the government’s proposed budget (see Section 3.3.2), found the outcomes structure of the budget confusing, and strongly preferred a programmatic approach to performance reporting and budgeting (Parliament of Australia, 2007, quoted by Mulgan, 2008).

Given the severity of these problems, it is not surprising that the framework was often not integrated with agencies' internal performance management processes (ANAO, 2007; Murray, 2008). Blöndal et al. (2008) argued that the outcomes focus was not integrated into budget decision making nor in agencies' daily operations. Instead, the focus of departments and agencies, of Cabinet, and of parliamentarians, remained on programmes.¹⁸ The main, and probably the only, purpose of portfolio budget statements and annual reports was as an external reporting requirement, for accountability purposes.

But even as an accountability tool, the Outcomes and Outputs Framework appears to have failed. This is evidenced by the various ANAO performance audits of aspects of the framework and by the various parliamentary enquiries cited above. The ANAO noted, for example, that "performance information generally had not been presented and analysed in annual reports in a way that would allow parliamentarians and other stakeholders to interpret and fully understand results" (ANAO, 2003, p. 13). Thus it is no surprise that the Auditor-General noted the dissatisfaction of parliamentary committees with the performance information provided by departments (Barrett, 2003). Particular difficulties included definitional changes from year to year and different definitions adopted by different departments; these made it difficult to analyse departmental performance over time, or to make efficiency comparisons between departments. These difficulties reinforce the conclusion that the government failed to achieve one of its reform objectives, i.e. greater transparency via benchmarking comparisons of unit costs for all departments and agencies. It can be argued that one advantage of a systemic and centralised approach to performance measurement is that it enables exactly such comparisons to be made. A devolved approach, in contrast, is inherently unlikely to achieve this.

A subsequent Labor government finance minister concluded in 2008 that:

Some outcomes are so broad and general as to be virtually meaningless for budget accounting purposes leading taxpayers to only guess what billions of their dollars are being spent on...

The Outcomes and Outputs Framework was intended to shift the focus of financial reporting from inputs... to outputs and outcomes, i.e. actual results. While this is worthy in theory, it has not worked. Basic information on inputs was lost in the changeover, and reporting of outcomes is seriously inadequate (Tanner, 2008, p. 4).

The extent to which the various objectives of the Outcomes and Outputs Framework were achieved is summarised in Table 3.

Table 3. The Outcomes and Outputs Framework: extent of success

Objectives	Results	Extent of success
Support the government's policy development	Framework information does not appear to have been used for policy development.	Weak
Support and strengthen departments' internal management, including staff learning	Framework information was often not used for internal management.	Mediocre
Strengthen external reporting, for accountability purposes	External reporting was weakened significantly.	Very poor
Clarify objectives and expected performance	Unclear results; a majority of agencies with purchaser-provider arrangements did not report performance information on them publicly.	Unclear
Understand results chains	There were poor logical links between many outputs and outcomes.	Weak
Facilitate benchmarking comparisons	Agencies did not use common performance indicators; insufficient measurement of efficiency and effectiveness.	Very poor
Promote shared objectives	Departments and agencies had no shared outcomes.	Very poor

It is unclear whether any of the problems with the framework arose because of inherent deficiencies in the data – in the performance information collected by departments and agencies. The evidence concerning data quality appears to be mixed, and it is not possible to reach a clear conclusion in the absence of detailed data audits.¹⁹

However, there do appear to have been at least two fundamental problems with the framework. The first is its conceptual – some would say ideological – basis. The framework assumed that government objectives could easily be captured in simple outcome statements, and that outcome-based purchaser-provider relationships – in effect between the elected government and departments and agencies – would be able to drive government performance. The first assumption is technically difficult to achieve, if not impossible, while the second assumption evidently did not work.

The second fundamental problem with the framework was the quality of its implementation, and the fault would appear to lie with departments and agencies, which were responsible for the performance reports that were published, and with the DoF, which was responsible for the design and oversight of the framework. The ANAO has noted the failure of agencies to comply with a number of the mandatory performance reporting requirements (ANAO, 2007). The apparently low priority given by a number of departments to external reporting indicates the lack of strong incentives for them to take it sufficiently seriously.²⁰

The DoF itself clearly displayed a “hands-off” approach: it issued reporting guidelines, and co-authored with the ANAO a better-practice guide on annual performance reporting (ANAO/DoF, 2004), but beyond that it was not prepared to enforce the reporting requirements in an environment where the absence of “red tape” and a high level of devolution to departments were seen as being more fundamentally important.²¹ The DoF reportedly shrugged off repeated criticisms, such as those made by a Senate committee in 2000, concerning the inadequate information content of portfolio budget statements (Thomas, 2009). The government-sponsored Murray inquiry into the implementation of the Outcomes and Outputs Framework concluded that oversight by the DoF had been “lackadaisical”, i.e. unenthusiastic (Murray, 2008, p. 88).

It is ironic that, despite the abolition of the evaluation strategy, the new framework resulted in new bureaucratic requirements for line departments to produce and report a large volume of performance information. Thus, overall the new reporting requirements increased rather than reduced the reporting burden on departments and agencies. It can be argued that these reforms in the 1996-2007 period “threw out the baby but kept the bathwater”.

3.3.2. Accountability and the role of parliament

The parliament, particularly the Senate, plays an important role in budget review and scrutiny, and in holding the government to account for its performance. Senators are elected by a system of proportional representation in each state and territory, and this virtually guarantees that the political party in power – typically the party with a majority of seats in the House of Representatives – will be in a minority in the Senate. Although the Senate has the constitutional power to block the government’s proposed budget, in practice it makes only relatively minor changes to the budget; the government will often accept these changes. There are several opportunities throughout the year for the Senate to scrutinise government performance.²² The most important involves the scrutiny and

passage of the main budget proposals in May; the portfolio budget statements (PBSs) are scrutinised at the same time. Despite the substantial weakening of the information content of PBSs as a result of the Outcomes and Outputs Framework, they remain the Senate's main source of information on government performance and they are prepared under the authority of the portfolio minister. The Senate's scrutiny of annual reports takes place in November and is much less detailed than that of PBSs; annual reports are prepared by departments on their own authority, and they are reportedly viewed by many parliamentarians as "public relations vehicles" (Thomas, 2009).

The Senate has eight committees that scrutinise the budget bills for portfolios. In addition to examining the information content of PBSs, the committees also question portfolio ministers and senior officials of departments and agencies. Although the committees are supported by 150 staff, they reportedly have limited analytical resources available for budget scrutiny. In 2006-07, the committees collectively spent 700 hours on budget hearings, and heard over 4 000 witnesses (Thomas, 2009). Parliamentary committees also consider ANAO performance audits on specific issues (Box 5).

Box 5. Performance audits by the Australian National Audit Office (ANAO)

The primary client of the Australian National Audit Office is the parliament. The ANAO provides the parliament with an independent assessment of selected areas of public administration as well as assurance about public sector financial reporting, administration and accountability. The ANAO also views the executive government and public sector entities as important clients. The Auditor-General is appointed directly by the parliament.

With a staff of about 360 and a budget of AUD 87 million (in 2010-11), the ANAO conducts performance audits and financial audits. Performance audits are a type of evaluation, and they account for about one-third of ANAO resources (McPhee, 2008). About 50-60 performance audits are performed each year. The ANAO explicitly does not pursue a "fault-finding" role with these audits. Instead, it takes a "client approach" with the objective of improving public sector management by identifying "better practice" and by making recommendations to improve the efficiency and effectiveness of government programmes. About 90% of the ANAO performance audit recommendations are accepted by government departments; the remainder are usually partially accepted. Performance audits have been conducted on a wide range of topics, such as:

- Aid given by AusAID to tertiary education.
- The Australian Federal Police's management of new policy implementation.
- The management of overseas leased estate.
- The Australian Taxation Office's administration of the luxury car tax.
- The service delivery of the Commonwealth Rehabilitation Service (for the disabled).
- Therapeutic goods regulation.
- Indigenous employment in government service delivery.

For more information, see www.anao.gov.au.

Thomas has observed that:

... the Senate takes the function of scrutiny very seriously. The idea of the Senate as a house of review for both legislation and spending has over time become entrenched in the culture of the institution. ... [Moreover,] the Australian Senate is probably entitled

to claim that among western democratic legislative bodies it takes the oversight function more seriously than any other, with the possible exception of the Senate in the United States (Thomas, 2009, p. 388).

The quality of the Senate's scrutiny of government performance is unclear. Podger has argued that:

Along with most [departmental] secretaries, I was frustrated by the style of most of the Senate committees I attended, which rarely addressed the major policy or performance issues and mostly pursued more superficial and immediate political matters. I believe these committees need more professional support from the Parliamentary Service, rather than from political staff, to probe more deeply and over time substantial policy and performance matters (Podger, 2009, p. 188).

Hawke (2007) has argued that the use by Senate committees of performance information from portfolio budget statements and annual reports varies enormously: some committees have many questions on actual *versus* promised performance; other committees have few such questions. Mulgan (2008) conducted a contents analysis of Senate committee budget hearings and found that – comparing 1986 to 1992 to 2003 – there was a growing focus on government results, especially on outputs (rather than outcomes), and less attention was being paid to inputs such as spending and personnel. Mulgan concluded that this reflects the maturing accountability priorities of parliamentarians. Even so, the extent to which Senators referred to information contained in portfolio budget statements and annual reports was not high even in 1986, and fell over the period examined; it was particularly low by 2003. He argued that:

... the fact that Senators have largely ignored the formal documentation placed before them, especially in the case of the much-vaunted Outcomes and Outputs Framework, reveals how far the finance [DoF] bureaucracy fails to meet the accountability needs of parliamentarians (Mulgan, 2008, pp. 467-468).

Perhaps more positively, Thomas concluded that:

Even if parliamentarians do not take full advantage of the mountainous volumes of performance information made available to them, the language of outputs and outcomes has become [since the 1980s] part of the culture of parliament and more attention is being paid to the effectiveness of policies and programs (Thomas, 2009, p. 391).

Thus Thomas believes that Australia now displays a “performance-based model of accountability”.²³ In 2010, the government announced plans to create a Parliamentary Budget Office to support parliament by providing fiscal analysis and policy-costing advice on budget-related matters.

As discussed above, the performance framework of the Howard government emphasised the collection and reporting of performance indicators, although the formal reporting requirements were not enforced by the Department of Finance. The evaluation strategy was abolished, and evaluation was deregulated. The decision whether or not to conduct and use evaluations was essentially left to individual departmental secretaries to make. In the absence of strong accountability pressures on line departments, and in an environment where policy and budget processes had been significantly weakened, any incentives for line departments to take monitoring and evaluation seriously would have to be internally generated. It could be expected that this, in turn, would depend on the corporate culture of each individual department and, in particular, on the priorities and commitment of each departmental secretary.

The poor quality of performance information reported in portfolio budget statements and in annual reports does not engender confidence in the totality of performance information collected by departments and agencies. And, *prima facie*, it might also suggest poor internal utilisation of this information by these bodies. This conclusion might be too harsh, however. A small number of agencies reportedly rely on reasonably advanced reporting techniques, such as balanced scorecards, performance dashboards and “traffic light” reports, for their internal reporting and management, in addition to the provision of regular performance information (Hawke, 2007). A possible explanation for this discrepancy is that external reporting to parliament is often not taken particularly seriously, whereas internal reporting for the use of agency senior management would be.

In addition, the voluminous and comprehensive performance information on government service delivery at the federal, state and territory levels that has been published annually since 1995 (for example, SCRCSSP, 1995, and SCRGSP, 2010) is generally regarded as sound. Most of these data relate to state and territory governments, and some data quality assurance is provided by the Productivity Commission.²⁴ Stakeholder surveys have revealed that central and line ministries (in the federal and state governments) find these data helpful in policy analysis and formulation, in assessing the resource needs of agencies, and in briefings for ministers and parliaments.

The lack of close central oversight of departments’ performance monitoring activities makes it difficult to reach a definitive conclusion about the collection, quality and internal utilisation of monitoring information. The same can be said about the scale, nature, quality and utilisation of departmental evaluation. Thus, in the Howard era, there was not a single evaluation system but instead the possibility of 20 – one for each department or more, given that major agencies themselves might choose to conduct their own evaluations.

By 2003, some six years after the deregulation of evaluation, there were still some departments that devoted considerable priority to evaluation, and some could be considered good practice in a number of respects; these included the Department of Family and Community Services and the Department of Employment and Workplace Relations (Box 6). These departments can be considered to be islands of good practice. However, it seems that even these departments tended to conduct evaluation less frequently, in order to address particular issues on a selective basis. It not clear that any departments continued to conduct evaluation as regularly or as systematically as they did under the evaluation strategy of the Hawke/Keating era. There has been no investigation of the reasons why these departmental islands of good practice evaluation persisted after the abolition of the government’s evaluation strategy; this is an issue that merits further research. However, one likely reason includes the personal commitment of some key individuals in these departments – *i.e.* champions of monitoring and evaluation (M&E). Another reason is a corporate culture and mindset of professional staff in the areas of health and education, whose professional training underscores the value of research, evaluation, monitoring and statistics.

Of course, these observations about the supply of monitoring and evaluation information tell us nothing about the extent of its utilisation for purposes of internal departmental management or to aid government decision making. Nevertheless, the fact that at least some departments choose to continue to take evaluation seriously suggests

Box 6. Good practice departments in 2003: evaluation islands**Department of Family and Community Services**

This department provided income support to the disabled, rent assistance, and housing grants to the states, with annual budget appropriations of about AUD 46 billion. It reported a wide range of performance information to parliament, particularly in terms of the quantity, quality and cost of outputs, together with some information on intermediate outcomes. The department's reports to parliament also included a substantive use of evaluation findings (FaCS, 2002a, 2002b). The department regularly prepared a research and evaluation plan, including 145 research/evaluation projects. The total budget for this work was AUD 26 million per annum, equivalent to about 1.4% of the department's operational budget (FaCS, 2001, 2002c). Funding was provided to six university research institutes, and for three longitudinal data sets. The research emphasis was on behavioural outcomes, and this was an important dimension of the evaluations which were conducted.

A significant aspect of this department's emphasis on research and evaluation was that it was a self-generated priority. The department received no specific funding for this work; rather, it chose to fund this work on its own authority within the overall budget envelope which it was provided. Thus, even in a deregulated environment, evaluation was still viewed as important by this department.

Department of Employment and Workplace Relations

This department had a wide range of performance indicators derived from its administrative information system and from surveys, and these provided information on outputs and outcomes (DEWR, 2002). The department also had an active evaluation branch which had a system for producing outcomes data on a regular basis, using longitudinal data on current and former programme participants, with the data interpreted using econometric models to estimate the net effects of programme interventions. Such data also formed the basis for the evaluations conducted by the department (or sometimes conducted by universities); these evaluations were typically overseen by steering committees comprising central ministries (such as the DoF) and other line ministries. This model of internal, independent evaluations is the same as the one followed by this and a number of other departments during the Hawke/Keating era (Crossfield and Byrne, 1994).

The department had a service charter with service standards such as response times. Regular surveys of client satisfaction were undertaken with respect both to departmental services delivered directly by the department and to outsourced services delivered under contract. An interesting feature of the department's client orientation was the feedback sought systematically from the ministers who had responsibility for the department: they were asked to rate each piece of policy advice work according to 11 criteria such as logic, accuracy, creativity and timeliness. This type of performance feedback can be expected to provide very strong incentives to public servants to provide high-quality policy advice. The ANAO has commended the department's public reporting of this performance information (ANAO, 2001b).

that they derive significant benefits from doing so. Neither the DoF nor the ANAO have conducted in-depth reviews of utilisation, so it is not possible to draw definitive conclusions. There is some fragmentary evidence, however.

Soon after the election of the Howard government in 1996, when the government was still facing a substantial budget deficit, the government embarked on a major effort to cut and to reprioritise government spending. In the area of labour market programmes, there was heavy utilisation of detailed evaluation findings – that had been commissioned under the previous government – concerning the relative cost-effectiveness of various types of

labour market programme, such as wage subsidies and direct job creation in the public sector. These findings were used to cut total spending on these programmes by 20%, or about AUD 1.5 billion, over two years. Within the lower budget available for labour market programmes, much more emphasis was placed on wage subsidies (Mackay, 1998, p. 11).

There is some evidence that most departments were not using performance information sufficiently to aid their policy development and internal resource allocation (ANAO, 2003).

The head of the Productivity Commission (the government's main advisory body on microeconomic reform) has criticised a number of policy decisions, including some major infrastructure investments, taken by the Howard government because of doubts about whether they could be justified by evidence and analysis (Banks, 2009a,b).

4. Third period: 2007 to 2011

4.1. Context

A Labor government was elected in November 2007, and Kevin Rudd became the new Prime Minister. He was committed to making substantial changes to many of the policies of the previous government, and was less favourably disposed towards the private sector. A former senior official in the Queensland government, he professed a belief in “evidence-based policy making”. In the first eight months in office, Prime Minister Rudd commissioned at least 140 government reviews of various issues, ranging from higher education to innovation policy (Symonds, 2009). The collective reasons for this flurry of reviews have not been clearly articulated but appear to include the new government's need – particularly for a government that had been out of power for almost 12 years – to clarify a range of policy issues and options, to gather evidence on these, and to engage in public debate on them.

4.2. The policy cycle and government decision making

One feature of this period has been the willingness of senior officials to speak out publicly on their concerns about how the public service – its capacities and policy-advising role – had deteriorated significantly, and about the lack of evidence-based decision making by the government.²⁵ Some of these criticisms relate to the Howard era and to the need to address the accumulating problems that had arisen during that time. The Rudd government did initiate a number of actions to address various problems with public sector management, including with the performance framework broadly defined. However, there were also growing concerns expressed over the style and approach to decision making of the Rudd government itself, with a widespread view that decision making was concentrated in the hands of the Prime Minister and with several close colleagues, rather than in the hands of the Cabinet or based on policy processes involving the public service in detailed policy analysis, advice and deliberation. These concerns culminated in the replacement, by Labor members of parliament, of Kevin Rudd as Prime Minister by Julia Gillard in June 2010.

The quality of the government's decision making has been criticised both implicitly and explicitly. One example is an ANAO performance audit relating to a government body, Infrastructure Australia, that the Labor government created in April 2008 in order to improve the quality of infrastructure planning and the government's investment strategy. A main function of Infrastructure Australia is to develop a priority list of major infrastructure projects that the government should undertake; the government had stated that “only public infrastructure projects that meet a minimum benchmark social rate of

return – determined through rigorous cost-benefit analysis, including evaluation and review – should be funded” (ANAO, 2010, p. 14). However, the ANAO found that, of nine projects that had met the Infrastructure Australia criteria, only seven were funded by the government (at a cost of AUD 6.3 billion), and that an additional ten projects that had either not been subject to cost-benefit analysis or that had failed it were also funded by the government in the May 2009 budget (the cost of these projects is unclear). This *modus operandi* casts doubt on the economic efficiency – as well as the evidentiary basis – of the government’s AUD 20 billion Nation Building Fund, which is meant to be allocated on the basis of impartial assessments by the Infrastructure Fund.

The most criticised government investment in Australia in recent years is the decision to construct a National Broadband Network that will deliver high-speed fiber optic internet cabling to almost every home in Australia. The government initially estimated its total cost to be up to AUD 43 billion – i.e. about 3.5% of GDP.²⁶ A rapid cost-benefit analysis conducted informally by respected economists indicated that, in present-value terms, the costs of this investment would exceed the benefits by between AUD 14 billion and AUD 20 billion (Ergas and Robson, 2010). However, despite repeated recommendations by the Productivity Commission, the OECD, the Business Council of Australia and the Reserve Bank of Australia (Stutchbury, 2010) that this investment should be subject to an in-depth economic appraisal using cost-benefit analysis, the government has insisted that a “cost-benefit analysis would waste time and money” (Communications Minister Stephen Conroy, 2010, p. 5).

Henry Ergas, who has been a senior adviser to the government, has concluded that:

... it is difficult to find any period in Australian history when there have been more badly flawed spending programs... What gives rise to the greatest concerns is the weakening of the policy and program evaluation disciplines that, at least in principle, had been endorsed by successive governments.

How could assurances of the importance the government attaches to project appraisal be taken at face value once public spending on an unprecedented scale had been committed on the basis of analyses of unprecedented shallowness? (Ergas, 2010, p. 14).

Ultimately, the quality of evaluation depends on the value governments place upon it. Governments that view project evaluation as merely a nuisance that stands in the way of the decisions they want to take, and that believe they can get away with no evaluation or poor quality evaluation will, over time, invariably succeed in devaluing the evaluation process. This has, we believe, occurred in Australia in recent years (Ergas and Robson, 2010, p. 154).

In a similar vein, the head of the Productivity Commission has criticised the government over its failure to use evidence in its industry policy (Banks, 2009b, quoted by Mitchell, 2009). Banks’ concerns focus on the structural arrangements that support evidence-based policy making, and with the converse – that their absence constrains such policy making. He has listed these necessary structural arrangements as including: good data; sufficient time for evidence building; good analytical methodology; evidence being open to scrutiny; capable, expert public servants; independence; and a receptive policy-making environment (Banks, 2009a). Among this list, he regards the last as fundamental. However, he regards all these steps in an evidence-based decision-making chain as having significant weaknesses in Australia. As shall be seen below, the government has announced several initiatives that should ameliorate these weaknesses.

4.3. Changes in public sector management

The government has taken several steps to improve the policy-advising capacities of the public service. One step is the provision in early 2009 of AUD 70 million in additional funding over four years to the three central departments – Prime Minister and Cabinet (PM&C), Treasury and Finance (DoF) – to enable them to strengthen their policy capacities. Another step has been the government’s acceptance of a blueprint for the reform of government administration.

4.3.1. “Ahead of the Game”

The reform blueprint, entitled “Ahead of the Game”, was prepared by an advisory group under the leadership of the secretary of the department of PM&C (AGRAGA, 2010). The blueprint contains a number of initiatives to improve the performance of the federal public sector (summarised in Box 7).

Box 7. Ahead of the Game: 2010 public sector reforms

- Surveys are to be conducted of citizen satisfaction with federal government service delivery, to identify the drivers of citizen satisfaction, and to enable benchmarking comparisons with other jurisdictions and internationally. Survey results are to be presented in annual reports. The surveys may eventually be extended to other levels of government.
- Reviews of departmental and agency performance are to be conducted, on a five-yearly basis, to assess their strategy, programme delivery and organisational effectiveness. The reviews will be conducted by eminent external reviewers, and will lead to agency capability plans. The structure of these reviews was influenced by the capability reviews of Canada and New Zealand.
- Departments and agencies are encouraged to strengthen their policy capabilities and to do more research and evaluation. To support these efforts, the Australian Public Service Commission (PSC) will make training available from sources such as the Australian National University, in core areas such as strategic policy, policy analysis, implementation and regulation.
- The Department of Finance (which was renamed the Department of Finance and Deregulation in 2007) is to streamline red tape – i.e. administrative and legislative requirements placed on departments and agencies – to reduce the compliance burden, especially with respect to financial management and corporate functions such as human resources. The DoF has identified over 2 000 such requirements.
- The DoF is to identify agencies that could be amalgamated or subsumed into departments. The DoF is to assist agencies to review their corporate functions with a view to more centralised provision.

Source: AGRAGA (Advisory Group on Reform of Australian Government Administration) (2010), *Ahead of the Game: Blueprint of Reform of Australian Government Administration*, Department of the Prime Minister and Cabinet, Canberra.

These reforms reflected the government’s acceptance of the need to strengthen the policy capabilities of the public service: to undertake rigorous research, gather and analyse data, conduct evaluations of policies and programmes, and provide the highest-quality policy advice. Departments are encouraged to improve their policy capabilities. This

principles-based approach means that they have the autonomy to decide how much effort, if any, to devote to this reform. They are also encouraged to develop partnerships with academic and research institutions.

The government also accepted that Australia lags behind other countries in systematically measuring departmental and agency performance, in areas such as strategy development, programme delivery and organisational operations. Thus, each department and agency will be reviewed at least once every five years. The reviews will be led by eminent external reviewers, and the review teams will have representatives from the departments of PM&C and Finance, the Public Service Commission, the agency itself, and other agencies as appropriate. The lead agency for these reviews will be PM&C; it will develop review methodologies, including the specific issues to be reviewed for each agency, and will manage the reviews. The reviews will also identify ways to improve data on agency performance; this will also help in the development of performance benchmarks for public service agencies. Agencies will be chosen for review on the basis of “risk management principles”. However, the reviews will not be published, at least initially. Once reviews have been conducted, the head of PM&C and the agency will jointly develop a capability improvement plan, and each agency head will be held accountable for its implementation.

The government expects that it will take a number of years for these reforms to be fully implemented. A number of the planned reforms are intended to create a more unified public service – a partial reversion to the situation before the Howard era. However, the government, and perhaps PM&C in particular, is cautious in how these revisions are presented. It has argued that: “There are elements of central planning in the reforms, but this should not be read as a centralist agenda” (AGRAGA, 2010, p. 74). For a public sector and public service that regard autonomy for departments and agencies as a central tenet, any suggestion of a reversal in this philosophy appears to be regarded as an anathema.

One way of viewing these reforms is that they constitute an attempt to fix a number of the problems caused by the public service changes introduced by the Howard government over the 1996-2007 period.²⁷ The changes to the Outcomes and Outputs Framework, discussed below, also belong in this remediation category.

4.3.2. The “Outcomes and Programmes Reporting Framework”

Lindsay Tanner, who became the Labor government’s finance minister after the 2007 election, had long criticised the quality and lack of transparency of budget documentation, including portfolio budget statements. As finance minister, he implemented “Operation Sunlight” which had the objectives of improving the transparency of government budgetary and financial management, and promoting good governance practices (Tanner, 2008). This initiative included a number of substantive changes to the government’s performance reporting:

- Replacement in 2009 of the previous government’s Outcomes and Outputs Framework with a new “Outcomes and Programmes Reporting Framework”.
- Budget reporting in portfolio budget statements to be provided on a programmatic basis – i.e. a reintroduction of programme budgeting which had been abolished by the Howard government in 1999 – rather than on an outcomes basis. This reform was introduced in the 2009-10 budget documentation.
- Improved specification of outcomes, to make them more specific and tangible. The Department of Finance played a leading advisory role vis-à-vis line departments and

agencies; outcomes/programmes structures were agreed with each department and agency. It was recognised, however, that changes to outcome statements would introduce a break in time series of performance indicators, making comparisons with previous years even more difficult. Thus the 2009-10 portfolio budget statements provided a bridge between the information provided by the outcomes/outputs framework and that of the outcomes/programmes framework.

- The introduction of cross-portfolio outcomes, with shared responsibility across portfolios and with performance monitored by the Department of the Prime Minister and Cabinet.
- Better reporting in annual reports of targets and comparisons with actual performance, with effect from FY2010. Targets are provided not only for the budget year but also for the three out-years of the forward estimates period. The finance department is to publish an omnibus report comparing the portfolios' actual performance with their targets.

The ANAO is currently conducting a performance audit of the new Outcomes and Programmes Reporting Framework.

4.4. Government monitoring and evaluation

The secretary of the DoF recently briefed the government, noting that:²⁸

The quality of performance monitoring and evaluation information across agencies and policy/programs is variable. While there are some programs (particularly some large ones) that benefit directly from good evaluation practices, average quality appears to be low. Even where good quality evaluation and review exists, this information is not readily available to inform government decision making, especially on cross-portfolio matters (DoF, 2010, pp. 3-5).

In other words, evaluation is being done for internal portfolio decision making and management, and it may also be done to provide support for ministers' new policy proposals (when the evaluation findings are favourable). But it is not being done to support the government's overall decision making nor for accountability purposes.

The government's formal M&E requirements remain focused on monitoring²⁹ but there are some developments that suggest that considerably more attention could soon be paid to evaluation, with the DoF once again taking a leading role.

As discussed above, the renovated Outcomes and Programmes Reporting Framework remains the centrepiece of the government's approach to performance monitoring. Only time will tell if the technical problems of its predecessor framework have been satisfactorily addressed and, more importantly, if departments and agencies choose to take this newer framework more seriously. The Labor government's commitment to transparency is a significant step in the right direction. Agencies might choose to be more receptive to this government priority, and the DoF may – or may not – choose to take a more pro-active role in policing the behaviour of agencies. However, given that the current climate in the public service remains focused on agency autonomy, and given the DoF mandate (reflected in its new title, the Department of Finance and Deregulation) to cut rather than add to government red tape, there do not seem to be strong grounds for optimism that the new framework will be markedly more successful than its predecessor.

4.4.1. *Performance reporting on government service delivery*

One continuing strong feature of performance monitoring and reporting in Australia is the annual reports on government service delivery. As discussed in Section 2 above, these reports involve the publication of detailed performance information on services provided by the federal, state and territory governments. At least as important as the performance information is the discussion of the reasons for performance differences among the different jurisdictions. This discussion also refers to contextual differences that help explain the differences in performance; these include issues such as population size, remoteness, and so on.

These reports relate to government service delivery in sectors such as: hospitals and primary health care; schools and vocational education; police, court administration and prisons; and community services such as public housing and support for the elderly, the disabled and children (SCRGSP, 2010). These services collectively involve annual expenditure of AUD 136 billion, covering 13.1% of GDP; most of these services are delivered by the state and territory governments. The voluminous reports contain about 1 600 pages and include about 930 performance indicators. The indicators relate to all parts of the results chain for each service, and especially: expenditure; staffing; outputs (including their efficiency, effectiveness and equity); and outcomes/impacts. The reports also provide information on trends over time. As noted earlier, the main purpose of these reports is to provide transparency and accountability regarding government service provision, and it is hoped that this transparency will drive improvements in performance (O'Loughlin, 2010).

User surveys reveal the continuing usefulness of these reports on service delivery (Productivity Commission, 2007). Almost 80% of respondents are satisfied or very satisfied with the reports. The main uses of the reports are: to brief management and ministers (69%); as a research tool (68%); to assess performance (58%); and to develop policy (43%). The reports are also used by parliaments and state audit offices. However, the surveys also highlight that improved comparability of data, better data quality and more timely data are all areas that are judged to be needing improvement.

The reports on government service delivery rely completely on the data provided by each jurisdiction (i.e. the federal government, the six state governments and the two territory governments). While efforts are reportedly being made to improve the quality of these data (McClintock, 2010), this appears to be the main potential weakness of these reports. For example, the health minister of New South Wales has publicly repudiated his government's data on hospital performance: they indicated very poor performance on the part of some of his government's hospitals (Steketee, 2008). A former auditor-general of New South Wales has also stated that the governments of New South Wales and of Victoria have falsified their hospital performance data (Harris, 2009); these data are always highly politically sensitive. He noted that:

Notwithstanding the significance of performance information, most Australian jurisdictions do not require annual auditing of the government's published indicators. Only the West Australian parliament compels state agencies to report performance indicators annually and only that state requires the auditor-general to issue an opinion each year on the relevance and appropriateness of those indicators (Harris, 2009, p. 36).

That the reliability of these data on government service provision is uncertain has to be of significant concern. On the other hand, if the visibility of these data is encouraging some governments – or at least some departments in some governments – to falsify their

data, then that at least tells us that data transparency is providing some “bite”. In other words, the performance information is sufficiently sensitive and important that it is worth falsifying; conversely, when data are ignored and are viewed as unimportant, then it can be inferred that performance reporting is essentially a waste of time.

There is also a national initiative, launched in early 2010 and supported by the federal, state and territory governments, that provides a report card on the performance of almost 10 000 primary and secondary schools in Australia. The “My School” website (www.myschool.edu.au) provides contextual information on each school as well as information on the school’s outcomes: student average test results for reading, writing, language (spelling, grammar, punctuation) and numeracy. It also provides Australia-wide averages for school outcomes, as well as for up to 60 comparable schools; these schools are identified using an index of socio-economic characteristics of student households.³⁰

This website was created to promote transparency and accountability for school performance. It has proved to be highly popular with parents and others, attracting very high web traffic with over nine million hits on the first day. The federal government has been a strong promoter of the website, notwithstanding strong opposition to it (on philosophical grounds) from teacher unions. The federal government launched a similar website for hospitals in late 2010 (www.myhospitals.gov.au).

One final observation on the data on government service provision is that, while Australia has made considerable progress in collecting comparable performance information on service delivery in the different jurisdictions of the country, the opportunity for learning across these jurisdictions – i.e. knowing what does or does not work well in different jurisdictions, and the reasons why – has not yet been fully exploited (Banks, 2009a). It is expected that the reports on government service delivery will in future place more emphasis on highlighting examples of good performance, to encourage the more widespread adoption of good service delivery practices and to encourage innovative reforms.

4.4.2. Performance information required in federal-state funding

The federal government provides about half (AUD 94.1 billion in FY2010-11) of the total funding for state and territory governments (Commonwealth of Australia, 2010). Of this amount, half (AUD 45.4 billion) is earmarked for specific purposes that include schools, skills training, health care, public housing and services for the disabled. The federal government sets broad policy parameters for these payments, in terms of the overall objectives, leaving the states and territories with full autonomy as to how they use these funds. Most of the remainder of the federal funding of the states and territories comprises general budget assistance, i.e. untied funding.

In March 2008, the Labor government reformed federal/state relations by reducing the number of special-purpose payments and by creating national agreements for each type of payment (O’Loughlin, 2010; McClintock, 2010). These agreements are performance-focused. They specify the roles and responsibilities of the different levels of government as well as the specific objectives of the funding, and they set performance benchmark targets in terms of measurable output and outcome performance indicators. However, there is generally no provision for funds to be withheld if a jurisdiction fails to meet a performance benchmark.

The statistics that are used to measure the performance of each jurisdiction are essentially the same as those used in the reports on government service delivery. Both these reports and the formal annual reports on each national agreement are prepared by the Productivity Commission. The data that are used are sourced from national statistics collections (especially the population census and the household surveys) and from governments' own administrative data. However, the data are not considered fully adequate – in terms of their coverage, quality, timeliness and comparability – partly because they were developed for other purposes (McClintock, 2010).

There appears to be a consensus that the performance reporting framework for the national agreements is too cumbersome and needs to be simplified. For example, the national healthcare agreement specifies 70 performance indicators, 26 progress measures, 15 outputs and 11 outcomes, and the annual performance report is currently almost 700 pages long (SCRGSP, 2009). The chair of the Council of Australian Governments (COAG) Reform Council has noted that this complexity makes it much more difficult to achieve effective public accountability (McClintock, 2010). The performance frameworks for the national agreements are currently being reviewed.

Notwithstanding these early difficulties with the data and with the performance reporting frameworks, it can be concluded that the early identification of them by senior stakeholders provides some confidence that they will be satisfactorily addressed.

A notable feature of the national agreements is that for some – currently minor – parts of them there is performance-based funding. The funding is termed “reward payments” to states and territories that are able to achieve ambitious performance benchmarks (COAG Reform Council, 2010). The amount of this funding is currently modest (around AUD 400 million per annum) but might grow in coming years if performance-based funding is judged to provide effective performance incentives.

4.4.3. A rejuvenated DoF evaluation strategy

The secretary of the DoF advised the newly re-elected government in 2010 that “procedures for evaluation and review ... need to be reinvigorated” (DoF, 2010, p.1.1). He has noted the range of evaluations and reviews that are conducted by different entities within the government; these include the department's own strategic reviews, DoF *ad hoc* savings reviews, ANAO performance audits, reviews conducted by the Productivity Commission, evaluations conducted by departments and agencies, parliamentary enquiries, and so on (Tune, 2010). However, these evaluative activities are *ad hoc* and piecemeal.

Even the DoF regards its own strategic reviews as being of variable quality and at times limited usefulness, due to the disinclination of some departments to become actively involved in them or to provide needed information. As noted earlier, the DoF secretary stated that while some departments' programmes have been subject to good-quality self-evaluation, the average quality appears to be low. Moreover, the evaluations conducted by line departments and agencies are done for their internal decision making and management; they are typically not conducted to support the government's overall decision making nor for accountability purposes. In addition, departmental secretaries tend to be disinclined to make evaluation findings available – either publicly or to the DoF – and so the DoF is unable to use these findings to inform its policy advice. The DoF secretary believes that this partly reflects concerns that the DoF might use any adverse evaluation findings for savings options to cut programmes. Podger noted that, consistent with a

secretive approach, a number of his fellow departmental secretaries take measures to frustrate freedom-of-information legislative requirements – for example, by ensuring that their senior officials keep few file notes and regularly destroy their diaries (Podger, 2005, quoted by Kelly, 2006, p. 12). Such approaches will tend to frustrate both formal and informal accountability requirements, in terms of accountability to the DoF and to other central agencies, to the elected government and to the parliament. Thus, a question for the government to consider is whether the fashion towards secretarial and departmental autonomy has become too permissive.

In this environment, the DoF secretary has stated that “Finance has retained its overall responsibility for the government’s monitoring, evaluation and review” (Tune, 2010, handout notes for slide 14), and he has advised his new minister that “a robust formal framework for evaluation and management of performance information would support fiscal strategies and improve delivery of services” (DoF, 2010, pp. 3-5). The DoF is still considering options for such a framework, and one model that is attractive to the DoF secretary is the Canadian approach which involves the evaluation of all government programmes on a four-year cycle in order to determine the efficiency, effectiveness and alignment with government priorities of all programmes.³¹ The DoF secretary has indicated that the components of a rejuvenated DoF evaluation strategy are likely to include:

- Reforming evaluation and review practices by: i) positive incentives to departments to conduct robust, transparent evaluations (e.g. by sharing any subsequent programme savings); ii) some centralisation of evaluation by means of DoF oversight of departmental and agency evaluations, in order to enhance evaluation quality; and iii) a governance framework encompassing both evaluation and performance information to provide transparency to government.
- Enhancing the strategic review processes via, for example, a more comprehensive programme of reviews, and by provision of greater authority for the reviews, such as by ensuring that their terms of reference are explicitly endorsed by the Cabinet (DoF, 2010, pp. 3-5).

The DoF secretary is keen to avoid what he perceives as the problems with Australia’s evaluation strategy in the 1987-97 period: that the requirements to prepare detailed portfolio evaluation plans and to evaluate every programme on a 3-5 year cycle were too cumbersome and resource-intensive (for portfolios and for DoF policy analysts), and that the level of evaluation skills both inside and outside the public service was inadequate for the evaluation task. However, the challenges to be faced will include, among others:

- How to build demand for performance information and evaluation in support of more informed public debate and government decision making.
- How to ensure a sufficient supply of evaluation skills to enable the regular evaluation of government programmes.
- How to change perceptions that evaluation is more of a fault-finding threat to line departments and to public servants, rather than an opportunity to improve programme performance.
- How to persuade reluctant departmental secretaries to conduct more, and higher-quality, evaluations and to allow greater DoF involvement.
- How to ensure a strategic approach to departments’ evaluations, so that the right programmes are evaluated at the right time, the right issues are evaluated, and they are evaluated rigorously.

- How to ensure that DoF budget analysts – i.e. the DoF officers who advise the Cabinet on new policy proposals and savings options – become fully familiar with departments' evaluations, and that they view evaluation as a core part of their work rather than as a “politically correct” distraction.

One final observation is that the challenge facing any greater emphasis on performance-based budgeting in Australia will require not simply more and better evaluation findings, but also a renovated policy decision-making process. This topic is discussed below.

5. Lessons from the Australian experience

The Australian evaluation system lasted for a decade, from 1987 to 1997. During this period, Australia became a model of evidence-based decision making and performance-based budgeting. Thus by the early to mid-1990s, the evaluation findings that the system was producing were having a significant influence on the contents of departments' policy advice and on the Cabinet's budget decisions. Ministers frequently stated the high value that they attached to having evaluation findings available to better inform their decision making. Evaluation findings were also being used quite intensively within line departments in support of their ongoing management.

Considerable effort was needed to reach this situation. It involved the progressive refinement of the evaluation strategy, and this in turn required an element of trial and error. There was also a need for ongoing monitoring, review and adjustment to the evaluation strategy itself. More fundamentally, there were a number of important factors that were crucial to the success of the strategy; their importance was highlighted starkly by changes that occurred during the subsequent Howard era, from 1996 to 2007. The reform champions at the most senior levels of the DoF, and reformist ministers in the Hawke/Keating governments (from 1983 to 1996), were a key success factor. Related to this was the important role of the Department of Finance. As the central budget office, it was powerful and highly influential, and it was the architect and implementer of the evaluation strategy. Its advocacy and use of evaluations required a substantial evolution of its staff and their skill sets. Conversely, if the DoF had remained a more traditional budget office concerned only with scrutiny of line-item costs, or if it had taken a more passive approach to evaluation, then it might have become a serious roadblock standing in the way of performance-oriented government.

Once senior officials had secured the agreement of key ministers, it was relatively easy to create the evaluation system in 1987 and to progressively fine-tune it in the following years. This flexibility resulted from the Westminster system of government in Australia, which does not require a legislative basis for central requirements such as an evaluation system. A disadvantage – compared, for example, with countries that have a Napoleonic system of government – is that such decisions can be easily reversed when there is a change in government.

The evaluation strategy was far from perfect. Even after it had been in existence for a decade, over one-third of evaluations suffered from methodological weaknesses of one kind or another, and this would have reduced their reliability and value. Related to this problem, there were evidently insufficient evaluation skills within the public service; most line departments relied on programme areas to conduct the evaluations of their own programmes, and a number of these apparently lacked the necessary skills and were thus

ill-equipped to cope with this additional, unwanted workload. This perceived burden might also have helped to maximise the pushback from line departments against the evaluation “red tape” when the opportunity arose with the change in government in 1996.

Some line departments avoided the problem of ill-equipped programme areas by creating large, specialist evaluation units. It is interesting to note that it is these same departments that constituted the “islands” of evaluation good practice that remained in existence after the evaluation strategy had been abolished. In these departments, at least, an evaluation culture has persisted. With the benefit of hindsight, it might have been desirable for the DoF to have mandated the creation of such units in each line department, to address the problems of evaluation quality. These units could either have conducted all major, significant evaluations, or alternatively could have provided close support and quality assurance to their programme areas. However, at the time it would have been considered too intrusive to mandate such a requirement.

When the evaluation strategy was created in 1987, there would have been a number of poor-performing programmes, and subsequent evaluations could be expected to have revealed their poor efficiency, effectiveness or appropriateness; this would usually have led to the programmes being improved (especially if they were an important government priority) or else cut or even abolished. But by the time that the strategy was abolished in 1997, most programmes would have been evaluated more than once, and it might be expected that the marginal returns to M&E would have declined considerably. There is no information on the changing returns to M&E over time, so this possibility cannot be investigated further; in any event, this was never stated as a reason for the abolition of the strategy.

The abolition of the evaluation strategy in 1997 revealed a number of risk factors facing other government systems for monitoring and evaluation. One such factor is obviously that a change in government can lead to fundamental change in public sector management. Another risk factor is the departure of key champions of M&E and of a centralised performance orientation within government. Related to this is their replacement by M&E “opponents” – key officials who are either sceptical of the benefits of M&E activities or who, in Australia’s case, pursued both a “let the managers manage” philosophy that had not worked in the past and a simplistic performance framework that was probably doomed to failure. The performance framework that was developed during the Howard government era, and the incentives that were meant to underlie it, were ideologically driven; there is ample evidence now to show that they constitute a failed experiment in public sector management. Of course, the evaluation strategy was only one casualty of this mindset. The DoF had traditionally been the main guardian of fiscal rectitude, but its budget estimates role and its policy-advising role were significantly degraded during this period, as indeed was the entire policy decision-making process of government.

The changed decision-making processes were related to another risk factor that Australia faced which was, ironically, economic prosperity and large budget surpluses. Conversely, large budget deficits and a macroeconomic crisis can and did act as a very powerful motivator for governments to cut expenditure by identifying inefficient or ineffective spending while searching for much better value for money from existing spending. This kind of situation provides fertile ground for monitoring information and especially evaluation findings to show which policies and programmes are cost-effective and which are not. The large budget surpluses that Australia enjoyed from

1998-99 onwards undermined the priority for budget discipline and eliminated a main driver of a performance orientation by government.

The demise of the evaluation strategy appears to have been followed soon after by a substantial decline in the quantity and quality of evaluations conducted by departments and agencies. The DoF had hoped that, after a decade of having a mandatory approach to the planning and conduct of evaluation, an evaluation culture would have grown up within the public service and that this would have persisted over time. That this appears not to have happened may be due to a number of reasons. One is the sudden replacement of a number of departmental secretaries after the change in government in 1996. Another reason is the substantial cuts in the public service, and these would have made it a lot more difficult to continue to fund what are often viewed as more “discretionary”, long-term activities such as evaluation and research.

Another reason may be that many departmental secretaries and their ministers are naturally disinclined to conduct evaluations: while positive evaluation findings that reveal good performance are always welcome, adverse findings can pose significant political and reputational risks. The current disinclination of departments to publish their evaluations and their reported willingness to frustrate freedom-of-information legislation would appear to be consistent with this interpretation. That said, some departmental secretaries remain strong advocates of monitoring and evaluation; they apparently view M&E as important to help their internal management and policy development. Their support of evaluation islands attests to this attitude.

The evaluation strategy that existed from 1987 to 1997 can be judged to have been a fairly successful evaluation system because it achieved a high level of utilisation, with a generally reasonable quality of evaluations; however, it proved not to be a sustainable system because of significant and adverse risk factors. The system took considerable effort and time to build – as did the expertise of the DoF regarding budget estimates and policy advice. But it took much less time to degrade these functions. Current efforts to renovate government evaluation can also be expected to require significant effort and to be time-consuming.

Australia’s experience is also notable because of its reliance from 1997 to 2007 on a performance framework that was based on a system of performance indicators. An advantage of indicators is that they are cheaper, simpler and quicker than evaluations. But while they can be used to highlight examples of good or bad performance, a major limitation is that they fail to explain the reasons for this performance or the strength of any relationship between government spending and subsequent outcomes; thus it is difficult to apply the performance lessons elsewhere. Australia’s performance framework during this period provides a strong example of how not to go about constructing a system of performance indicators. The framework encountered many conceptual and data difficulties. It also suffered from severe problems of implementation by departments and agencies, and from a lack of effective oversight by the DoF.

There are interesting choices facing any government that wishes to achieve a more evidence-based approach to its decision making. Perhaps ironically, these very same choices once again face the Australian government and the Department of Finance. One choice is how centralist or devolutionary to be. The answer must surely lie in what are the intended purposes of monitoring and evaluation information. If the intended use is to aid the internal management and decision making of line departments and agencies, then this

would seem to favour a more devolutionary approach – unless it could be convincingly shown that these line units would tend to significantly under-invest in M&E if they were left to their own devices. The reality that most departments and agencies currently appear to engage in little evaluation activity would suggest that a devolutionary approach to evaluation is insufficient to support sound programme management.

If regular M&E information on the performance of all government programmes is needed, and on a systematic, whole-of-government basis, to aid government decision making – i.e. to assist in deciding new programmes or which existing programmes to cut – then this would argue for some form of centralist approach with leadership from the central budget office (i.e. the DoF). Only a centralist approach is likely to be able to achieve sufficient coverage and quality of the M&E information that would be produced. Australia's experience in the years leading up to the creation of the evaluation strategy, and in the years after its abolition, demonstrates that a principles-based approach that encourages M&E but does not mandate it, and does not monitor and ensure compliance, is highly unlikely to work. Similar arguments would apply when a major purpose of M&E information is to support accountability for performance, such as accountability to the parliament.

Of course, only some aspects of Australia's evaluation system in the 1987-97 evaluation system were centralised: the evaluation policy itself, and the central oversight and quality assurance roles of the DoF. Evaluations themselves were planned and conducted by line departments, with the DoF and other central agencies investing considerable effort in attempting to influence departments' evaluation agendas as well as the focus and conduct of individual evaluations. Evaluation was therefore a collaborative effort.

Thus, the DoF, as the system's architect, was attempting to have the best of both worlds – to bring together its own (and other central agencies') objective scrutiny and willingness to ask tough evaluation questions with the programme expertise of line departments and agencies. This approach had the potential to meet the evidentiary needs of budget decision making as well as to maximise the "ownership" of evaluation findings by line departments and agencies. It can fairly be said that these needs were substantially met, albeit at the cost of some important reduction in evaluation quality. This reduction in quality could have been avoided if the DoF had mandated a requirement for each line department to create a large, specialist evaluation unit. Of course, this would have entailed a budgetary cost.

Some observers (such as the current secretary of the DoF) have argued that another disadvantage of the evaluation system was that it imposed an overly onerous burden on the DoF and other departments. This viewpoint is debatable, however, and it was certainly not identified by the ANAO in its 1997 performance audit of the evaluation strategy as a whole. It is also worth remembering that the partially centralised approach to evaluation from 1987 to 1997 was framed as the *quid pro quo* for a devolutionary approach to other public sector reforms. It reflected the observation that most line departments and agencies prefer not to devote much effort to measuring their performance. This observation is equally relevant today.

The nature of a centralised or partially centralised M&E system need not consist simply of measures to force line departments to comply. Indeed, there are reasons why an authoritarian approach might even be counterproductive in some respects: it might discourage the co-operation of line departments, whose programme expertise is invaluable

in any evaluations of them. And it may well also reduce the “ownership” by line departments of evaluations that are forced on them, and thus reduce their willingness to use the evaluation findings.³² With the evaluation strategy, the DoF tried to soften such disadvantages by relying on persuasion wherever possible and by providing a range of positive support and assistance, rather than by using more forceful methods. The incentives that it adopted for evaluation comprised a mix of “carrots, sticks and sermons” rather than simply relying on a “sticks” approach.³³ The carrots included the advisory support provided by the DoF, as well as possible access to resource agreements for line departments to aid their management of the programmes revealed by evaluations to be under-performing. The sticks were related to the ongoing relationship of the DoF with line departments and the finance department’s ability to influence their budget allocations. The DoF also had the option of embarrassing departments by releasing the comparative rankings it prepared concerning departments’ approaches to the planning and conduct of evaluation.³⁴ The sermons included persistent advocacy by the secretary of the DoF and his senior executives, as well as the explicit support for evaluation from some powerful ministers.

Of course, the real challenge currently facing the government is not simply how best to renovate monitoring and evaluation and the broader performance framework. While important, these are essentially technocratic or supply-side issues. More significant is the challenge of renovating the entire policy-advising and government decision-making process (of which the budget is the central part); this decision-making process constitutes a principal demand-side use of M&E information. There appear to be problems with many of the stages of this entire process: obtaining reliable monitoring information and evaluation evidence (this requires adequate data, skilled evaluators inside and outside the public service, and the commitment to conduct reliable M&E); making full use of this information by the DoF, other central departments, line departments, external advisers and others in their policy-advising roles (this also necessitates having a sufficient number of highly skilled policy analysts); having budget processes that allow and demand high-quality policy advice from all key stakeholders (especially ministers and their departments); and having a government that places a high value on having evidence available to inform its decisions.

Changes currently under way within the Australian government provide hope that some of these stages are being or will be renovated. These stages can be viewed as a “results chain” similar to the results chains that underlie each government programme, linking its expenditure via its processes to its outputs, outcomes and impacts. The danger is that a persistent weakness at any point along the policy results chain could tend to frustrate the achievement of evidence-based decision making. Put another way, if a government pays little attention to M&E information, then the substantial effort needed to build up an M&E system is likely to be partly or largely wasted. That said, there are certainly other uses of M&E information – such as for programme management, for departmental decision making, and for accountability purposes – and these other uses might make an M&E system a worthwhile effort.

Australia is at an interesting juncture. It once had the best evaluation system in the world, but now it lags considerably behind developed and developing countries such as Canada, Chile, Colombia, Mexico and the United States.³⁵ Only time will tell if current efforts to renovate monitoring and evaluation in the Australian government are successful.

Notes

1. Bob Hawke was replaced as Prime Minister by Paul Keating in 1991.
2. In 1991, Michael Keating was replaced as departmental secretary of the DoF by Steve Sedgwick, another strong supporter of public sector reform and of the formal evaluation strategy that had been proposed by the DoF. Mike Keating then became secretary of PM&C, the most senior public servant.
3. This evaluation system is described in greater detail by Mackay, 1998.
4. There was only modest success with the requirement that ministers' new policy proposals include an evaluation plan of action that would be undertaken if the proposal was accepted. Feedback from portfolios indicated that this requirement was onerous for portfolio managers during the busy budget period. For example, only about 30% of proposals broadly met this requirement in the 1993-94 budget, although an additional 50% of proposals included a clear undertaking to evaluate the proposal if accepted (DoF, 1994b). These percentages were only achieved after considerable prodding by line areas within the DoF.
5. The annualised cost of these evaluations was equivalent, on average, to less than one per cent of the government's spending on these evaluated programmes. Thus, if the evaluation findings had led to only a very modest improvement in the efficiency or the effectiveness of the programmes, the evaluations would have been cost effective.
6. He also added that ... "good evidence can ameliorate or 'neutralise' political obstacles, thereby making reforms more feasible" (Banks, 2009a, p. 6).
7. In that year, the government's total outlays were AUD 123.6 billion. Of this amount, the large majority was specified in the forward estimates and was not subject to scrutiny. The "margin" that was actively scrutinised comprised new policy proposals plus savings options.
8. Moreover, where policy proposals were supported by evaluation, the evaluation was judged to have also influenced the Cabinet's decision in 89% of cases.
9. Performance pay had been introduced for the senior executive service and less senior public servants in the late 1980s.
10. This particular New Zealand reform is often viewed as unsuccessful in that country; see, for example, Schick, 1996, 1998; Campbell, 2001. The notion of a minister purchasing the outputs of a government department implies an imaginary market-place for what is essentially, in most cases, a bilateral monopoly situation. The absence of substantive incentives to take seriously this kind of notional purchaser-provider relationship undermines any value in this approach. The Australian approach went beyond that of New Zealand in that ministers (and the parliament via its control over appropriations) were expected to purchase outcomes rather than outputs. Given the often fuzzy links between outputs and outcomes, this Australian version is even more fanciful.
11. This perspective is confirmed by a number of interviews of senior public servants (Howard, 2005).
12. This was also confirmed by a departmental secretary upon his retirement in 2009 (Borthwick, quoted by Burgess, 2009). He stated that "during my time [in the Australian public service], some of the most important decisions were made by the Prime Minister. ... Cabinet was little more than a rubber stamp." He advised that "departments should more rigorously analyse and evaluate different choices".
13. Advocates of this period have argued that one of its strengths was the explicit focus on results – i.e. on outputs and outcomes (and impacts). Yet the evaluation strategy and other public sector reforms in the earlier period stressed the achievement of efficiency and effectiveness. Efficiency is the achievement of results at least cost, while effectiveness is the achievement of programme objectives – which are defined as the outcomes that the government wishes to achieve. Thus the focus in the two periods was not so different, with the exception that in the later period there seemed to be much less explicit focus on the cost of government programmes.
14. It is not known if such omitted findings reflected adversely on the performance of the departments.
15. This requirement excludes most transfer payments.
16. The ANAO (2007) found that one agency had 52 outputs.
17. Notwithstanding this long list of serious deficiencies, some agencies have been identified by the Auditor-General as providing good-practice reporting. They include the Department of Family and Community Services, the National Library of Australia, and the Australian Customs Service (McPhee, 2005).

18. Programmes in Australia are objective-based. They comprise a set of related activities with a common objective (i.e. a desired outcome). While they have a conceptual relationship with the outcomes focus of the Outcomes and Outputs Framework, in practice programmes have been defined in a much more detailed manner. Programmes in the Australian government are also organisation-based.
19. A 2003 ANAO performance audit on annual performance reporting concluded that agencies did not possess the necessary data standards and procedures to assure data quality and coherence (ANAO, 2003). In contrast, the 2007 ANAO performance audit on the Outcomes and Outputs Framework relied heavily on self-reporting by agencies in its conclusion that agencies have sound systems for capturing and reporting performance information, and that they provide accurate and reliable information (ANAO, 2007). This later performance audit conclusion was contradicted by the Murray inquiry that was commissioned by the subsequent Labor government (Murray, 2008).
20. The Auditor-General has observed that: "In my experience, organisations that have reliable performance information for both external requirements and internal management have achieved good performance reporting through strategies such as: establishing a robust performance culture based on public sector values; maintaining strong links between reporting, planning and management; and ensuring strong links between external and internal reporting" (McPhee, 2008, p. 16).
21. It is interesting that the current DoF departmental secretary has noted that the DoF remains the main generator of formal "red tape" requirements, generating nearly half of the 2 000 compliance requirements (especially those relating to financial compliance) on government agencies (Tune, 2010).
22. Other opportunities include the Senate's consideration of the additional estimates bills in February, its consideration of ANAO efficiency and financial audits, and the Senate's own inquiries into issues relating to government performance and other issues.
23. It is interesting to note in passing that Bovens has developed a taxonomy of the ways in which accountability can improve performance: i) preventive, by setting standards to hold institutions to account; ii) remedial, by encouraging responsibility to fix problems and to prevent recurrence; and iii) educative, by tracing connections between past, present and future policies (Bovens, 2006, p. 26, quoted by O'Loughlin, 2010).
24. The Productivity Commission may devote some additional effort to data quality issues in coming years (Independent Reference Group, 2010).
25. In contrast, senior officials during the Howard era usually voiced their concerns only in their retirement speeches or after they had retired.
26. More recent costings have ranged from AUD 35.7 billion to AUD 55 billion.
27. Other areas of public sector management where some recentralisation is occurring include government procurement and public sector pay (McPhee, 2009).
28. This brief, which was initially confidential, was prepared for the Labor government re-elected in September 2010. Although the comments applied to the state of evaluation at that time, they would be equally applicable to the situation at the time of the Howard government.
29. From 2009, budget rules were changed to require new policy proposals (NPPs) to outline the review and performance measurement framework under which each proposal would operate if agreed by the Cabinet. The proportion of NPPs meeting this requirement, and the quality of the performance frameworks, are not known at this stage. As noted in footnote 4, a comparable requirement during the 1987-97 evaluation strategy had only limited success.
30. The index is based on measures of average income, level of education, and types of employment of households whose students attend the school. The index also measures remoteness and the proportion of Aboriginal students at the school. These socio-economic characteristics are correlated with student test results; it is the remaining variance in student average performance that a school can influence. The school outcomes data are the same as those used in the annual reports on government service delivery.
31. Income transfer programmes are explicitly excluded in the Canadian system. The DoF secretary has argued for the inclusion of such programmes in a rejuvenated evaluation strategy in Australia.
32. This has happened with Chile's centralised monitoring and evaluation system, for example, which was designed by and is managed for the budget needs of the finance ministry (Rojas et al., 2005).

33. A detailed taxonomy of carrots, sticks and sermons for encouraging M&E is provided by Mackay (2007, Chapter 11).
34. The DoF never released these rankings publicly, but the DoF secretary did inform his fellow secretaries when they asked to know their department's relative performance.
35. Chile, Colombia and the United States are discussed by Mackay, 2007. For an analysis of Canada, see Lahey, 2010. Mexico is discussed by Castro et al., 2009.

References

- AGRAGA (Advisory Group on Reform of Australian Government Administration) (2010), *Ahead of the Game: Blueprint of Reform of Australian Government Administration*, Department of the Prime Minister and Cabinet, Canberra.
- ANAO (Australian National Audit Office) (1991a), *Implementation of Program Evaluation – Stage 1*, Efficiency Audit Report No. 23, 1990-91, ANAO, Canberra.
- ANAO (1991b), *Evaluation in Preparation of the Budget*, Efficiency Audit Report No. 13, 1991-92, ANAO, Canberra.
- ANAO (1992a), *Program Evaluation in the Departments of Social Security and Primary Industries and Energy*, Efficiency Audit Report No. 26, 1991-92, ANAO, Canberra.
- ANAO (1992b), *Auditing Program Evaluation – ANAO Performance Auditing Guide*, ANAO, Canberra.
- ANAO (1992c), *Department of the Treasury – Procedures for Managing the Economic Policy Program*, Efficiency Audit Report No. 36, 1991-92, ANAO, Canberra.
- ANAO (1993), *Program Evaluation: Strategies, Practices and Impacts – Industry, Technology and Regional Development Portfolio*, Efficiency Audit Report No. 35, 1992-93, ANAO, Canberra.
- ANAO (1996), *Performance Information – Department of Employment, Education, Training and Youth Affairs*, Performance Audit Report No. 25, 1995-96, ANAO, Canberra.
- ANAO (1997), *Program Evaluation in the Australian Public Service*, Performance Audit Report No. 3, 1997-98, ANAO, Canberra.
- ANAO (2000), *Family Relationships Services Program – Department of Family and Community Services*, Performance Audit Report No. 24, 2000-01, ANAO, Canberra.
- ANAO (2001a), *Performance Information in Portfolio Budget Statements*, Performance Audit Report No. 18, 2001-02, ANAO, Canberra.
- ANAO (2001b), *Developing Policy Advice*, Performance Audit Report No. 21, 2001-02, ANAO, Canberra.
- ANAO (2003), *Annual Performance Reporting*, Performance Audit Report No. 11, 2003-04, ANAO, Canberra.
- ANAO (2007), *Application of the Outcomes and Outputs Framework*, Performance Audit Report No. 23, 2006-07, ANAO, Canberra.
- ANAO (2010), *Conduct by Infrastructure Australia of the First National Infrastructure Audit and Development of the Infrastructure Priority List*, Performance Audit Report No. 2, 2010-11, ANAO, Canberra.
- ANAO/DoF (Department of Finance) (1996), *Performance Information Principles*, ANAO, Canberra.
- ANAO/DoF (Department of Finance and Administration) (2004), *Better Practice Guide: Better Practice in Annual Performance Reporting*, ANAO, Canberra.
- Banks, Gary (2009a), *Challenges of Evidence-Based Policy-Making*, Productivity Commission and Australian Public Service Commission, Canberra.
- Banks, Gary (2009b), "Evidence-based policy-making: What is it? How do we get it?", *Australian National University Public Lecture Series*, presented by ANZSOG (Australia and New Zealand School of Government), 4 February 2010, Productivity Commission, Canberra, quoted by Alan Mitchell, 2009.
- Barrett, Pat, Auditor-General of Australia (2001), "Evaluation and performance auditing: sharing the common ground – a review of developments", address to the Australasian Evaluation Society, Canberra, 10 October.
- Barrett, Pat, Auditor-General of Australia (2003), "Australian Public Sector Financial Management Reforms", presentation at a World Bank seminar, 25 June.

- Blöndal, Jon R., Daniel Bergvall, Ian Hawkesworth and Rex Deighton-Smith (2008), "Budgeting in Australia", *OECD Journal on Budgeting*, 8(2):133-196.
- Borthwick, David, quoted by Verona Burgess (2009), "Everyone on the same page", *Australian Financial Review*, 13 March.
- Bovens, M. (2006), "Analysing and Assessing Public Accountability: A Conceptual Framework", *European Governance Papers* C-06-02, quoted by Mary Ann O'Loughlin, 2010.
- Briggs, Lynelle (2005), "A Passion for Policy" in John Wanna (ed.), *A Passion for Policy: Essays in Public Sector Reform*, pp. 1-18, ANZSOG Lecture Series 2005-06, Australian National University, Canberra.
- Burgess, Verona (2009), "Everyone on the same page", *Australian Financial Review*, 13 March, p. 46.
- Campbell, Colin (2001), "Juggling Inputs, Outputs and Outcomes in the Search for Policy Competence: Recent Experience in Australia", *Governance: An International Journal of Policy and Administration*, 14(2):253-282.
- Castro, Manuel Fernando, Gladys Lopez-Acevedo, Gita Beker Busjeet and Ximena Fernandez Ordonez (2009), *Mexico's M&E System: Scaling Up from the Sectoral to the National Level*, ECD Working Paper No. 20, Independent Evaluation Group, The World Bank, Washington DC.
- Chan, Matthew, Mark Nizette, Lisa La Rance, Charles Broughton and Derek Russell (2002), "Australia", *OECD Journal on Budgeting*, 1(4):35-69.
- COAG (Council of Australian Governments) Reform Council (2010), *COAG Reform Agenda: Report on Progress 2010*, COAG Reform Council, Sydney.
- Commonwealth of Australia (2010), *2010-11 Australian Government Budget – Budget Paper No. 3*, Commonwealth of Australia, Canberra.
- Conroy, Stephen, Communications Minister (2010), "NBN cost-benefit analysis a waste of time and money: Stephen Conroy", *The Australian*, 5 November, p. 5.
- Crossfield, Len and Anne Byrne (1994), *Review of the Evaluation Function in DEET*, Department of Employment, Education and Training, and Department of Finance, Canberra.
- DEWR (Department of Employment and Workplace Relations (2002), *2001-02 Annual Report*, Australian Government Publishing Service, Canberra.
- DoF (Department of Finance) (1991), *Handbook of Cost-Benefit Analysis*, DoF, Canberra.
- DoF (1993), *The Cost of Evaluations: The Findings of a Pilot Study*, DoF, Canberra.
- DoF (1994a), *Doing Evaluations: A Practical Guide*, DoF, Canberra.
- DoF (1994b), "The Use of Evaluation in the 1994-95 Budget", *Finance Discussion Paper*, DoF, Canberra.
- DoF (1996), "Performance Information Review: Overview of the First Year of the Review", DoF, Canberra.
- DoF (Department of Finance and Administration) (2000), *The Outcomes and Outputs Framework: Guidance Document*, DoF, Canberra.
- DoF (2007), *2006-07 Annual Report*, DoF, Canberra.
- DoF (Department of Finance and Deregulation) (2010), "Incoming Government Brief", DoF, Canberra.
- Ergas, Henry (2010), "Faulkner and Tanner fell short of their lofty aims", *The Australian*, 13 July.
- Ergas, Henry and Alex Robson (2010), "Evaluating Major Infrastructure Projects: How Robust are our Processes?" in Productivity Commission, *Strengthening Evidence-Based Policy in the Australian Federation*, Volume 1: *Proceedings*, pp. 127-167, Productivity Commission, Canberra.
- FaCS (Department of Family and Community Services) (2001), *Research and Evaluation Framework*, FaCS, Canberra.
- FaCS (2002a), *Annual Report 2001-02*, FaCS, Canberra.
- FaCS (2002b), *Portfolio Budget Statements 2002-03 – Family and Community Services Portfolio*, Commonwealth of Australia, Canberra.
- FaCS (2002c), *Research and Evaluation Digest*, FaCS, Canberra.
- Harris, Tony (2009), "Eradicate this dodgy data", *Australian Financial Review*, 14 April.
- Hawke, Lewis (2007), "Performance Budgeting in Australia", *OECD Journal on Budgeting*, 7(3):133-147.

- Hawke, Lewis and John Wanna (2010), "Australia after Budgetary Reform: A Lapsed Pioneer or Decorative Architect?" in John Wanna, Lotte Jensen and Jouke de Vries (eds.), *The Reality of Budgetary Reform in OECD Nations: Trajectories and Consequences*, pp. 65-90, Edward Elgar Publishing, Cheltenham, United Kingdom.
- Howard, Cosmo (2005), "The Policy Cycle: A Model of Post-Machiavellian Policy Making?", *Australian Journal of Public Administration*, (64)3:3-13.
- Independent Reference Group (2010), *Review of the Report on Government Services' Performance Indicator Framework. Report to the Steering Committee for the Review of Government Service Provision*, Productivity Commission, Canberra.
- Keating, Mike and Malcolm Holmes (1990), "Australia's Budgeting and Financial Management Reforms", *Governance: An International Journal of Policy and Administration*, 3(2):168-185.
- Kelly, Paul (2006), "Re-thinking Australian Governance: The Howard Legacy", *Australian Journal of Public Administration*, 65(1):7-24.
- Lahey, Robert (2010), *The Canadian M&E System: Lessons Learned from 30 Years of Development*, ECD Working Paper No. 23, Independent Evaluation Group, The World Bank, Washington DC.
- Mackay, Keith (1998), *The Development of Australia's Evaluation System*, ECD Working Paper No. 4, Operations Evaluation Department, The World Bank, Washington DC.
- Mackay, Keith (2007), *How to Build M&E Systems to Support Better Government*, Independent Evaluation Group, The World Bank, Washington DC.
- Mackay, Keith (2011), *The Australian Government's Performance Framework*, ECD Working Paper No. 25, Independent Evaluation Group, The World Bank, Washington DC.
- McClintock, Paul (2010), "Statistics, public accountability and the federation", presentation to the NatStats 2010 Conference, COAG Reform Council, Council of Australian Governments, Sydney.
- McPhee, Ian, Auditor-General of Australia (2005), "Outcomes and Outputs: Are We Managing Better as a Result?", presentation to the CPA National Public Sector Convention, 20 May, Australian National Audit Office, Canberra.
- McPhee, Ian, Auditor-General of Australia (2008), "The ANAO's Contribution to Improving Public Sector Administration", presentation to the Canberra Evaluation Forum, 21 February, Australian National Audit Office, Canberra.
- McPhee, Ian, Auditor-General of Australia (2009), "The Business of Government: Why Public Sector Management Must Evolve", Brookes Oration Presentation to the Deakin Business School, Deakin University, Australian National Audit Office, Canberra.
- Mitchell, Alan (2009), "Hard data paves way to reform", *Australian Financial Review*, 16 February, p. 20.
- Mulgan, Richard (2008), "The Accountability Priorities of Australian Parliamentarians", *Australian Journal of Public Administration*, 67(4):457-469.
- Murray, Andrew, Senator (2008), *Review of Operation Sunlight: Overhauling Budgetary Transparency*, Canberra.
- OECD (2002), "Public Sector Modernisation: A New Agenda", GOV/PUMA(2002)2, OECD, Paris.
- O'Loughlin, Mary Ann (2010), "Intelligent Federalism: Accountability Arrangements under COAG's Reform of Federal Financial Relations" in Productivity Commission, *Strengthening Evidence-Based Policy in the Australian Federation, Volume 1: Proceedings*, pp. 259-274, Productivity Commission, Canberra.
- Parliament of Australia, House of Representatives Standing Committee on Finance and Public Administration (1990), *Not Dollars Alone: Review of the Financial Management Improvement Program*, Parliament of Australia, Canberra.
- Parliament of Australia, Joint Committee of Public Accounts and Audit (2004), *Review of Auditor-General's Reports 2003-04: First and Second Quarters*, Parliament of Australia, Canberra.
- Parliament of Australia, Senate Standing Committee on Finance and Public Administration (2007), *Transparency and Accountability of Commonwealth Public Funding and Expenditure*, Parliament of Australia, Canberra.
- Podger, Andrew (2005), "Retirement speech", 30 June (quoted by Paul Kelly, 2006, pp. 12-13).

- Podger, Andrew (2007), "What really happens: departmental secretary appointments, contracts and performance pay in the Australian Public Service", *Australian Journal of Public Administration*, 66(2):131-147.
- Podger, Andrew (2009), *The Role of Departmental Secretaries: Personal Reflections on the Breadth of Responsibilities Today*, Australian National University, Canberra.
- Productivity Commission (2007), *Productivity Commission Annual Report 2006-07*, Productivity Commission, Canberra.
- Rojas, Fernando, Keith Mackay, Yasuhiko Matsuda, Geoffrey Shepherd, Azul del Villar, Ariel Zaltsman and Philipp Krause (2005), *Chile: Study of Evaluation Program – Impact Evaluation and Evaluations of Government Programs*, The World Bank, Washington DC.
- Russell, Derek (2003), "Performance Management and Evaluation: The Australian Experience" in Jay-Hyung Kim (ed.), *Developing a Performance Evaluation System in Korea*, Korea Development Institute, Seoul.
- Schick, Allen (1996), *The Spirit of Reform: Managing the New Zealand State Sector in a Time of Change*, State Services Commission, Wellington.
- Schick, Allen (1998), "Why most developing countries should not try New Zealand's reforms", *World Bank Research Observer*, 13:123-31.
- Schick, Allen (2002), "Does Budgeting Have a Future?", *OECD Journal on Budgeting*, 2(2):7-48.
- SCRSSP (Steering Committee for the Review of Commonwealth/State Service Provision) (1995), *Report on Government Service Provision*, Industry Commission, Melbourne.
- SCRGSP (Steering Committee for the Review of Government Service Provision) (2009), *National Agreement performance information 2008-09: National Healthcare Agreement*, Productivity Commission, Canberra.
- SCRGSP (2010), *Report on Government Services 2010*, Productivity Commission, Canberra.
- Steketee, Mike (2008), "Hospital statistics 'worth nothing'", *The Weekend Australian*, 11-12 October.
- Stutchbury, Michael (2010), "Imagine if Labor's broadband payoff is just hype", *The Australian*, 7 December.
- Symonds, Alexander (2009), "Reviews up for review", *Australian Financial Review*, 5 February.
- Tanner, Lindsay (2008), *Operation Sunlight: Enhancing Budget Transparency*, Australian Government, Canberra.
- Thomas, Paul G. (2009), "Parliament Scrutiny of Government Performance in Australia", *Australian Journal of Public Administration*, 68(4):373-398.
- Tingle, Laura (2009), "Spending to be spelled out", *Australian Financial Review*, 12 May.
- Tune, David (2010), "Evaluation: Renewed Strategic Emphasis", presentation to the Canberra Evaluation Forum, 19 August, Department of Finance, Canberra.
- Wanna, John and Stephen Bartos (2003), "Good Practice: Does it Work in Theory? Australia's Quest for Better Outcomes" in John Wanna, Lotte Jensen and Jouke de Vries (eds.), *Controlling Public Expenditure: The Changing Roles of Central Budget Agencies – Better Guardians?*, pp. 1-29, Edward Elgar Publishing, Cheltenham, United Kingdom.
- Webb, Richard (2010), *The Commonwealth Budget: Process and Presentation*, Parliament of Australia Research Paper, Department of Parliamentary Services, Canberra.
- Wilkins, Roger (2008), *Strategic Review of Australian Government Climate Change Programs*, Department of Finance and Deregulation, Canberra.

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

The OECD is a unique forum where governments work together to address the economic, social and environmental challenges of globalisation. The OECD is also at the forefront of efforts to understand and to help governments respond to new developments and concerns, such as corporate governance, the information economy and the challenges of an ageing population. The Organisation provides a setting where governments can compare policy experiences, seek answers to common problems, identify good practice and work to co-ordinate domestic and international policies.

The OECD member countries are: Australia, Austria, Belgium, Canada, Chile, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Israel, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, the Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. The European Union takes part in the work of the OECD.

OECD Publishing disseminates widely the results of the Organisation's statistics gathering and research on economic, social and environmental issues, as well as the conventions, guidelines and standards agreed by its members.

OECD Journal on Budgeting

Contents

Repairing the Budget Contract between Citizens and the State
by *Allen Schick*

Independent Fiscal Institutions: Developing Good Practices
by *George Kopits*

The Fiscal Stimulus Programme and Public Governance Issues in China
by *Christine Wong*

The Performance Framework of the Australian Government, 1987 to 2011
by *Keith Mackay*

Please cite this publication as:

OECD (2011), *OECD Journal on Budgeting, Volume 11 Issue 3*, OECD Publishing.

<http://dx.doi.org/10.1787/budget-v11-3-en>

This work is published on the *OECD iLibrary*, which gathers all OECD books, periodicals and statistical databases. Visit **www.oecd-ilibrary.org**, and do not hesitate to contact us for more information.

Volume 2011/3

OECD publishing
www.oecd.org/publishing

ISSN 1608-7143

VOLUME 2011

(3 ISSUES)

42 2011 05 1 P 9



771608 714309