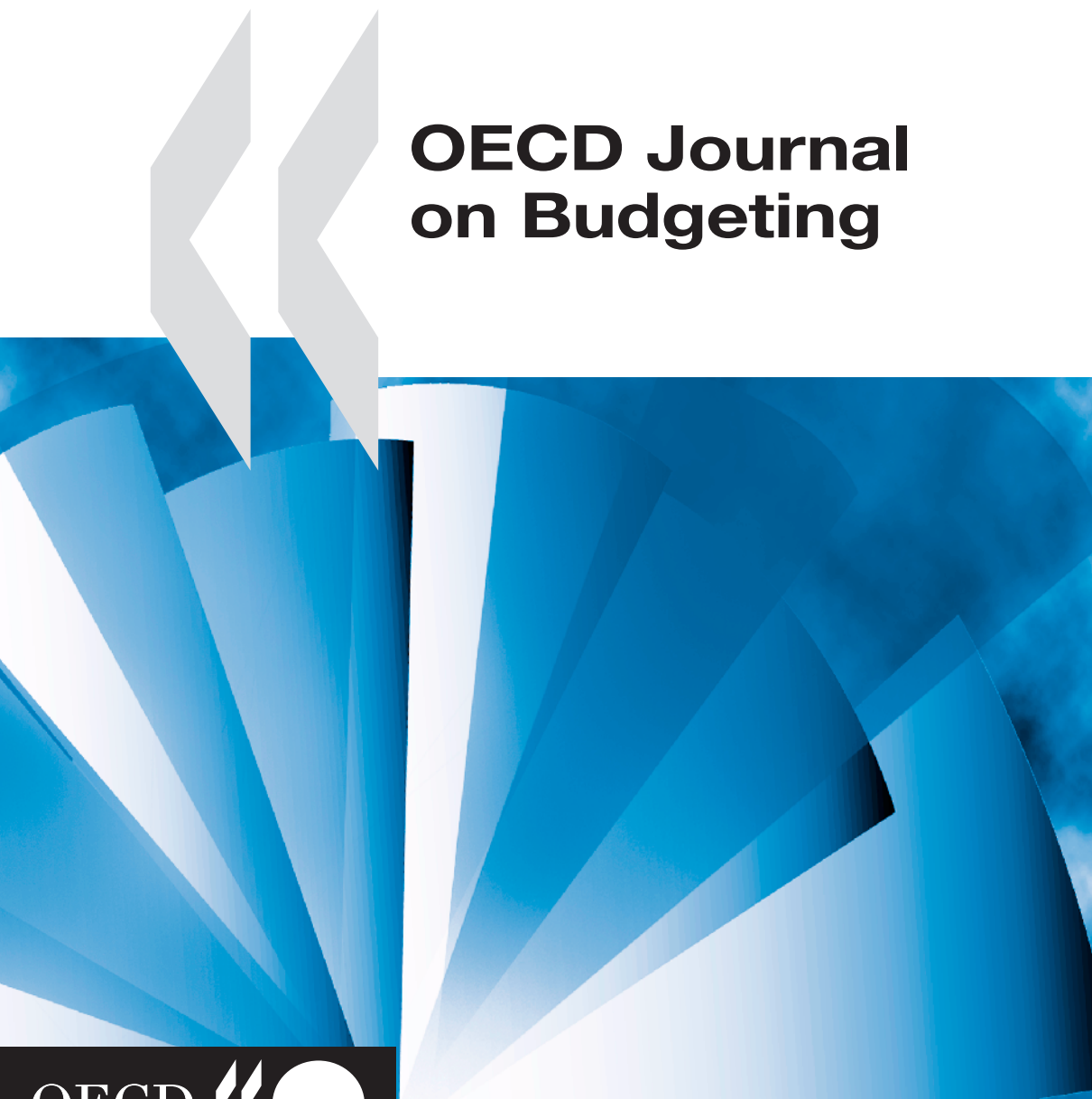




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Foreword

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

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Agencies: Their Benefits and Risks

by
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1. Introduction

This paper is about the benefits and risks of setting up new public “agencies”, outside the mainstream of ministries and departments and working under different rules of central control and internal operations.¹ In the OECD area, in transition economies and in the developing world, a new fashion for agencies took hold in the 1980s and 1990s. “Agencies” are sometimes seen as a distinctly “Anglo” phenomenon, a New Public Management fashion epitomised by the Next Steps executive agencies in the United Kingdom. But most OECD countries have had several types of public organisation as well as ministries for a long time, and in several governments apart from the United Kingdom a minority of civil servants work in “core government”. Is this rich organisational variety simply a reflection of national administrative traditions, or are there lessons to be drawn about organisational form fit for purpose? What benefits and risks are there from genetic engineering of public organisation structures? Can transition economies and developing countries learn anything useful about the organisational forms in their own public sectors from the experience of the governments of OECD countries?

In most OECD countries, agencies generally work well and meet important needs of good governance. There is no evidence that agencies that have been created have resulted in a lower quality of governance in the governments of OECD countries. There is indeed some evidence (James, 2001) that in the appropriate roles they have improved both the quality and the credibility of public performance. On the other hand, the jury is still out on agency experiments in the developing world and transition economies. Some agencies appear to have created benefits; others have caused significant problems for public governance.

Overall there are concerns about the fragmentation of public governance that agencies may represent and the feasibility of directing and controlling complex public operations through specified agency agreements or contracts. Typical criticisms are:

- loss of control of agency operations;
- abrogation of political accountability;
- evasion of general rules for staffing and budgets;
- exposure of government to financial and employment risks;
- opportunities for political patronage and corruption.

2. Defining and classifying agencies

The term “agency” in this paper is shorthand for the variety of organisations that are outside of core government and that do not have a vertically integrated hierarchical relationship with a parent ministry or department.

Defining agencies by what they are not is problematic. In most of the governments of Western Europe, Asia and Africa, “core government” can be defined as the ministries or departments of the executive² under the direct hierarchical control of a minister or a president. In these governments, a ministry or department would generally be understood as an organisation that: 1) has no separate corporate status; 2) is predominantly funded from taxes; 3) is subject to the general provisions of civil service and public finance law; and 4) is headed by a member of the government.³

In a lot of the rest of the world, however, it is not as easy to distinguish a “core” which meets all four of these criteria. In much of Eastern Europe, the Balkans and the former Commonwealth of Independent States, ministries do have legal status and may not be predominantly funded from taxes and there may be no general civil service law.⁴ In the United States, the term “agency” applies to all organisations of the executive branch. There are general laws applicable by default to all these entities but in practice there are a wide variety and extent of direction and control and degree of distance from direct oversight by the president or members of cabinet. Similarly in the presidential systems of Latin America, the idea of a “core” in the sense of a common form of ministerial department has less significance. What is important is the proximity of the organisation to direct control or influence by the president.

Severing vertically integrated hierarchical relationships with bodies in core government is generally undertaken in one of three ways:

- making a clear distinction between the internal governance (reporting and control arrangements) within the agency and that of the parent ministry;
- providing the agency with a separate legal identity under public law;
- providing the agency with a governing board – either under public law or as a corporation, trust or similar body under private law.

The OECD suggests three main types of organisation that can be distinguished from core government and that are not in a vertically integrated hierarchical relationship with core government organisations:⁵

- **Departmental agencies** are part of ministries and have no separate legal identity, but their internal governance is generally differentiated from that of their parent ministry.
- **Public law administrations** are generally created by a public statute so that they have a separate legal identity under public law. Their governance – both internal and external – will generally be different from that of a ministry; they may or may not have a governing board.
- **Private law bodies** are a variety of organisations including corporations, trusts and other organisational forms recognised in private law. They will usually have a governing board, and a minister will have only indirect control.

A further more detailed analysis of the categories of organisation is shown in Table 1. Trying to classify public organisations by their legal status is, however, not altogether useful for an analysis of benefits and risks. It is more important to focus on how organisations are directed and controlled and how that affects their behaviour.

3. Agencies in OECD countries

Agencies have a long history in many OECD countries. In Sweden, most famously, the establishment of agencies and boards originated in the 16th and 17th centuries, and agencies are today the basic form of public organisation in Sweden. The earliest national public agencies and authorities in Germany also date back to the 1870s. Many other OECD countries have long traditions of exercising important government functions outside the classical generic ministerial department.

In the last two decades, most OECD countries have experimented with new forms of agency, but the trend towards organisations outside core government has varied widely from country to country. In the Netherlands and the United Kingdom, the move towards agencies in the last decade has shifted significant numbers of civil servants from core ministries and departments into agencies. In New Zealand, there has been a proliferation of central “Crown entities” but also a significant increase in management authority delegated to core government departments. In other countries, such as Canada, France and the United States, the agency form as defined in this paper has had much more limited impact. The OECD concludes, however, that the number of autonomous bodies has significantly increased in most countries over time. During the last 50 years, it seems that only a few autonomous bodies have been drawn back under the core traditionally vertical integrated hierarchy.

Table 1. **Classification of agency types**

Attribute	Departmental agencies	Public law administrations	Private law bodies
Institutional and legal foundations	Part of ministries. No separate legal identity from the State. Function under public law.	Function mostly under public law, but can be partially separate or fully separate legal bodies.	Quasi-corporations and non-commercial private law bodies.
Governance structure and control	No governing board (although might have advisory boards). Director-general ¹ is directly appointed by the minister. Minister has formal (but less direct) control while the director-general is responsible for management of the organisation.	May either have a governing board or single person authority, possibly with advisory board. Top governance has management responsibility, minister has indirect control.	Usually have a governing board, and minister has indirect control.
Financial management and personnel rules	Staff employed under general civil service rules for appointment, promotion and removal. Input controls on the price and quantity of labour are generally relaxed. Most funded through allocations from the State budget and budget is annually reviewed through the annual State budget process. Some are partially financed by user fees.	Staff rules vary between full civil service controls, differentiated controls, and outside civil service but subject to a general framework for State servants. Most PLAs are financed by tax revenue, and their budget is part of general budget law, although they often can carry forward surpluses.	Staff usually employed under general labour laws, with no (or limited) external controls on inputs. Usually mostly financed by sales revenue and can carry forward surpluses, borrow and lend. Budgets are separate from those of ministries.
Function	Usually delivery of non-commercial services to citizens and support services to other State sector bodies.	Created for a differentiated governance structure (governing board), allowing more management autonomy or policy independence in some cases, for a differentiated control environment, or for managerial autonomy. Specific functions vary tremendously, from service delivery to regulatory and quasi-judicial functions.	Might have a full profit objective or mainly a service objective function.

1. Equivalent to the term "chief executive".

Source: Based on OECD (2002), *Distributed Public Governance: Agencies, Authorities and Other Government Bodies*.

4. Agencies in developing and transition economies

A very few developing countries have embarked on systematic restructuring of their public sectors along agency lines. The research by Talbot et al. (2000) investigates case studies in Jamaica, Latvia and Tanzania. But references to agencies are also scattered throughout the World Bank and related literature and include the following:

- Parastatals: government trading enterprises that may be on the way to becoming fully corporatised or privatised businesses run according to corporate governance rules.
- AGETIPs:⁶ non-profit, non-governmental agencies for executing public works, popular particularly in Francophone Africa.
- Social funds: organisations designed to fund a wide range of projects aimed at poverty alleviation, particularly in situations of structural adjustment; sometimes called “social investment funds”.
- Extrabudgetary fund administrations: examples are pension funds, health insurance funds, agricultural subsidy funds, etc.
- Independent revenue authorities (IRAs): agencies charged with tax collection and administration within general tax policy.

Recently also the Report on LICUS (low income countries under stress) (World Bank, 2002) has discussed the establishment of independent service authorities – with features analogous to independent revenue authorities – in LICUS countries, to fund and monitor basic service delivery through local providers when government provision is weak. Effective service delivery is considered more important than revenue collection in LICUS countries “precisely because LICUS governments are not effective in spending revenues to deliver services”. However, some features of IRAs which make them effective could be copied, according to the Report:

... have adopted a number of the features desirable for a well-functioning organisation. They are autonomous agencies, with their own staff incentive systems and with intensive scrutiny of performance. However, the feature of particular pertinence here is that independent revenue authorities are not just responsible for the collection of new taxes; rather, they take over the entire system.

(World Bank, 2002, p. 28-29)

5. Mixed results to date

In developing countries and in transition economies, then, agencies are quite often proposed as a means of protecting important functions from poor governance in core government. AGETIPs were seen as part of the answer to poor project implementation; low rates of revenue collection led to proposals for IRAs; failure to get social assistance directly to the poor led to the establishment of social funds. In transition economies, strong and independent regulatory authorities are seen as a requirement of efficient market institutions. Quite often, international agencies have actively promoted agency independence to protect their own interests in aid effectiveness. The LICUS Report suggests that, when the State cannot meet the basic development needs of its people, the crisis demands the radical if hopefully temporary solution of bypassing the public bureaucracy altogether, to deliver basic services. But in a wider range of countries where departments do not pay market wages or have no culture of performance, shifting functions into agencies with greater management autonomy may be seen as the only way to respond to major failures in public management.

History however gives mixed messages about setting up new organisations to evade general problems of governance in the public sector. First, it is very difficult for any public organisation to be completely insulated from relations with other public organisations. Except when agencies are entirely the clients of donors, they will depend on ministries of finance and other central organisations for some services or approvals. Second, experience suggests that it is not impossible but certainly very difficult to create a lasting performance culture in the midst of a non-performing government. Third, if corruption or patronage is pervasive in government, then setting up a new agency to create a *cordon sanitaire* around vital functions is risky. Whenever power is redistributed, as it is when a new organisation is created, somebody's interests are being affected, and he/she will react.

Fjeldstad (2002), for example, reports that the Tanzania Revenue Authority (TRA) was set up in 1996 to improve performance in revenue collection in Tanzania and insulate it from the endemic corruption in the Tanzanian public sector. The philosophy was twofold: "first to eliminate the direct political influence of the Ministry of Finance on the day-to-day operations of the tax administration. And second, to raise the salary of tax officials without parallel increases for the rest of the public sector" (Fjeldstad, 2002, p. 8).

Initially the TRA seemed to meet with success. During the first year of its operations, tax revenues grew by more than 30%, attributable almost entirely to the efforts of TRA officials. Nearly 300 officials were dismissed for corruption. The number of corrupt acts fell, although there is evidence that

the price per bribe rose because of the additional risk premium on bribes. However, after the initial successes, the rate of collection fell away and there was evidence that bribery and internal rent-seeking rose again. Fjeldstad asserts that the “assumption that higher salaries would boost productivity over time was most likely also exaggerated” (Fjeldstad, 2002, p. 9) and due to a “Hawthorne effect”. He notes also that for many workers, higher salaries may simply have resulted in larger obligations to family networks and perhaps even a net loss for the staff concerned, leading to greater incentives to augment income by rent-seeking.

There are similar gloomy stories from IRAs elsewhere: initial success, followed by a regrouping of existing political and bureaucratic interests and a reinfestation of endemic cultures of corruption. In Peru, the State revenue authority (SUNAT) was protected for a while from the depredations of its parent ministry by the influence of President Fujimori. Eventually, however, according to its founding chairman (Estela, 2000), the agency was undermined. “People astutely operating from the Ministry of Economy, adopted a two-pronged approach: at the verbal level, they praised SUNAT, while in the level of deeds they arranged a progressive dismantling of the institution, with the hidden purpose of returning her to the condition prior to the reform” (Estela, 2000, p. 7). Ghana and Uganda have similar stories to tell.

The moral for reformers is that any proposal for institutional re-design has to consider the political economy of public institutions. Reformers need to ask whose interests are affected adversely, where does support for reform originate, and what countervailing power will be exercised in defence of the new organisation (*e.g.* in terms of protection from powerful political figures, major stakeholders in the status quo like civil servants or local mafias). Reform is not impossible when this protection is provided, but continuing good performance demands continuing vigilance. The risks may be justified by the high stakes – collapse of State revenues or of basic services – but enclaving does not appear to be a long-term solution. More basic changes in core bureaucratic institutions are required.

6. Issues in agency creation

The risks of setting up agencies come under three broad headings:

- Creating new organisations without a clear public policy justification.
- Not getting the right rules and systems in place for external direction and control of new organisations, leading to:
 - ❖ problems of organisational “legibility”;
 - ❖ weak direction and oversight;
 - ❖ loss of political control.

- Creating organisations that are not set up to manage themselves properly.

These risks and the issues they raise for good governance are discussed in turn.

6.1. *Being clear about the public policy reasons for agencies*

The two most common “good governance” reasons given by governments of OECD countries for setting up agencies are to improve the performance of the public sector or to make public decision making more credible by separating it from direct political intervention. Governments therefore give their agencies respectively relative **management autonomy** (the freedom to allocate resources to achieve given policy objectives) or **policy autonomy** to interpret or decide policy in specific cases. Gill (2002) has defined a parallel distinction: policy autonomy for an agency requires a specific public law power; management autonomy increases the agency’s powers of a natural person.⁷

Better management: The usual arguments for agencies delivering better results are that organisations with clear specific objectives and the freedom to make management decisions will out-perform those with multiple or unclear objectives and limited managerial freedom. The United Kingdom, for example, gave the chief executives of its Next Steps agencies performance objectives and the power to manage people and budgets to achieve them. Other OECD countries that have experimented with agencies cite “focus on results and performance” (Canada), “functional decentralisation” (France), “managerial differentiation in rules control” (Netherlands), “improved service delivery” (New Zealand), and “management flexibility” (Spain).

The New Public Management and the United Kingdom model of executive agencies have also had an influence on thinking about public organisations in some developing countries. The agency reforms in Jamaica and Tanzania both clearly bear the hallmark of the British model and some other NPM ideas such as customer responsiveness and “steering not rowing”. In addition, AGETIPs, social funds and IRAs have all been justified on the grounds that they require an extra degree of independence from central control to function effectively.

More credible policy: A second broad reason for agencies is to legitimate public decision making – sometimes neglected in debate but arguably as important as or more important than efficiency. Majone (2001) argues that some types of decision depend on the impartial administration of rules and that the public credibility of these decisions (e.g. of regulatory “fairness”) depends on them being seen to be made by a politically independent organisation. Even States with a constitutional basis for administrative decision making by civil servants may vest some decisions in authorities

outside ministries. Examples in OECD countries include the French AAIs⁸ and authorities enforcing major administrative regulations in Germany. Agencies set up for these reasons include:

- central banks;
- general economic and financial regulators such as authorities for consumer protection, competition or financial markets;
- industry regulators as in telecommunications and energy;
- authorities for investigation and prosecution of human rights abuses, or public fraud and corruption.

There may therefore be good public policy arguments for new agencies. But agencies may also serve other objectives, sometimes simply to signal the importance of a particular political objective: arguably the establishment of a new agency in France to manage blood supplies in the wake of the “bad blood” scandal of the 1980s is an example (Tabuteau, 1996). Agencies may also be created to protect a function from legislative interference, pay off political allies or create power bases for specific factions, or to capture public assets or resources for private interests. Examples include sharing out political power among competing political factions in Croatia, vesting public assets in specific agencies in Latvia, or the many new agencies set up by the Marcos administration in the Philippines.

As in the case of the new blood agency in France, some specific political reasons for setting up agencies are not necessarily incompatible with good governance. Nevertheless, the question is legitimately asked: why cannot the functions of an agency be carried out in a line ministry or department? Other agencies, however, are clearly not set up for good public policy reasons. The general message is that the given reason for creating an agency is not necessarily the real reason; and that if the basic reason for an agency is incompatible with good governance, the safeguards discussed in this paper are unlikely to be effective.

6.2. Rules and systems for external direction and control of new organisations

6.2.1. Avoid building in opacity

Gill’s attempt to reduce the zoo of organisational forms in OECD countries to a manageable classification makes a more basic point (Gill, 2002). The fewer the categories of public organisation and the more uniform the rules applying to them, the more legible the public governance system is to politicians, civil servants and citizens alike. Some governments have created problems for themselves by setting up too many organisations, with too many different sets of rules. In the 1980s and 1990s for example, successive

New Zealand governments created a wide range of new agencies out of government departments, to serve a variety of service delivery and regulatory functions. Now the current Labour administration is introducing a bill to bring some order back to its zoo through “an umbrella statute containing consistent governance and accountability requirements for Crown entities [...] according to their relationship with the Crown” (New Zealand Government, 2003).

Having lots of agencies with different rules creates risks in two ways. First, it increases the risk that agencies will not work together on important common objectives (the Blair Government’s “joined-up government” initiative in the United Kingdom addresses this problem); that complex problems of public policy will “fall between the cracks” of agency responsibilities; or that agencies will have unclear boundaries between them – leading to overlapping responsibilities or clashing jurisdictions – and get into turf wars as a result. But it also makes it more difficult to manage from the centre: the span of control for parent ministries grows; and each new set of rules about agency operations creates precedents for others. For example there were many different provisions in New Zealand law governing investments by Crown organisations or the appointment of board members.

Problems of inter-agency rivalry and lack of joint effort will not be cured solely by harmonising legal provisions, but this is an important first step, as the New Zealand Government has recognised. At the least, a uniform framework law for public organisations is recommended – covering matters such as board and senior management appointments and responsibilities, rules governing financial management and external accountability, and general powers of and arrangements for political direction and control.⁹ If agencies are to be set up under their own law, then a template model agency law is also desirable.

6.2.2. *Get the governance right*

The evidence is that organisational form **can** have an important part to play in getting the governance right, given that many other formal and informal factors are important as well. Three questions are to be asked:

- Does the agency need to be constituted under its own law? The British executive agency model offers an alternative, where the agency can be nominally a division of an existing ministry or department, operating under a specific performance agreement with its parent and having been delegated significant managerial autonomy. Arguably the Local Government Engineering Division in Bangladesh has operated effectively inside its parent Ministry of Works.¹⁰
- Should the agency be constituted under public law or private law? Private law bodies would normally be reserved for those where the government’s

principal interest was as owner: for example, parastatals on their way to becoming fully commercial trading activities, candidates for privatisation and subject to the discipline of market trading and market institutions. Inappropriate use of private law in other cases can put governments seriously at risk by limiting their ability to direct agencies, which can create quite significant contingent liabilities – financial and otherwise – for the public budget.¹¹

- Does the agency need a board? In OECD countries, agencies frequently have boards inserted between the political executive and the management of the organisation. Boards can be either advisory (carrying some powers of supervision of policy execution or the right to be consulted by the agency head or to advise the minister on policy matters) or executive (carrying some direct authority over the policy and management of the agency). Christensen (1999) suggests that either an advisory or a management board can usefully blur political accountability, increase commitment to present policies and shield agencies from parliamentary interference. But boards – particularly executive boards – may be redundant if the actual policy-related steering of the organisation requires frequent intervention by a minister or a supervising ministry. If the minister or senior ministry officials need to take frequent day-to-day policy or operational decisions, then there is little justification for the agency to be anything more than a division of the parent ministry.

6.2.3. *Keep political control*

Governments are always and everywhere politically exposed to the quality of agency performance. They may expect agencies to carry quite significant policy and operational responsibilities, but unless governments are clear on how and when they can intervene, they may simply “lose political control” (Talbot *et al.*, 2000). Creating an agency can create a constituency for that agency that is politically difficult to reverse. When governments attempt to re-assert control over agencies, the most vocal opponents may well be the agencies themselves. Delegating freedom of management action requires careful attention to how the State’s broader interests in the operations of the agency will be protected. How will the government ensure that the agency is carrying out public policy or administering the law properly and that it is not creating new risks or unintended liabilities for the State?

Powers of direction: Under these circumstances, a minister or a president’s authority and power of direction over an agency needs to be made explicit from the outset. How will the mission and policy direction of the agency be set? Will there be a specific planning agreement with performance targets? What happens when the agency is making a mess of its management? How can the government intervene to direct changes? An

agency framework law may therefore need to cover three specific types of external political direction:

- the general arrangements for a planning agreement, regularly updated, between the political executive (and/or parent ministry) and the agency, covering mission, specific performance targets and budgets, and reporting arrangements;
- powers for the minister or other political authority to give policy or operational directives transparently (by public notice or tabling in the legislature);
- emergency powers – for the political executive to intervene to dismiss the board and/or the chief executive if and when there is a failure of management.

Managing by the numbers: The NPM approach of the United Kingdom and other countries replaces detailed hierarchical control of ministry divisions with arm's-length performance agreements emphasising specified measurable targets. Many OECD countries now have at least some experience with performance agreements. In some cases (Netherlands, New Zealand, United Kingdom) they are the basis of a whole system of public management. In others (France, Germany) management by performance has made less impact, at least at a national level. But there is a body of experience now with some of the problems and advantages of performance contracting. In most OECD countries, learning how to specify results and how to supplement attenuated management through reports with other forms of surveillance has taken many years. It may be difficult to define measures that properly represent desired results and that are comprehensive in their coverage and reasonably parsimonious in number. Poor specification – and excessive reliance on inadequate measures – can lead to focusing on the measure rather than the desired outcome, and to “gaming” in the setting of performance targets or misrepresentation of performance statistics.

Competent (and benign) parenting: Getting the balance right in monitoring in the end comes back to the reporting relationship between agencies and their parents. In both OECD and developing country governments, failure of supervision is a problem. The agency framework law needs to define a clear formal line of accountability from the agency to the political executive. A parent ministry or the president's office should be clearly responsible for transmitting policy requirements and monitoring implementation. But even with the right formal framework, a common problem is not getting the day-to-day supervision right. This is particularly a problem of the incentives and capability of parent ministries.

What is known about well-performing public organisations in Western countries¹² (and what little is known about successful performance in the

developing world¹³) suggests that this parenting relationship is both important and non-linear. Parent ministries need to take an interest and provide support without meddling too much in detail. Several OECD countries report nevertheless that supervising ministries can oscillate between micro-management of specific issues and inattention or neglect. The incentives for central ministries frequently lie in day-to-day political and policy management, rather than in operational oversight. Parent ministries may also lack the necessary competence to administer a performance management system which requires capabilities akin to the operational management skills of the agency itself (particularly given the agency's advantage of detailed knowledge of its own operations). The problems will be multiplied, of course, if the parent organisation has an interest in securing the non-performance of the agency.

Safeguarding accountability for resources: The two freedoms that public managers generally say they value most are to control their own spending and to manage their own staff. But what is good for managers may expose a government to wider financial and employment risks. If agencies are in part self-funding, they can reduce the ability of the government to control its overall spending and its fiscal impact on the economy, and they can disguise inefficiencies by extracting more revenues from their clients. If they are permitted to do their own borrowing or enter into leases, they may create contingent liabilities for governments. Freedom from general rules regarding hiring and remuneration for staff can compete away skilled staff from core government. In addition, the dark side of managerial autonomy is the opportunity it may represent for corruption and patronage.

Increasing managerial control over budgets and staff does not mean abrogating control: it means shifting away from a form of governance based on detailed external rules and individual transactions-based approvals to one based on strong external budget disciplines, monitoring, reporting and audit; and assurance through good systems of internal controls and internal audit. No government should delegate without being satisfied that it has both the internal and external frameworks for effective steering and control in place. If there is to be a board, how will appointments to it be made, and what rules will there be for dealing with conflict of interest? What rules are in place about internal policy setting, risk management, monitoring and review? What accounting standards are being adopted? What provisions are there for internal control and audit?¹⁴

6.3. Learning how to be free

A further change theme emerges from concerns about management in agencies themselves. A shift from detailed external control of inputs to greater reliance on internal agency governance – and from there to a shift in

focus towards contracting for results – requires not only new management capabilities but a change in incentives and culture as well. To quote a Netherlands report:

Becoming an agency is a complex and time-consuming process of change. Becoming an agency does not take place overnight. Organisations that have gone a long way in introducing results-oriented elements into their management can make the switch responsibly in two to three years. Organisations with a poorer starting position will sometimes follow a transitional path that will take a few more years. It is important not to rush the changes in order to guarantee cultural change within an organisation.

(Oosterroom, 2002, p. 130-131)

Management in public organisations themselves may not have the skills or experience to assume the responsibilities of internal governance in terms of planning, task definition, hiring and reward of staff, procurement and contracting, reporting, internal control and audit. Failures in internal governance may either result in a *de facto* resumption of detailed control by supervisory ministries or in a vacuum in which there is no effective control of the organisation, either internal or external.

In Chile, for example, the external governance regime seems fairly stable and well developed, but there are challenges both for the quality of external surveillance and for agency internal governance:

One of the important challenges for the future will be to increase the capacity of ministries to define public policies, monitor agencies, control and assess their results. At the same time, it will be important to improve communications on policies between agencies and ministries, and the understanding by the ministries of the activities and results of the agencies.

At the same time, it will be important to improve the agencies' capacity to manage themselves, especially in the context of recent reform which aims at increase technical, financial and personal flexibility of agencies and better define the roles and relationships between definition and implementation of a policy, what is expected of CEOs, their levels of management discretion, and the responsibilities of agency managers.

(Pardo, 2000)

7. Lessons for agency creators

The evidence concerning good public management suggests that governments work better when their organisations have clear missions, strong support from the centre, visionary leadership, task motivation and professionalism among the staff, and managers with authority to get on and do the job. Sometimes agencies are the right form for supplying these

conditions. But there are some questions that governments and international agencies should address when considering the creation of new agencies:

- Be clear why the change is being made – and why it will be better than the status quo. Be particularly clear about motives: if they are not primarily for better governance, then it is unlikely that the formal rules will be effective.
- Ask what a specific change proposal implies for the quality of governance in the core public sector and what needs to be done to improve overall public management (financial management, public employment practices, performance management) – as well as or instead of trying to avoid the problem by ring-fencing particular functions in agencies. Basically, assume that enclaving will not last and is at best a temporary expedient when the real problems lie elsewhere.
- Understand also the environment and the risks it may present to a new agency. Where are the enemies of change? Who gains power and who loses it? Inside the public sector, look to powerful bureaucratic forces like existing line ministries or ministries of finance for significant opposition. The staff of existing organisations and their unions as well as the management may oppose change. Outside the civil service, there may be powerful stakeholder groups, politicians, business interests and mafias whose interests will be adversely affected. How will they react?
- On the obverse of the coin, consider who is supporting the change (the president? influential cabinet ministers?) and if they will continue to support and champion the organisation when things go wrong.
- Follow principles of good governance: generally what is appropriate in government departments to safeguard the basic interests of the State is appropriate for agencies. There are checklists for this purpose.
- Ask whether the mission of an agency really requires that it be constituted as a separate legal entity, with its own board and governing law; or whether some lesser degree of autonomy, perhaps under a parent ministry, will equally serve the purpose.
- Make sure that the incentive and capability exists in central ministries to manage the new relationships; that the politicians and legislators are clear on their powers and responsibilities of policy setting and surveillance; and that, in the agencies themselves, there are the management skills necessary to “learn to be free”.
- Expect a “Hawthorne effect” – a first burst of enthusiasm and motivation for the mission of the new organisation, maybe a charismatic leader with the strong support of a powerful politician, followed by a re-grouping of the forces of opposition and re-emergence of old habits and cultures of performance. How is improvement going to be embedded and thus survive beyond the pioneering phase?

Notes

1. The research underpinning this paper is a study undertaken by the OECD of distributed public governance (OECD, 2002). There is no similar comprehensive review for either transition economies or developing countries. Specific mention should be made of the ongoing project of Professors Colin Talbot and Christopher Pollitt (Talbot et al., 2000). Other writers and references in some World Bank documents are cited in the paper.
2. For the remainder of this paper, these terms are used as if they are synonymous.
3. Manning, 2002.
4. Bonwitt, 2002.
5. Consistent with other OECD work, the definition excludes constitutional bodies (such as audit courts), State-owned enterprises, private companies and fully politically devolved bodies (such as regional or local government).
6. An acronym from the French term *agences d'exécution des travaux d'intérêt public*.
7. Christensen (1999) offers an alternative classification of "bureaucratic" autonomy (departures from clear and unequivocal ministerial direction and control of public organisations) into "structural" (where alternative top-level governance is inserted between minister and agency), "financial" (where agencies have some independence of control over financial resources) and "legal" (where the minister cannot interfere in individual decisions made by agency officials).
8. Autonomous administrative authorities which "act on behalf of the State without being subordinate to the government and enjoy, for the proper conduct of their assignments, guarantees which enable them to act in a fully autonomous fashion, such that their action may not be directed or censured except by the courts" (*Conseil d'État*, reported in Rochet et al., 2002, p. 76).
9. An example is the agency law developed in Latvia. See for example Maurina and Gray, 2003.
10. The LGED was cited for its efficiency in an otherwise depressingly underperforming civil bureaucracy (World Bank, 1996). The reasons given by a later case study were, among other things, the leadership qualities of its director, a team work ethic, a high degree of professionalism, decentralised management and community participation, decision making with the minimum of red tape, a high degree of autonomy from its parent ministry, and a unified sense of mission. See Pankaj, 2002.
11. Proskurovska (2003) suggests that in Latvia the *ad hoc* creation of State service delivery entities in the form of State non-profit shareholding companies created very significant risks for the government, particularly because of their ability to manage their own bank accounts and escape from central government financial controls.
12. See, for example, Rainey and Steinbauer, 1999.
13. For example, Grindle, 1997.
14. These aspects of the governance of agencies are discussed in more detail in Laking, 2002. Other discussions of public organisational governance requirements can be found in International Federation of Accountants, 2001.

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Budgeting in Romania

by

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Preface

This review of the Romanian budget system was carried out as part of the Budget Project of the Working Party of Senior Budget Officials (SBO). The Budget Project aims to initiate and foster regional networks of Senior Budget Officials outside the OECD area. This review served as a basis for the examination of the Romanian budget system at the first meeting of the network of Senior Budget Officials of Central and Eastern Europe, held on 10-11 November 2004 in The Hague.

A mission comprising Mr. Michael Ruffner, Mr. Joachim Wehner, and Mr. Matthias Witt visited Romania in May 2004. During the mission, the team met with a wide variety of Romanian authorities in the Ministry of Public Finance, National Prognosis Commission, Ministry of Health, Ministry of Justice, Chamber of Control, Parliament, and Economic and Social Council, as well as other bodies.

The OECD would like to thank the Romanian team for putting together a comprehensive and informative programme. All participants were open and forthcoming for the team. In particular, the team would like to thank: Mr. Gheorghe Gherghina, Secretary of State, Ministry of Public Finance; Mr. Viorel Stefan, President, Budget and Finance Commission, Senate; Mr. Mircea Panaite, President, National Prognosis Commission; Mr. Patru Rotaru, Counsellor of Accounts, Court of Accounts; and Ms. Mariana Punguta, Ministry of Finance. We would also like to thank Ms. Elena Georgescu for her invaluable help in co-ordinating the mission.

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The views expressed in this report are those of the OECD Secretariat and should not be attributed to any organisations or individuals consulted for this review.

1. Introduction

The budget system in Romania is undergoing fundamental changes affecting all facets of the budget process. There is in many areas a good foundation on which to seek further and continuous improvements to the

budget system. However, Romania needs to be sensitive to those processes that are core to good budgeting during this time of change. Much of the legislation that governs the budget process was passed within the last five years and has been modified several times since then. Thus, government employees are still grappling with the implementation of fundamental changes to the budget process and in many respects it is too early to tell whether these changes are a success or fully implemented. Moreover, unrealistic expectations and external pressures should not lead to undue haste in the reform process. It is therefore realistic to assume that practice will lag behind policy for some time, and to allow for a gradual narrowing of the gap between formal frameworks and actual practice.

It is fair to say that European Union accession is the number one goal of the government and all reforms are focussed on achieving that goal. It has meant an impressive number of procedural and structural changes over the past few years. Great strides have been made in making the budget more transparent especially with regard to off-budget activities and quasi-governmental enterprises. This has been aided by an ambitious privatisation effort and other market disciplining reforms. Nevertheless, more effort in these areas, as discussed later, is needed.

Table 1. General consolidated budget totals, 1998-2007 (percentage of GDP)

	Actual					Estimates				
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Expenditures	34.5	34.7	35.2	33.4	32.1	33.1	33.1	32.2	32.3	32.7
Revenues	31.5	32.8	31.2	30.1	29.6	30.4	30.1	29.2	29.3	29.7
Deficit	-3.0	-1.9	-4.0	-3.2	-2.5	-2.7	-3.0	-3.0	-3.0	-3.0

Note: The general consolidated budget is made up of the State budget, local budgets, the State social security budget, the health insurance special fund, the unemployment fund, external loans for project funding, and the budget for privatisation activities. It excludes expenditures and revenues of some activities funded from revenue collected and managed by certain credit holders, revenue and expenditures of public institutions fully funded from own revenue, and external non-reimbursable assistance.

Source: Ministry of Public Finance, Romania.

Fiscal policy, like other government priorities, is largely driven by the goal of EU accession and oversight by the International Monetary Fund (IMF) and other multilateral institutions. This means that the government's "goal" is a deficit of 3% of GDP and other constraints that mimic the Maastricht Treaty requirements, and that macroeconomic policy is discussed and approved by the IMF. The government programme does not include, however, specific deficit targets beyond the deficit limit. The 3% limit aids the other main economic goal of lowering the inflation rate to single digits down from a high

of almost 60% in 1998. General government spending accounted for 33% of GDP in 2004. The national debt of 29% of GDP in 2003, while rising modestly, was relatively low compared to other countries. The vast majority of this debt is payable to international creditors. Overall, fiscal aggregates have been relatively stable over the past few years and are envisaged to remain so over the medium term.

The Romanian budget and treasury system closely resembles other continental systems, notably France and Italy with whom the Romanians are culturally linked. It is characterised by a three-level system of *ordinateurs* or credit holders which plan for, receive and spend funds from the budget. The main credit holder or first *ordonateur* typically is the ministry whose manager is the main credit holder. The other two levels are represented by secondary hierarchic institutions whose managers are, case by case, second-order or tertiary credit holders. For example, in the health system funding for hospitals flows from the main credit holder, the President of the “Health House”, then flows down eventually to the tertiary credit holder which is the individual hospital.

2. The budget formulation process

2.1. Setting overall priorities

The current government is a minority government which lacks only a few votes necessary for a majority and depends on a small ethnic party to support it in parliamentary voting. This coalition has been sustained since 2000 and has proven reliable. New elections were held later in 2004. Because there is a broad consensus that EU accession is a priority, the government has fairly liberal authority to craft laws and procedures aimed at meeting accession criteria. As such the government programme for overall expenditure policy is limited to higher order goals including the 3% deficit limit. This government programme was set in 2000 and has remained in force since. However, while the government programme has remained constant, the government has broader powers to make changes as required by the drive for accession to the EU.

2.2. Development of macroeconomic estimates

The first step in the budget process is the release of the first of two official macroeconomic projections. The projections are the product of the National Prognosis Commission which was founded in 1990 but has been reorganised several times since then. In 1993 it was spun off from the Ministry of Development and Prognosis and gained commission status reporting directly to the prime minister. While it is technically independent and has always been a separate legal entity even when attached to a ministry, it is still a government body. The Commission is formally responsible for the main macroeconomic projections including GDP, sectoral demand, inflation,

Box 1. Stages in the budget formulation process

31 March	National Prognosis Commission provides preliminary macroeconomic forecasts.
1 May	Ministry of Public Finance (MPF) submits proposed spending frames to the government for main political discussions.
15 May	Government approves the ceilings set for main credit holders as well as fiscal and budgetary policy objectives for the following three years.
1 June	MPF sends main credit holders a framework letter and key macroeconomic assumptions, the methodology for drafting the budget, and the expenditure ceilings approved by government.
15 June	Modification and approval to ceilings based on macroeconomic assumptions.
15 July	Main credit holders submit budget proposals with three out-year estimates to MPF.
1 August	Conclusion of discussions on departmental budget submissions.
30 September	Preparation and submission to government of final draft budget.
15 October	Submission of draft budget to parliament.
By 28 December	Final approval of budget by parliament.

Source: Law on Public Finance, Romania.

unemployment, wage growth, import/export and exchange rates. The forward projections mirror the medium-term framework with projections for the coming budget year and the following three years. The Commission produces the forward estimates at the same level of detail as the coming year estimates; however, these details are not made public. The Commission simply provides higher-level estimates for public review. Indicators and data are generally available to the public through reports and budget documents and on the Commission's Internet site. The Commission does not make available full details of its model, but the methodology is discussed with Romanian academics as well as with the IMF.

The Commission sends a preliminary analysis to the Ministry of Public Finance (MPF) in March for informal discussions. The Commission includes an

analysis from the MPF of governmental consumption and taxation for the coming years. The MPF does not however have a macroeconomic unit and does not have the ability to challenge the Prognosis Commission's estimates. The Commission finalises its estimates on the basis of the MPF discussions and produces the first of two formal forecasts in April. The Commission also informally consults with the Central Bank, although the inflation targets are identical between the government and the Central Bank. Regardless of the past organisational structure, the timeline has been the same. The forecast is officially approved by the Cabinet (and implicitly approved by parliament in the budget). The Prognosis Commission also is the main organisation charged with monitoring whether the economic targets in the government programme are achieved.

Macroeconomic assumptions have proven to be a source of problems for some countries and the OECD places great emphasis on the generation of reliable and pragmatic assumptions. For example, overly optimistic assumptions create room for spending growth while pessimistic assumptions allow for additional revenues to be collected and hidden. While the estimates are produced in Romania by a government entity and therefore are potentially vulnerable to manipulation, they are in fact constrained by non-governmental forces. First they are developed and reviewed in collaboration with others including academia and the private sector. Second, they are discussed with the social partners (trade unions, private sector groups) of government, although there is no longer a formal requirement for consultation. Finally, the estimates are constrained by international groups. Under the drive for accession to the EU as well as conditionalities from groups like the IMF, the Prognosis Commission develops the estimates in conjunction with these outside groups and must have them approved. It appears that the forecasts have been accurate, with actual outcome close to forecast. Recently the results proved modestly conservative and economic growth was a little better than forecast, allowing a dip in the deficit below the stated goal of 3%. The head of the Commission proudly stated that the IMF even changed their estimates to match the Commission's forecast.

2.3. The annual budget

Following many problems in developing a budget on time, the new Law on Public Finance sets out a stringent but longer than previous timetable for budget development. The annual budget process begins in earnest on 1 May with the submission by the Minister of Public Finance to the government of the goals of tax and spending plans for the coming year and for three forward years. There is no reconciliation or formal relationship between year 2 of the previous year's medium-term expenditure framework (MTEF) and the development of the current year's budget. Thus the point of departure for the

Box 2. The comprehensiveness of the budget

The structure of the Romanian budget is undergoing large and important changes. Special and other extra-budget funds historically were commonplace, but starting in 2001 many of these funds were either abolished or moved on-budget. The Health and Social Security Funds are not included in the unified budget but are presented at the same time as the budget in other documents. The health budget is approved as an appendix to the annual State budget while the social security fund and unemployment budget are approved by the annual State social security law.¹ Some spending financed by external loans and development aid is not presented in the main State budget and those loans by international financial institutions and the EU are held to a higher standard of execution and review than normal spending. Revenues and expenditures of certain public institutions² that are self-funded are also not included in the State budget. In terms of types of spending, most spending is considered discretionary and subject to annual appropriations.

1. Beyond the scope of this review is the relationship between the State budget and State-owned enterprises. Other reviews have been critical of this aspect of the budget and recommend further consolidating the budget and making the linkages more explicit. This aspect will be discussed in the section on contingent liabilities.
2. For example, the National Regulatory Authority for the Natural Gas Sector is fully self-funded from fees; however, penalties are submitted to the national treasury. The agency's budget is not subject to MPF review and it is accountable directly to the government. The fee basis is a governmental decision based on advice from the authority and the government approves the budget. The agency is subject to audits by the State audit institution, but the audits are optional since they are under the materiality threshold. In practice, such audits are very infrequent.

development of the current year plan seems to be more incremental than related to the MTEF. This first submission to the government includes proposed ceilings for each first credit holder (government ministries). The ceilings are discussed by the Cabinet and then approved with any changes that are deemed necessary. For the most part there are few changes to the ceilings. The ceilings are expressed in nominal terms and are not automatically changed if there are differences in projected inflation.

After the ceilings are agreed to and transmitted to the primary credit holders, they develop their budget proposals based on annual instruction guidelines prepared by the MPF. This process takes about one month from mid-June to mid-July. This appears to be a good top-down budget process, with the MPF more or less staying out of the budget decisions of the individual ministries. The MPF is only concerned with upper level ceilings and ministries can propose funding levels for individual programmes. They operate under

the general principle that increases in funding must be fully offset by cuts elsewhere in their budget.

What has not happened to date, although it is improving, is that primary credit holders respect the original limit and fund spending increases. It is normal in countries to have gamesmanship in the requests from spending ministries to the MPF on the upcoming budget proposal. Often, ministries submit requests above their guidance with no offsets proposed and in Romania this gamesmanship seems particularly acute. The MPF noted that if one were to total all the initial requests by the ministries, the deficit in spending would be 22% of GDP. While this result might be slightly exaggerated and it was noted that some ministries came very close to their guidance level, it still indicates that initial guidance is not respected. There are many possible explanations for this phenomenon but the large differences between guidance instructions and requests do not seem to hinder the timing of the budget process. It is an open question though whether the opportunity cost of debating the differences could be reduced and the time spent discussing other issues. It also points to a deficiency and opportunity in the medium-term expenditure process which is discussed in Box 3.

Box 3. The medium-term expenditure framework (MTEF)

The government programme announces the intention to hold deficits to 3% of GDP. However, there is no path or hard target which includes a sequestration or other rectifying mechanism. The operational vehicle for the goal is the medium-term expenditure framework (MTEF). The current MTEF plans for the coming budget year with estimates for the three following years. The MTEF is detailed and explicit with spending paths that look like real projections rather than mechanical increments. The framework is comprehensive and mirrors the detail of each programme's budget. The report is presented to parliament for information but is not voted on or binding. Parliament has welcomed the presentation of the MTEF and believes that it adds valuable information for its work.

The following year, there is no column for reconciliation between the projections and the deviation from actual spending and macroeconomic assumptions. Moreover, the ministries developing their budgets do not seem to use the previous year estimates as a guide for their budget submissions leading to the large requests for additional spending. However, the MTEF, like many features of the budget process, was being fully implemented in 2003. Ministries did have experience using a framework for investments prior to 2003, but time and experience with the full MTEF may improve its use.

Despite the seemingly large difference between ceiling and proposed budget, the formal negotiations between the MPF and the spending ministries proceed quickly. Major decisions between the Minister of Finance and the government are completed in two weeks. Staff indicated however that low-level negotiations and discussions take place throughout the development of the ceilings and the spending ministries' budgets. Therefore, the decisions during the two weeks are funnelled down to fewer, more sensitive items. In principle the MPF makes all but the most political decisions. Some, but not many, decisions at this time get submitted to the government for a resolution.

For the next several weeks, the MPF prepares the final draft of the budget and the budget bills. While the MPF drafts the laws, the Ministry of Justice has a legislative office which reviews all legislation including the budget bills for technical, but not substantive problems. This draft is submitted to the government for final approval by 15 October. The budget is reported to parliament along with the report on the macroeconomic review for the budgetary year and the forecast for the following three years, as well as other support documents. This report contains a summary of the macroeconomic policies on which the draft budget was elaborated.

2.4. Consultation with the Economic and Social Council

The role of the Economic and Social Council (CES) is an interesting feature of the Romanian system. Created in 1997, the Council is a tri-partite sounding board for government policies. Twenty-one members representing government, employer associations and trade unions analyse new government policy and make recommendations on those policies to government as well as parliament. The Council's mandate is quite wide and it has legislative authority to review policies concerning economic restructuring, privatisation, competition policy, labour relations and wage policy, social protection, health, education as well as fiscal and monetary policies. The latter category gives the Council the authority to review the draft budget. The CES starts its review early on during the formulation of individual ministry budgets and continues through until the State budget is presented to parliament. The majority of the work on the State budget is performed through a budget and finance committee of the CES. The work of the Council members is supported by a secretariat of 30 people. In addition, there is often staff employed by the trade union or employer association that sponsors the Council member.

CES recommendations must either be unanimous or voted on by a three-quarter majority with corresponding weight attached to each voting threshold (in other words unanimous votes are taken quite seriously). The three-quarter threshold (of those present) means that two parties to the board cannot impose their will – for example, two groups must be joined by members of the

third group or (and more likely) one of the groups is not fully present at the time of voting. If a supermajority cannot be formed, individual members can write views on the policies reviewed. The recommendations are not binding on the government and if they are not acted on, the CES sends the recommendations to parliament.

This system is interesting because it provides the government a useful sounding board for policies prior to action. In some parliamentary systems, the government gets into trouble for specific policies because they are controversial, developed in a political vacuum or simply not well constructed. The CES provides a first feasibility check as well as a formal forum to gauge social partner reaction. However, this is a limited check. The Council is starved of resources with only 30 staff members for the wide range of review responsibilities. The three-quarter and unanimous voting rules are quite difficult to achieve and, because government representatives can effectively veto recommendations by voting together, implicitly government has to allow itself to be criticised. On top of the limits, even when they do pass all the hurdles, only 20% of the Council's recommendations are ultimately adopted. Attempts to increase the Council's own budget, for instance, have not been successful. Also for many of the more controversial policies of the government that come before the CES, many already have the force of law because of the government ordinance function. Thus while it is an interesting and useful feature of the system, its role in the process should not be overstated.

2.5. Programme budgeting

The 2002 Law on Public Finance requires that all primary credit holders provide a report on programmes as an annex to the budget. This is an extension of programme budget pilot testing which had been in effect since 2000. In 2000 there were initial experiments with programme budgeting in eight ministries, and by 2002 such pilot activities were extended to all ministries. In 2004, each ministry had several programmes. Particularly important ones relate to health, education and defence. Given the high level of detail that generally characterises the Romanian legal framework for budgeting, it is striking that there are three short sections in the Law on Public Finance on programme budgeting requirements and that to date only primary credit holders are required to report on performance. MPF staff indicated that secondary and tertiary credit holders would start developing measures over the next several years.

For the most part the development of objectives and reporting against the targets seemed to be a secondary or afterthought activity for most involved. Spending ministries appeared to have limited knowledge of the requirements and necessary steps involved in programme budgeting. Programme budgeting does not seem to be a serious requirement as there are little incentives or

Box 4. Fiscal decentralisation in Romania

Local government has a two-tier structure with the county level consisting of 41 *judete* (counties) and the municipality of Bucharest, and the lower tier made up of a large number of towns and communes. Decentralisation transferred expenditure functions to the local level, for example in the areas of public health and education. Local budget expenditures are estimated to total 6.8% of GDP in 2004. Since 2000, local authorities have enhanced powers to collect local taxes and fees including property tax. In 2003, the government issued an Emergency Ordinance on Local Public Finance that provides a legal framework for local budgeting akin to the Law on Public Finance for the central government level. The national budget remains an important source of local government funding. Revenue-sharing arrangements extend to personal income tax as well as value-added tax. The Romanian Federation of Local Authorities, a body representing organised local government, discusses the budgetary implications for local government of the draft budget laws during the annual budget process and comments are forwarded to the government.

penalties to make credit holders take it seriously and parliament and civil society have not used the data to hold the executive to account. Moreover there are virtually no performance audits performed by either the internal auditors or the external audit institution, although this capacity is being developed. This suggests that programme budgeting is at a very early stage and no conclusions should be drawn as to its usefulness in the Romanian context.

2.6. Conclusions

The arrangements for the development of macroeconomic assumptions work well. While the estimates are currently reliable, the institutional arrangement may not ensure that this is sustained over time. The OECD believes that the sound development of macroeconomic indicators is an important and often overlooked feature of the budget system. The current development of macroeconomic indicators is circumscribed by outside forces such as the IMF and the EU, but in the absence of these forces there do not seem to be institutional checks to verify the accuracy.

The formulation process is generally good; however, the gamesmanship in developing budgets by spending ministries seems acute. Mostly this is the result of great financial needs but little available money to fund those needs. While this is a fact in most systems, a more robust MTEF could help with the planning from year to year.

3. Parliamentary approval

3.1. Timing of the parliamentary process

The overall timeframe for parliamentary approval is relatively tight. Government is required to submit budget bills to parliament for approval by 15 October, two and a half months before the beginning of the fiscal year.¹ Both chambers of parliament jointly determine the timetable for discussing the budget. After the tabling of the budget, members are given a period of between seven to ten days to study the budget documents and to develop their proposals for amendments. This is followed by a committee stage and discussions in the plenary that conclude with a final vote on the State budget.

The Constitution provides that if the budget bills have not been passed at least three days before the expiry of the relevant fiscal year, the previous year's State budget and social security budget continue to be applied until the adoption of the new laws.² The Law on Public Finance also allows for the implementation of certain proposed amounts in the draft budget in "special cases".³ In the past, parliamentary deliberations were not always completed in time and delays of several months occurred. Under the current government, which commands a stable parliamentary majority, the conclusion of debate has in recent years been reached before the beginning of the new fiscal year. For instance, the budget for the 2004 fiscal year was approved at the end of November 2003. This means that parliamentary scrutiny is in current practice compressed into about one and a half months. By contrast, the OECD Best Practices for Budget Transparency recommend a minimum of three months for parliamentary scrutiny of the draft budget.⁴

3.2. Committee process

Parliament draws on wide committee participation that is organised as a two-step process. Principally, the relevant committees of both chambers sit jointly to discuss the budget and also produce a joint report. The first step involves consideration of relevant sections of the budget by the appropriate sectoral committees. For example, the health committees of both chambers issued a 58-page joint report on the 2004 budget at the end of October 2003 that mostly suggested increases of individual items in the health budget.

Following the sectoral committee process, the Committees on Budget, Finances and Banks take an overall view and go through the budget article by article. The budget committees conduct hearings that bring together officials from the relevant spending ministries and the MPF. Additional witnesses are sometimes invited, such as outside experts, civil society representatives or other relevant stakeholders. As discussed above, the Economic and Social Council submits an opinion on the draft budget law that may be accompanied by some suggestions for amendments. Members of other committees may

Box 5. The structure of the Romanian Parliament

The Parliament of Romania has a bicameral structure and consists of the *Camera Deputatilor* (Chamber of Deputies) and the *Senat* (Senate). Both chambers are elected in constituencies on the basis of a party list system and according to the principle of proportional representation. The Chamber of Deputies is composed of 345 members and the Senate of 143 members. The difference results from the fact that a Deputy represents 70 000 voters and a Senator represents 160 000 voters. Certain national minorities are granted special representational rights. Elections are held concurrently for both chambers and members are elected for four-year terms. The two chambers have equal powers in budgetary matters.

Both chambers have standing committee structures. There are 17 such committees in the Chamber of Deputies and 15 in the Senate. Both chambers have a Committee on Budget, Finances and Banks. Membership of committees reflects the party political majorities in the respective chambers. Senate committees are smaller in size than their Chamber counterparts. For example, the Senate budget committee has 11 members of whom five are currently from the governing party and one from a party that has a parliamentary co-operation agreement with the government. Its counterpart in the Chamber of Deputies consists of 27 members, of whom 13 are from the ruling party plus two from its parliamentary co-operation partner.

Source: Parliament of Romania.

attend the budget committee debates but they have no voting rights. These hearings are open to the press and the public and there appears to be extensive coverage of discussions. For the 2004 State budget bill, the budget committees issued their joint report comprising over 400 pages in mid-November 2003, as well as a shorter joint report on the social security budget bill.⁵

There are different sources of technical support to parliament and its committees. Each parliamentary committee has some expert staff and it might also draw on funds to take on consultants on a temporary basis. For instance, the Senate Committee on Budget, Finances and Banks has five attached councillors not all of whom specialise in budget matters, however, given the committee's wide remit. In addition, committees can draw on logistical support from the parliamentary information and documentation department. There is no specialised budget research institution or similar that is attached to parliament, but political parties might employ staff for such purposes. The legal provisions suggest relative autonomy of parliament in drafting its own budget for inclusion in the State budget law.⁶ In practice, the parliamentary budget is subject to negotiations with the MPF.

3.3. Amendments and approval

The views of the budget committees carry particular weight during the debate on the budget bills in the plenary consisting of a joint sitting of both chambers. Although both chambers have the same powers in budgetary matters, the fact that their total membership differs effectively gives the Chamber of Deputies more voting power than the Senate. At present, this has little effect, as the party political majorities are very similar in both chambers. The final vote on the budget in the plenary is characterised by voting along party political lines. A rejection of the budget would be interpreted as a vote of no confidence and cause the fall of the government. Since democratisation, parliament has never refused to approve the budget.

The total number of changes made and the associated overall budgetary effect are very modest. Parliamentary powers to amend the draft budget are circumscribed, as the Law on Public Finance prohibits amendments that would result in an increase of the deficit.⁷ Members get several subsequent opportunities to argue the case for their amendments, i.e. in the sectoral committees, during the budget committee hearings and on the floor of the chamber. Proposals for spending increases have to indicate the source of funding for additional expenditures, principally by suggesting commensurate cuts elsewhere in the budget. There are generally about 300 to 400 amendments that are proposed by members. Health and education appear to be particularly high profile areas. As some of these may be of a similar nature, the sectoral committee process serves to filter out any duplicates and co-ordinate proposed changes, so that the actual number of amendments that have to be considered by the budget committees is around 250 to 300. About one-third of these are typically adopted, and occasionally there is some cross-party consensus. Not all parliamentary amendments shift money as some serve the purpose of clarifying text in the budget bills. Officials from the MPF indicated that the reserve fund is sometimes used to finance small increases in particular items.

It appears that parliamentarians benefit from ongoing improvements in budgetary information. One member commented that the medium-term figures that are now provided are useful for indicating an overall trend and provide “context” to annual appropriations. However, members’ attention is still predominantly focused on the budget figures for the upcoming fiscal year. In accordance with legal provisions, the parliamentary vote is on the figures for the upcoming budget year only and does not bind government to the out-year projections, with the exception of multi-annual authorisations for capital spending.⁸ The development of programme budgeting was seen as “most desirable” while at the same time the need to enhance capacity to assess performance was acknowledged. Also, it was indicated that the Budget Report

that the MPF prepares and tables with the budget has matured into a consistent source of information that members use in their scrutiny of the budget. The report contains an analysis of economic and budgetary developments in the expiring fiscal year, an overview of macroeconomic assumptions and budgetary policy for the upcoming year and a medium-term outlook.⁹

During the course of the fiscal year, parliament might be asked to approve “rectifying laws” to provide additional spending or to adjust the main budget. Modifications to the main budget law are allowed only up to the end of November of the relevant fiscal year.¹⁰ In recent years there have been one and only occasionally two rectifying laws per fiscal period. This indicates that the implementation of the budget is fairly sound. The procedure for the consideration of rectifying budget bills in parliament is essentially the same as for the main budget, but far less elaborate. The passage of a rectifying law would often be required around the time of the parliamentary vacation. Parliament typically grants the government interim authorisation to make adjustments by ordinance and then considers and approves any such measures when it reconvenes.

3.4. Conclusions

To sum up, the stabilised political situation and the new timetable provided by the Law on Public Finance have smoothed the passage of budget legislation and facilitated timely approval. However, the timetable for parliamentary scrutiny is perhaps too tight for proper scrutiny, although parliament has more recently chosen not to exhaust the full amount of time that is legally available for approval. Nonetheless, it appears that parliament provides a useful forum to broaden public debate on budgetary matters.

The two-tier committee process allows parliament to draw on the whole breadth of its expertise, while at the same time guarding fiscal discipline. The budget committees are largely effective in moderating spending demands from sectoral committees and the two-tier committee process is quite close to what the OECD considers good practice in parliamentary involvement.¹¹ The limitations on parliamentary powers of amendment further serve to safeguard the government's deficit target, but they are sufficiently broad to allow for meaningful engagement. Overall, parliament plays a minor role in setting budget priorities but it has retained the capacity to make limited changes to the budget proposed by the executive.

4. Budget execution and internal control

Like other parts of the budget process, the budget execution process is undergoing fundamental changes. Coupled with quickly changing organisational structures, the large number of legal changes means that

practice struggles to keep up with formal requirements. However, the basic procedures for budget execution are quite well entrenched and designed with the primary purpose of not spending over the amount provided in the budget. The relative success in enforcing fiscal aggregates during budget execution is reflected in the moderate use of rectifying budget laws.

After the approval of the annual budget law, funds are disbursed on the basis of quarterly distribution plans for each credit, which are approved by the MPF. Within this ceiling, the main credit holders distribute the approved budgetary credits for their own budget and for subordinated public institutions whose managers are secondary or tertiary credit holders. The secondary credit holders distribute the approved budgetary credits for their own budget and the subordinate tertiary credit holders.

The main credit holders retain 10% of the approved amount for a reserve, excluding wages and salaries and funds related to external liabilities, which are entirely distributed. The retained amount is distributed in the second quarter, after the government reviews the first quarter budgetary execution. Periodically, the main credit holders send reports to the Ministry of Public Finance regarding the utilisation of funds, and draw up financial statements on budget execution.

4.1. Internal control and audit

Ministries are responsible for committing and using budget credits within the amounts and destinations approved and for expenditures related to their functions and in accordance with the law. In committing and validating expenditures, their own preventive financial control structures issue preliminary checks on expenditures. In addition, each large governmental entity also has a “delegated” controller from the MPF. The delegated controllers are independent of the spending ministries and conduct legality and regularity reviews for large spending items over a set threshold. They also assess the legality of contracts and new commitments. The main job of preventive control – both “own” and “delegated” – is to ensure that appropriation limits are adhered to as well as the legality and regularity of expenditures. The General Directorate for Preventive Internal Control of the MPF co-ordinates all internal controllers.

In 2002, Romania added a new *ex post* internal audit function to work with the continuing *ex ante* internal control. The units started to become operational in 2003. Each ministry is required to have an internal audit division but it is up to the minister to determine its size and make-up. The basic functions of internal audit are quite wide according to their statutory authority. They are charged with performing system, performance and financial audits for all levels and all activities of credit holders in government organisations.

The internal controllers and internal auditors are co-ordinated by separate divisions of the MPF: the General Directorate for Preventive Internal Control and the Central Harmonisation Unit for Public Internal Audit (CHUPIA). The CHUPIA is relatively more independent and reports only to the Minister of Finance. Each role though is similar: they set standards and guidelines for units in government entities, provide technical assistance and oversee the functioning of control. The CHUPIA acts also as an auditor of the auditors. There is no co-ordination of internal control or audit with the Court of Accounts.

Each internal audit unit creates its own audit plans and carries out the audits according to centrally developed risk assessment norms. The plans can also incorporate suggestions by the head of the public unit. The statute generally gives the internal auditors rights to all information they deem necessary and the ability to resort to civil penalties if they are blocked from carrying out their duties. A completed audit report including recommendations is sent to the head of the public entity depending on the level of credit holder. The head of the entity formally responds to the recommendations and sets out a plan for rectifying problems found by the audit. According to Law No. 672/2002, should the head of an internal audit structure feel that the recommendations are not being addressed, he/she must inform the CHUPIA. However, it is not clear what happens in the case of continued non-compliance. While there are civil penalties for a number of violations, there are no penalties, monetary or otherwise, for failing to comply with internal audit recommendations. Therefore it is ultimately the government which has to decide on corrective action.

It is far too early to judge the success or usefulness of the internal audit function. One goal is to make self-control effective and efficient so that delegated controllers are not needed and *ex ante* control can be loosened. In practice, the current system is far from this goal. Most internal audit structures have suffered from a lack of viable candidates for positions. At the time of the review, the CHUPIA had only 16 of a planned staff of 33 persons, and the ratios are similar or worse in the departments. The MPF properly sees the inclusion of internal audit as a gradual process that will culminate in full integration by the EU accession target date. The CHUPIA is to evaluate the achievement of this objective and planned 13 assessment missions of main credit holders in 2004.¹²

Despite heavy internal controls, expenditures have exceeded limits in the past since some creditors can legally spend more than budgeted and others simply ignore the tight budget constraints and spend more. This is a particularly acute problem in the health sector where budgets for individual hospitals (tertiary creditors) are mixed with public and private sources and no consolidated budget is presented to the Health House. The hospitals are

allowed to continue spending and build up budget arrears. This indicates that there are breakdowns in the internal control environment. Nonetheless, internal control might be considered effective in the sense that the Ministry of Justice does not see overspending or other misappropriation of funds as large concerns for the anti-corruption division. The *ex ante* control is inefficient, however, since there are high transaction costs and low levels of automation in the process. This is not a recommendation to end *ex ante* control in Romania as it is entrenched in the culture, only a suggestion to review where transaction costs can be lowered.

4.2. Limits on transfers

The budget is rather detailed and classifies expenditures in parts, chapters, subchapters, titles, items and paragraphs. Moreover, the Law on Public Finance includes extensive rules on virement, or the transfer of funds between items during the execution of the budget. Article 47 includes an outright prohibition for personnel allocations down to the chapter level of ministerial budgets to be increased or used for other expenditure purposes. Credits for primary credit holders (ministries) cannot be adjusted, nor can funds be transferred from one chapter to another. Starting with the third quarter of the fiscal year, adjustments of up to 10% of spending within chapters are possible as well as limited transfers between chapters and programmes with the special approval of the MPF. In addition, Article 61 of the Law on Public Finance disallows carryover of unspent funds at the end of the fiscal year.

Detailed appropriations and strict rules on budget execution support compliance with budget laws. In the medium to long term, greater flexibility will be needed in order to give managers the tools to improve performance. This can be achieved by making implementation rules less rigid and the budget classification less detailed, while at the same time strengthening output and outcome reporting. One option might be to introduce an experimentation clause that allows for relaxation of rules in certain spending units in order to pilot more flexible execution arrangements. Experiments with flexibilisation should focus on spending units where the risk associated with the relaxation of input controls is low and such experiments would have to be closely monitored and evaluated against agreed targets and expected results.

4.3. Budget reporting

The OECD Best Practices for Budget Transparency¹³ call for a number of reports during the budget process.¹⁴ Among the most important, apart from the basic requirement of crafting a comprehensive budget, are the regular reports on budget execution. Execution reports are published by the MPF on a monthly, quarterly and annual basis and much of what is generated is

available to the public on the MPF Internet site. What could be improved is the timeliness of the information (i.e. the annual end-of-year financial report takes five months to produce and six months to audit) and the types of disclosures increased. For example, better analyses of tax expenditures and contingent liabilities are needed. In general the freedom of information laws for citizens are comprehensive and noteworthy, and the independence and right of access for internal controllers, internal auditors and external auditors are legally assured. Thus Romania has a solid base on which to build.

4.4. Conclusions

As in other areas, there are many changes occurring in the budget execution phase of the budget process. These changes are viewed positively, but in most cases it is too early to tell what the effects will be. The current process focuses on financial control. This is necessary given that there are still places where overspending occurs and arrears build up. As the financial control improves and other components – especially internal audit and programme budgeting – come on line, the internal control environment can move away from a highly legalistic undertaking to one that emphasises systems and procedure confidence.

Romania could work on better and more timely budget reporting, including a more comprehensive mid-year assessment and incorporating better reports on liabilities and financial risks.

Performance budgeting and management is a long way off in Romania. To hold people to account, managers will need more flexibility than is currently available to achieve goals. Experience in OECD countries shows that more time and attention should be placed on developing appropriate targets and measures.

5. Accounting and external audit

5.1. Accounting

Accounting in Romania is heavily guided by EU directives and guidelines. Currently financial accounting is officially done solely on a cash basis. The Law on Accounting gives the MPF wide regulatory authority to issue guidelines on drawing up accounts and a new chart of accounts was issued by the MPF in 2002 that will take effect government-wide by 2005. Monthly, quarterly and annual budget execution reports are currently issued. Other observers including the EU, the IMF and the World Bank have indicated that the financial reports are generally reliable and accurate; however, due to widespread manual bookkeeping, the process is not efficient. Romania has noted this problem and is taking steps to automate the process.

The major event regarding accounting is the 2002 government decision to move accounting to a parallel cash and accrual basis. The addition of a full accrual basis started with pilot programmes in 2003 and then will move to government-wide application by 2007 (the date of planned EU accession). There are 13 line agencies that are engaged in pilot testing and the development of accruals and are benefiting from a twinning project with France and Italy. The current plan to introduce accruals is focussing on training. Head accountants will be trained first and training will cascade down the ranks of government employees. The first step is to train the trainers for each ministry and in regional centres, and to engage the Institute of Public Administration in the process. However, this training plan still awaits large scale roll-out.

The team reviewing Romania views the move to accrual-based accounting as positive but with a great deal of caution. The benefits of moving to a system of financial reports generated on an accrual basis are well documented. Implementing full accrual accounting will improve transparency and accountability by providing a more comprehensive picture of the government's assets and liabilities and showing an annual fiscal result which better reflects the impact of economic events and government decisions during the fiscal year. It should help with many areas that are currently lacking or need improvement. Reporting and monitoring on an accrual basis for capital assets, tax revenues, contingent liabilities and long-term liabilities – all areas that need upgrading in the Romanian context – should be improved.

Yet, there are many challenges that Romania will face in implementing accruals and experience in OECD countries is informative. First, the move to accruals is projected to be complete within three years. This is an extremely ambitious goal as the few OECD countries that have completed this process have taken longer to move to full accruals. In fact, a recent OECD survey shows that only seven out of 30 OECD member countries have thus far adopted full accrual accounting, and 21 use only or mostly cash accounting for whole-of-government financial statements.¹⁵ The assembling of a complete asset record – like that which Romania is currently undertaking – is one area that countries found took much longer than expected and slowed down the process. OECD countries underestimated both the time to train staff as well as the amount of new staff needed to implement a new accounting system. OECD countries moving from cash to accruals found that it requires an entirely new set of skills in many cases for the people who are working on accounting issues for government, and it may in fact lead countries to have to recruit people with those new skills rather than only training existing staff. Moreover, OECD countries found that the move to accruals is costly.

Romania is implementing the new accounting regime at a time when many other budget processes as well as organisational structures are in

motion. Co-ordinating the many changes and ensuring that public servants know the new rules in their new organisations will be extremely difficult. The level of automation must increase especially since accruals imply fluctuations resulting from changing exogenous variables. Accrual accounting is also an area where there are still large international debates on the appropriate method. Thus many interpretations and decisions on accounting concepts will need to be fitted to the Romanian environment.

The team was disturbed to hear doubts expressed by several people involved in financial management wondering why the changes needed to occur now. Some senior officials involved in the process were under the impression that the move to accrual accounting was a requirement for EU accession. Given the state of the system and the costs of the changeover, in sum, the team believes that it may be appropriate to slow down the move to accruals. There are ways to continue the drive to accruals such as implementation in those areas which have the most benefit in terms of effective management and increased transparency compared to the costs involved.

5.2. External audit

The *Curtea de Conturi* (Court of Accounts) is the supreme audit institution of Romania. Its origins date back to 1864, although institutional discontinuities characterised the communist era and the present Court was re-established in 1993. The Court of Accounts is an independent body that has the constitutional duty to report to parliament. Its principal legal framework is the Law No. 94/1992 on the Organisation and Operation of the Court of Accounts, which was amended in 2002. The audit law provides that the Court “performs its activity independently” but at the same time “functions near the parliament” (Article 1). Parliament appoints the 18 members of the Court including a president and a vice-president. Their term of office has recently been changed from six to nine years without the possibility of renewal. The constitutional provisions envisage that one-third of the Court’s membership is renewed every three years. The Constitution and the audit law describe members of the Court as “irremovable”, but the audit law allows parliament to dismiss members of the Court from office following recommendation from specialised committees (Article 140).

The Court’s control mandate covers government units, the central bank, public companies, companies in which the State holds a majority of shares, and self-managed social security bodies.¹⁶ The audit law guarantees access to relevant information (Article 4), although access in practice remains a subject for further study. The main focus of audit is to assess the legality of spending, in particular that ceilings for expenditures set out in the budget laws were observed. The Court can issue a decision requiring credit holders to comply with accounting norms. As infringements occur, the Court refers matters to

Box 6. Revised constitutional mandate for the Court of Accounts

- The Court of Accounts shall exercise control over the formation, administration, and use of the financial resources of the State and public sector. Under the terms of the organic law, the disputes resulting from the activity of the Court of Accounts shall be solved by specialised courts of law.
- The Court of Accounts shall annually report to parliament on the accounts of the national public budget administration in the expired budgetary year, including cases of mismanagement.
- At the request of the Chamber of Deputies or the Senate, the Court of Accounts shall check the management of public resources, and report on its findings.
- Audit advisers shall be appointed by parliament for a term of office of nine years, which cannot be extended or renewed. Members of the Court of Accounts shall be independent in exercising their term of office and irremovable throughout its duration. They shall be subject to the incompatibilities the law stipulates for judges.
- The Court of Accounts shall be renewed with one-third of the audit advisers appointed by parliament, every three years, under the terms stipulated by the organic law of the Court.
- Parliament shall be entitled to revoke the members of the Court of Accounts, in the instances and under the terms stipulated by the law.

Source: Article 140 of the Constitution of Romania.

the Financial Prosecutor-General and this is apparently a frequent occurrence. The Court uses a sampling method to select individual accounts for audit. In its main audit report relating to the 2002 fiscal year the Court reported coverage of 47% of auditable entities.¹⁷

Overall the Court employs over a thousand staff, many in its territorial units. In 2001 its budget was cut severely, affecting about one-quarter of its staff. Some of the eliminated positions were associated with a transfer of *ex ante* control functions from the Court to the MPF. These developments at the time caused concern about the independence of external audit and led to the resignation of the president of the Court. The revised audit law implies that the Court has relative autonomy in determining its budget (Article 5).¹⁸ According to the discussions held with the review team, the Court regards its independence as sufficiently respected in practice.

The timeliness of audit reporting has been problematic in the past. The MPF is charged with the preparation of the annual general execution account of the State budget and the social security budget, based on reports submitted by the primary credit holders.¹⁹ The general annual execution account has to be presented to parliament within five months after the end of the relevant fiscal year and it is passed on to the Court of Accounts. The Court submitted its main audit reports for the 2001 and 2002 fiscal years the following December, six months after it had received the execution accounts. Although the tabling in December is unfavourable in terms of the parliamentary calendar, it nonetheless represents a substantial improvement over some previous years when the gap between the end of the fiscal year and the submission of the main audit report was at times more than two years. Swifter finalisation of the execution accounts by executive authorities could bring further advances in timeliness. Ideally, the main audit report should be available prior to parliament's deliberations on the upcoming draft budget. This would allow parliamentarians to harness audit findings for budget scrutiny.

The Romanian Constitution and the audit law allow parliament to order that particular audits are carried out, and the Court has to oblige. At the same time, the Court is to determine "autonomously" its own programme.²⁰ These provisions are to some extent contradictory, as extensive or excessive use of the power of parliament to demand specific audits would be in conflict with the autonomy of the Court. Some countries in the region have struck a more even balance between aiding parliamentary control and ensuring the autonomy of external audit by limiting the number of audits that have to be carried out at the order of parliament. In Slovenia, for instance, the Court of Audit has to select for its annual work programme at least five proposals from the National Assembly, two of which must come from opposition deputies.²¹ To improve the legal basis for independent State audit, Romania might consider adopting similar provisions.

The Court is improving its financial audit process to consistently comply with international standards and recently started to build capacity for performance audit. To perform the mandate to conduct performance audits for utilisation of public resources (Article 16), the Court has created a special division on performance audit with a staff of about 25 that has developed an activity plan. So far the unit has mainly carried out preparatory work and some pilot activities. It was reported that the Court has completed the development of a performance audit manual. The Court has benefited from technical assistance to develop performance audit capacity and study visits have also been undertaken. In its report on the 2002 fiscal year the Court included a section with comments on the performance of the salary system in public institutions, a programme for funding scientific research, the protection of historic monuments and financial management in loss-making

government enterprises.²² It is unclear how the Court is planning to engage with the annual performance reports that the public finance law requires ministries to submit with their yearly financial reports.²³ These reports are to include information on the achievement of objectives, and thus appear relevant to the Court's work in the area of performance audit.

5.3. Parliamentary review of audit findings

The main audit report is referred to parliament by the president of the Court. Additional special reports can focus on particular areas of inquiry and are discussed in the relevant subject committee in parliament. It appears that interaction with parliamentary committees varies to some degree according to the interests of currently serving members. There is no debate in the plenary of special reports, but parliament has the possibility to follow up issues by setting up committees of inquiry. The Court has a unit for external relations that follows the parliamentary agenda and co-ordinates inputs into parliamentary discussions. The Court appears to have strengthened its public relations functions and broadened the use of press conferences to draw attention to the release of its reports.

The main report is discussed in the parliamentary budget committees. The Court does not report to a specialised committee on public accounts as typically exists in countries that follow the auditor general model, nor do the budget committees in either chamber have permanent sub-committees to discuss audit findings as exist in some countries in the region.²⁴ The main audit report is subject to review in the budget committees and it is the only report of the Court that is subject to a formal discussion in the plenary consisting of a joint sitting of both chambers of parliament. As is common under the court model of public sector audit, Romania follows the tradition of granting discharge by approving budget execution in law.²⁵ The purpose of the main audit report is to provide parliament with the information that is necessary in order to vote on budget execution.

The parliamentary debate on budget execution attracts considerably less interest than the discussions of the draft budget law, and approval is usually quickly obtained. Refusal to approve the execution of the budget would be interpreted as a vote of no confidence in the government, but this has never occurred since democratisation. Parliamentary debate on the execution of the budget currently takes place more than one year after the end of the relevant fiscal year. This time lag might be one reason why debate is largely formalistic and attracts limited interest from members, which limits the potential for audit issues to provide pointers for parliamentary scrutiny of upcoming draft budgets. Parliament's interest might increase over time as the performance aspect of auditing is strengthened and it would appear important for the Court

to engage with parliament on the usefulness and presentation of its performance audits.

5.4. Conclusions

Romania is starting an ambitious move to accrual accounting. In the view of the team, this move should be reassessed and slowed down to a more realistic timeline and more attention should be given to basic processes and automation of the current system.

The external audit process is undergoing noteworthy improvements. The time required by the Court of Accounts to prepare the main audit report has been reduced substantially, and the Court is building its capacity for performance audit. In the medium term, it is desirable to make audit reporting even more timely, which would also require enhanced swiftness in the preparation of accounts by government.

Parliamentary engagement with audit findings is sub-optimal. This is a crucial shortcoming in the accountability process. Parliament might consider the setting up of a permanent committee to scrutinise audit findings. Such a body would be useful for conducting hearings on audit findings and to track the government's response.

6. Comments on budget transparency in Romania

In general, the transparency of the Romanian budget is fairly good. From an analysis of the system looking purely at whether Romania produces reports and has processes in place, it is perhaps better than average. Moreover, there is a positive overall trend. Romania has made large strides in making the budget more comprehensive, producing more and better data, and improving the quality assurance and accountability processes. Thus Romania has a good legal base from which to improve the transparency of the budget. The guideline items should not be viewed as equal in importance and as such Romania receives positive marks in the most important categories of, for example, budget comprehensiveness, availability of data and role of parliament. Generally, though, each area of budget transparency and the quality of the process could be improved and some new specific budget disclosures generated. Below are a few specific areas for improvement (but not an exhaustive list):

- The budget: While health and social funds are voted at the same time, they are voted on separately. Romania should continue to consolidate all funds into one budgetary document and one decision point so that all budgetary tradeoffs can be made. A column in the budget data presentation should be added to show the changes in the MTEF for what was forecast in year 2 from

Table 2. **Budget transparency in Romania according to OECD guidelines**

	Assessment	Comments
1. Budget reports		
The budget	Item substantially met.	The budget is more comprehensive than in the past, but large funds in health, social security and unemployment are voted on separately from the annual budget.
Pre-budget report		
Monthly reports	Item substantially met.	
Mid-year report		While there are monthly and quarterly execution reports, there is no comprehensive mid-year report – although some important sectors like pension and health do produce mid-year reports.
Year-end report	Item met, situation needs improvement.	Year-end report is released but not timely.
Pre-election report		
Long-term report		
2. Specific disclosures		
Economic assumptions	Item substantially met.	Quality of assumptions assured by outside factors; need to think of how forecasts are constructed in the future.
Tax expenditures	Item met, situation needs improvement.	There is some analysis on tax expenditures, but it is not comprehensive or part of the budget documents.
Financial liabilities and financial assets	Item met, situation needs improvement.	Foreseen with the implementation of accruals; in 2004, first reassessment of fixed assets in several years. There is current reporting in separate statements attached to the balance sheets.
Non-financial assets		
Employee pension obligations	Item met, situation needs improvement.	Foreseen with the implementation of accruals.
Contingent liabilities	Item met, situation needs improvement.	Governmental guarantees for domestic and external loans are presented with public debt accounts.
3. Integrity, control and accountability		
Accounting policies	Item met, situation needs improvement.	
Internal audit and control (systems responsibility)	Item met, situation needs improvement.	Internal control is effective but not efficient; internal audit is new and has not reached critical mass.
Audit	Item met, situation needs improvement.	Could be more timely with audit of year-end report; better follow-up needed; increase in performance audits.
Parliamentary scrutiny	Item met, situation needs improvement.	The budget has recently been approved in time, but the timetable for parliamentary scrutiny is tight.
Public scrutiny	Item met, situation needs improvement.	Little civil society involvement in budget process; the Economic and Social Council (CES) lends institutionalised civil society involvement.

the previous year's budget and the amount budgeted for that year accompanied by a short explanation on the deviations.

- Mid-year report: The guidelines call for a comprehensive mid-year report on the implementation of the budget which includes an updated forecast of budget outcome for the current year and if possible for the medium term. The economic assumptions underlying the budget should be reviewed and the impact of any changes on the budget disclosed.
- Year-end report: The year-end report should be prepared and audited in a more timely manner so that it can be used during the budget formulation and parliamentary stage. The year-end report should include non-financial performance data and a comparison of targets and results. The year-end report should contain a comprehensive discussion of the government's financial assets and financial liabilities, non-financial assets, employee pension obligations and contingent liabilities.
- Contingent liabilities: In a system with large external loans and loan guarantees and explicit and implicit budgetary relations with State-owned enterprises, more reporting is needed on contingent liabilities.
- Tax expenditures: Tax expenditures are functionally similar to budget expenditures and should be included in the debate on the annual budget. A short review or table of tax expenditures could be included in the documents accompanying the budget.
- The role of parliament: The current budget is transmitted to parliament on 15 October. Parliament needs more time and better resources to scrutinise the budget. The authorities could consider a more formal process early in the year to set expenditure totals.

Notes

1. Article 35 of the Law on Public Finance.
2. Article 138 of the Constitution of Romania as amended in 2003.
3. Article 37 of the Law on Public Finance.
4. OECD (2001), "OECD Best Practices for Budget Transparency", *OECD Journal on Budgeting*, Volume 1, Number 3, p. 8: "The government's draft budget should be submitted to parliament far enough in advance to allow parliament to review it properly. In no case should this be less than three months prior to the start of the fiscal year. The budget should be approved by parliament prior to the start of the fiscal year."
5. Committee reports can be accessed via the Internet site of the Chamber of Deputies: www.cdep.ro/.
6. Article 64 of the Constitution of Romania and Article 34 of the Law on Public Finance.

7. Article 17 of the Law on Public Finance.
8. Article 36 of the Law on Public Finance.
9. Guvernul României, Ministerul Finanțelor Publice, *Raport privind situația macroeconomică pentru anul 2004 și proiecția acesteia pe anii 2005-2007*.
10. Article 6 of the Law on Public Finance.
11. Jón R. Blöndal (2001), "Budgeting in Sweden", *OECD Journal on Budgeting*, Volume 1, Number 1, pp. 27-57.
12. MPF Order No. 1031/2003 establishes evaluation criteria for preventive financial control at the level of the public institutions and the procedures for their integration into managerial structures, as well as the role of the MPF in this process.
13. OECD (2001), *op. cit.*
14. See Table 2 for a comprehensive assessment of the OECD transparency guidelines for Romania.
15. See Table 1 in Jón R. Blöndal (2004), "Issues in Accrual Budgeting", *OECD Journal on Budgeting*, Volume 4, Number 1, pp. 103-119.
16. Article 18 of the Law on the Organisation and Operation of the Court of Accounts.
17. Court of Accounts, *Synthesis of the Public Report of the Romanian Court of Accounts for the Year 2002*.
18. Romania is a member of the International Organisation of Supreme Audit Institutions (INTOSAI) whose *Lima Declaration of Guidelines on Auditing Precepts* demands the functional and organisational independence of supreme audit institutions.
19. Article 56 of the Law on Public Finance.
20. Article 2 of the Law on the Organisation and Operation of the Court of Accounts.
21. Court of Audit of the Republic of Slovenia (2002), *Watching Over Public Money*, p. 13.
22. Court of Accounts, *Synthesis of the Public Report of the Romanian Court of Accounts for the Year 2002*.
23. Article 56 of the Law on Public Finance.
24. In the Czech Republic, for instance, the Budget Committee of the Chamber of Deputies has an audit sub-committee.
25. See United Kingdom National Audit Office (2001), *State Audit in the European Union*.

Budgeting in Slovenia

by

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Preface

This review of the Slovenian budget system was carried out as part of the Budget Project of the Working Party of Senior Budget Officials (SBO). The Budget Project aims to initiate and foster regional networks of Senior Budget Officials outside the OECD area. This review served as a basis for the examination of the Slovenian budget system at the first meeting of the network of Senior Budget Officials of Central and Eastern Europe, held on 10-11 November 2004 in The Hague.

A mission comprising Mr. Dirk-Jan Kraan and Mr. Joachim Wehner visited Ljubljana in September 2004 to carry out the review. During its visit the mission met with the Minister of Finance, Dr. Dusan Mramor, and with senior officials from the Ministry of Finance and two line ministries. The mission also met with the Chairman and staff of the Committee on Finance and Monetary Policy and the Commission for Budgetary and Other Public Finance Control of the National Assembly (the directly elected Chamber of the Slovenian Parliament), with the Second Deputy President and staff of the Court of Audit, with the Director of the Institute of Macro-economic Analysis and Development (IMAD), and with members of the boards of the Associations of Municipalities.

The mission would like to express its gratitude and appreciation for the warm and cordial reception by the Slovenian authorities and the frank and useful discussions with Slovenian officials. In particular the mission would like to express its thanks to Dr. Dusan Mramor, the Minister of Finance, Mr. Ciril Pucko, the Chairman of Parliament's Committee on Finance and Monetary Policy, Mrs. Zdenka Vidovic, the Second Deputy President of the Court of Audit, and Mr. Boris Sovic, the Mayor of Maribor, for the generous time they shared with the mission during its stay in Ljubljana.

Finally, the mission would like to thank Mr. Bojan Pogacar, Adviser to the Minister, Mrs. Helena Kamnar, State Secretary for the Budget, and Mrs. Irena Sodin, State Undersecretary for the Budget, for organising the mission's visit. Furthermore, the mission expresses special thanks to Miranda Groff Ferjanic, Adviser to the Minister, for her contribution to the organisation of the mission and her unsparing help and assistance during our stay in Ljubljana.

The OECD would like to thank the German Gesellschaft für Technische Zusammenarbeit (GTZ) and the German government for their financial and

personnel support of this review and their general support for the OECD Budget Project.

The views expressed in this report are those of the OECD Secretariat and should not be attributed to any organisations or individuals consulted for this review.

1. Introduction

1.1. General characteristics

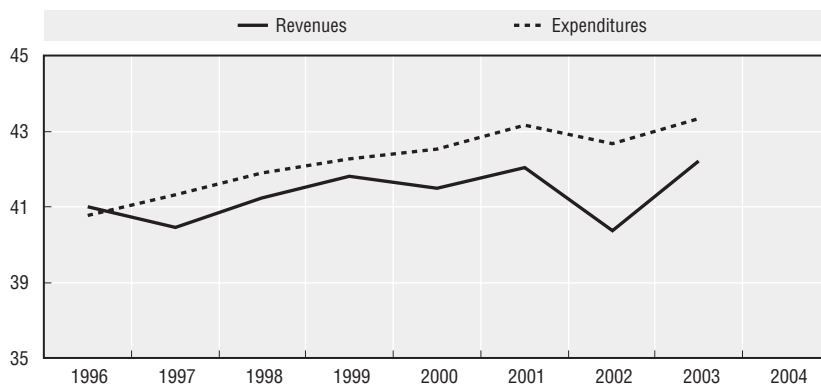
Slovenia is a young country. It came into existence as an independent State in 1991 after a short war against the Yugoslavian army. In its short history as an independent State it has experienced an amazing development. It has developed its public sector institutions almost from scratch, including its constitution, major organic laws, and working processes of the major organs of the State. At the same time, it has privatised almost its entire manufacturing, financial and wholesale sectors. This process has been very successful and was crowned by the accession of Slovenia to the European Union on 1 May 2004.

Slovenia is a relatively small country. It has about 2 million inhabitants and thus belongs with Cyprus, Estonia, Malta and Luxembourg as the countries of the European Union with less than 2 million inhabitants. Given its size, and the absence of any intermediate level of government between the central State and the municipalities, its public sector is relatively large. General government expenditure (including sub-national government) was 42.9% of GDP in 2003, but expenditure of sub-national government was only 5.0% of GDP. Abstracting from size however, Slovenia takes an intermediate position compared to OECD countries in this respect. Also this share of GDP has been fairly constant since 1996.

Public expenditure in Slovenia is firmly under control. Thanks to a well-designed budget procedure with strong institutional barriers against runaway programme expansion and overspending, deficits have remained low, even in the recent years of relatively modest real economic growth since 2000. It should be taken into account though that growth has remained relatively high in most EU accession countries during the slowdown experienced throughout the OECD area in the period 2000-03. Real gross domestic growth in Slovenia was well above the EU average in this period. Under these circumstances, the general government deficit has remained at a prudent level.

Under these circumstances the government's debt is at a more or less stable level since 1996, well below the EU average. In 2003 it stood at 26% of GDP.

Figure 1. **General government expenditures and revenues as a percentage of GDP**



Sources: Bulletin of Government Finance Year V, No. 6, June 2004. Forecast Spring Report 2004, Institute of Macro-economic Analysis and Development (IMAD).

Table 1. **Real gross domestic growth as a percentage of GDP in the previous year 2000-03 and forecast for 2004-05**

	2000	2001	2002	2003	2004	2005
EU 15	3.4	1.5	1.1	0.8	2.0	2.4
Slovenia	4.1	2.7	3.4	2.3	3.6	3.7

Sources: EU 15: Economic Commission, Economic Forecasts, April 2004; Slovenia: Spring Report 2004, Institute of Macro-economic Analysis and Development (IMAD).

Table 2. **General government deficits 2000-03 and forecast for 2004**

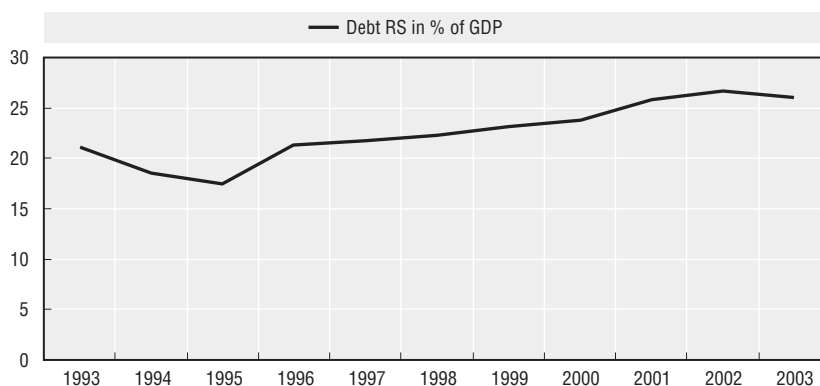
	2000	2001	2002	2003	2004
EU 15	1.0	-1.0	-2.0	-2.6	-2.3
Slovenia	-3.0	-2.7	-1.9	-1.8	-1.7

Source: Bulletin of Government Finance Year V, No. 6, June 2004.

1.2. Political environment

Slovenia has an electoral system of proportional representation. Since independence, no party has held an overall majority in Parliament, so that governing coalitions have to be formed. The present coalition¹ consists of Liberal Democracy of Slovenia (LDS) and smaller parties (the largest among them is the United List of Social Democrats). LDS was also the strongest member of the previous coalitions since 1992. Although the cabinet is

Figure 2. **General government gross financial liabilities as a percentage of GDP 1996-2003**



Source: Bulletin of Government Finance Year V, No. 6, June 2004.

primarily supported in Parliament by the coalition parties, it also includes ministers who are not members of these parties and are chosen on the basis of their expertise, such as the present minister of Finance.

The Slovenian budget process, while imbedded in the general democratic legislative institutions of the country, seems to run its course in a rather consensual political environment. Macroeconomic policy, including fiscal policy, seems to be a relatively uncontroversial area of general cabinet policy. Until the accession to the EU, the main efforts were directed at early and successful entry into the EU. Next to that, the main policy aim was to realise rapid economic growth above the EU average, in order to close the income per capita gap with the rest of the EU. Presently, as appears from the Budget Memorandum for 2004, the latter aim is still at the top of the political agenda, whereas simultaneously much attention is paid to the limitation of the macroeconomic and budgetary risks associated with EU entry.

The governing coalition, although at the end of its mandate, has a very ambitious reform agenda, which stretches far into the next parliamentary term. This agenda entails among other things the complete overhaul of the tax system, the reform of the health care system, the rationalisation of the system of social transfers and the reallocation of budgetary funds towards infrastructure investment. This reform agenda also, seems to be relatively uncontroversial, so that it will probably stay in place more or less in its present shape, regardless of whether the coalition will remain in office.

The consensual character of Slovenian fiscal policy also appears from the reasonably harmonious co-operation with the social partners and the sub-national governments. In July 2003 the government has reached an agreement

with the social partners on public sector wage policy in 2004 and 2005, leading to a restrained growth of real wages in exchange for a more equitable distribution among public sector workers and an improved supplementary collective pension insurance system, which in the short term will contribute to savings and make room for public investment. Similarly, the co-operation of the municipalities with the national development programme is based on institutionalised consultation with the two associations of municipalities.

The relatively stable political environment of the Slovenian budget process does not imply that the opposition does not bring forwards amendments to budget proposals. However, such proposals are mainly directed at concrete expenditures or fiscal measures and do not seem to embody deep ideological differences about fundamental aspects of fiscal policy, as exist in many OECD countries.

2. Budget formulation

2.1. Key characteristics of the Slovenian budgeting system

It should be mentioned at the outset that the Slovenian budget system has two special features, which differentiate it from most OECD countries:

- First, in contrast to all OECD countries, Slovenia makes budgets for two consecutive years.
- Second, the Slovenian budget has a very detailed account structure, but still maintains flexibility during execution through a unique legislative device, called the “Law on Budget Execution”.

Each of these features is briefly discussed below.

2.2. Budgets for two consecutive years

Article 13a paragraph 1 of the Public Finance Act of the Republic of Slovenia (the organic budget law) stipulates that the government shall submit to the National Assembly, together with the proposed budget for the subsequent budget year, a proposed budget for the year that follows this. This budget has to include everything that the budget of the upcoming year has to include. Paragraph 2 of the same article specifies that if the budget under the preceding paragraph is accepted, the Government shall no later than 1 October of the coming year submit to the National Assembly a proposal for budgetary changes that are necessitated by significant alterations in the assumptions of economic development or the guidelines of economic and public finances policies. This procedure comes down to annual budgeting for two consecutive years on a rolling basis. It is thus not the case that Slovenia makes a biannual budget every two years. Rather it makes two annual budgets every year.

This way of budgeting on a rolling basis does not occur in the OECD area. The Slovenian authorities see as its main advantage that it contributes to budgetary discipline. This would be the case for two reasons. First, it would rein in the tendency of line ministries to bring forward requests for budget expansion for the upcoming budget year in the annual budget negotiations. Since the budget for the upcoming year has already been decided during the previous budget cycle, only a limited set of changes can be considered. Indeed, these changes have to be motivated by macroeconomic developments or by adjustments of general fiscal policy. Since both reasons for amendment can not easily be invoked by line ministries, but rather have to be established by the cabinet and in particular the Ministry of Finance, the room for additional spending requests for the upcoming budget is narrowed down substantially, if not eliminated. Second, the procedure would contribute to budgetary discipline because line ministries would be more willing to co-operate in reform initiatives directed at rationalisation and realisation of savings, if these initiatives apply to a period that is still more than a year in the future, than if these initiatives would apply to the upcoming budget year.

Although the Slovenian system is quite unique, the reasoning behind it resembles in major respects the ideas that in a few OECD countries have inspired the so-called fixed expenditure frameworks. Particularly in Sweden and the United Kingdom, the government announces multi-year expenditure ceilings in the annual budget documents that cannot be changed from year to year, except for specific, predetermined reasons. These multi-year ceilings are confirmed from year to year on a rolling basis, with a new year added at the end of the medium-term framework each year. In the Netherlands, the government announces unalterable multi-year expenditure frameworks at the beginning of each parliamentary term for a period of four years. The idea is identical but the ceilings are not extended on a rolling basis but after expiration (once in four years).

The Slovenian procedure resembles the fixed multi-year frameworks of some OECD countries because it provides tranquillity and a medium-term orientation to the budget process: the annual upheaval characteristic for budget negotiations in many other countries is avoided and reform initiatives have a better chance when they are planned far in advance. However, the Slovenian procedure does not realise another stated advantage of multi-annual frameworks. It does not provide an automatic stabiliser, because it does not maintain expenditure ceiling regardless of macroeconomic circumstances, but on the contrary explicitly recognises the need to adjust the second year budget in the light of such circumstances.²

It appears then that the Slovenian two-year budget procedure is not a first step on the way to fixed multi-year expenditure frameworks. Apart from the fact that the Slovenian second year budget is a complete budget rather

than an expenditure ceiling,³ the Slovenian authorities seem to attach much value to a countercyclical stance in expenditure policy, that goes even further than automatic stabilisation. In this respect they refer to other EU countries that in recent years have taken a similar course, even though in some cases such policies have been hard to reconcile with the deficit ceiling of 3% of the EU Stability and Growth Pact. Slovenia, though not in the Euro zone, does want to respect the requirements of the pact, given its aim to adopt the Euro in 2007. However, in the view of the Slovenian authorities this does not preclude an active fiscal policy aimed at macroeconomic stabilisation. Indeed Slovenia has more leeway in this respect than some other EU countries, because both its structural and nominal deficits are well below the 3% ceiling.

In sum, the Slovenian two-year budget procedure is the outcome of a unique compromise between the aim to provide tranquillity and a medium-term orientation to the budget process and the need to maintain flexibility in the face of macroeconomic circumstances and new developments. In its present form the procedure is explicitly not meant as an automatic stabilisation device.

2.3. A detailed account structure

The account structure of the Slovenian budget is complex. According to the Public Finance Act the budget consists of a general part, a special part and a development programmes part. The general part applies to both direct and indirect budget users and contains the macro-budgetary totals of the central government: revenues, expenditures, liabilities and means of financing. The direct budget users are all bodies and organisations that are financed by the State budget, mainly the ministries with their administrative bodies and organisations, as well as independent bodies such as Parliament, Court of Audits and all the judicial bodies (all together more than 250). The indirect budget users are the State funds, public institutions and agencies founded by the central government (but not being financed by the State budget). The special part contains the financial plans of the direct budget users. The general and special part of the budget contains estimates for the budget year as well as estimated outcomes for the two preceding years (Article 10 paragraph 5 of the Public Finance Act).⁴ The development programmes part contains the planned annual expenditures for investments and State aid of direct budget users in the subsequent four years (including the budget year), as required by the long-term development planning documents, special laws or other regulations. It is the responsibility of the budget users to see to it that their long-term development plans are adjusted in accordance with the development programmes part of the budget.

It follows from this set-up that the budget year slice of the expenditures of the direct budget users that figure in the development programmes part of

the budget (mostly capital expenditures), are shown twice: once in the special part and once in the development programmes part. The financial plans of the indirect budget users and of the Health Insurance Institute of Slovenia (the health insurance fund) and the Retirement and Disability Pension Insurance Institute of Slovenia (the social insurance fund) are not part of the budget, but have to be submitted to the National Assembly together with the budget (and the Budget Memorandum). Both the budget and the financial plans of the indirect budget users and health and social insurance funds show estimates for the budget year but not for subsequent years. Multi-year estimates only figure in the development programmes of the direct budget users for a limited group of expenditures (capital expenditures, State aid, grants, projects financed through EU structural funds).⁵

The special part of the budget consists in the financial plans of the direct spending units and is divided into:

- budget expenditure areas;
- main programmes;
- sub-programmes;
- budget items;
- account sub-groups;
- accounts.

The subdivisions at the first three levels are mainly programme oriented. The subdivision at the account sub-groups level is based on the economic classification (salaries, goods and services, transfers, subsidies, etc.). In total there are some 9 000 budget lines at the lowest level of aggregation (accounts). The Slovenian authorities explain the detailed account structure of the budget by the necessity to hold a firm grip on spending and by the fact that Slovenia did not want to give up input control while moving towards a more output-oriented budget (the present account structure appears a cross table of an input and output classification).

The detailed account structure of the special part of the budget makes it necessary to provide for special procedures to allow reallocation during budget execution in order to cope with new developments. These procedures make it possible to shift expenditures between accounts without formally changing the budget through supplementary legislation. The rules and constraints for these reallocations are laid down in the “Law on Budget Execution”. This is a law which is submitted annually to the National Assembly together with the budget (more below). The budget itself is not a law but it has special status and is obligatory.

2.4. Annual budget process

In Slovenia the annual procedure for budget formulation is prescribed in an executive decree, namely the Decree on the Bases and Procedures for Preparation of the Proposed National Budget. It prescribes among other things: the time schedules and procedures for the preparation of the economic forecasts, the Budget Memorandum, the budget including the financial plans and development programmes of the line ministries and the indirect budget users and the budget amendments.

The budget year in Slovenia coincides with the calendar year.

Annual budget formulation starts with the release of the spring economic forecasts, which is due by 15 April. According to the abovementioned decree it should take account of the statistical data on the development of gross domestic product in the final quarter of the previous year, but in fact it also takes into account the statistical data of the first quarter of the current year. The forecasts should include estimates of macroeconomic aggregates for the current year and the following two years and the scenario for the next three years. It should also include an assessment of the principal risks for their realisation and a conservative assessment of the possible consequences of these risks. The economic forecasts are made by the IMAD, which is a semi-independent economic forecast bureau, modelled after the Swedish Konjunkturinstitutet and the Dutch Central Planning Bureau (see Box 2).

The Ministry of Finance is responsible for the revenue forecasts that are used in the budget. The Ministry of Finance has a staff of around 500 of which about 40 in the Budget Department. A systematic approach to revenue forecasting started in 2003. The forecasting division of the Budget Directorate uses basically the IMAD numbers for the development of domestic production but it may also look at the forecasts of other macroeconomic forecasting institutes, such as the Bank of Slovenia and the Economic Institute of the University of Ljubljana. The forecasting division claims to put up conservative estimates but there is no explicit use of a prudence factor, such as practiced by certain OECD countries (for instance, Canada and the Netherlands). The revenue forecasts have to be prepared within two weeks after the IMAD numbers have become available. Projections are made for both actual revenues and cyclically adjusted revenues. Trend estimation is complicated by the fact that only 11 reliable observations (of previous years) are available. The division also makes long-term forecasts for the next fifty years.

The revenue forecasts are used to draft the Budget Memorandum. This document has to be tabled at the First Budget Session of the Government, which has to begin by 15 May. The Budget Memorandum includes the overall nominal expenditure framework of general government (including health and social insurance and sub-national government). The framework states the

Box 1. Budget formulation timetable

April	The Institute of Macro-economic Analysis and Development (IMAD) releases the spring economic forecasts.
April-May	Preliminary discussions between Ministry of Finance and line ministries about priorities in new budget year (the year after the upcoming budget year) and amendment of the budget for the upcoming year.
May	The Prime Minister, Minister of Finance and Director of IMAD present the draft Budget Memorandum in the First Budget Session of the Government. The cabinet decides about overall nominal expenditure framework for the new budget year (including target numbers for the deficit or surplus) and guidelines for supplementing the draft Budget Memorandum (including national priorities for the budget period).
May-June	Meetings between Ministry of Finance and line ministries about the distribution of expenditures by budget user, budget expenditure areas (24) and main programmes (95) for the new budget year and amendment of the budget for the upcoming year.
June	On a proposal of the Minister of Finance, the cabinet decides in the Second Budget Session of the Government about the distribution of expenditures by budget user, budget expenditure areas (24) and main programmes (95) for the new budget year and amendment of the budget for the upcoming year. Within ten days after the end of the Second Budget Session, the Ministry of Finance sends a circular to the budget users about the preparation of the financial plans and development programmes.
June-August	Submission of financial plans and development programmes by line ministries to the Ministry of Finance.
September	The Minister of Finance submits the budget for the new budget year, the Budget Memorandum and proposed amendments of the budget for the upcoming year to the cabinet.
September	The Government submits the budget for the new budget year, the Budget Memorandum and proposed amendments of the budget for the upcoming year to the National Assembly.

Box 2. The Institute of Macro-economic Analysis and Development (IMAD)

IMAD is a semi-independent institute belonging to the government. It employs approximately 60 economists. It is responsible for the spring and autumn economic forecasts. Its director is responsible, together with the Prime Minister and the Minister of Finance, for the formulation of the draft Budget Memorandum, including the expenditure framework that is decided in the First Budget Session of the Government, and takes part in the cabinet discussion at that occasion. The IMAD also publishes economic studies on specific projects and government programmes. It also plays an important role in the development of the Economic Development Strategy of Slovenia and is responsible for the annual Development Report that monitors the progress of the Economic Development Strategy of Slovenia. IMAD also advises about many other long-term development plans for agencies and institutions in Slovenia. IMAD seeks to give advice that is based on the best available economic expertise and that is strictly objective without any political bias.

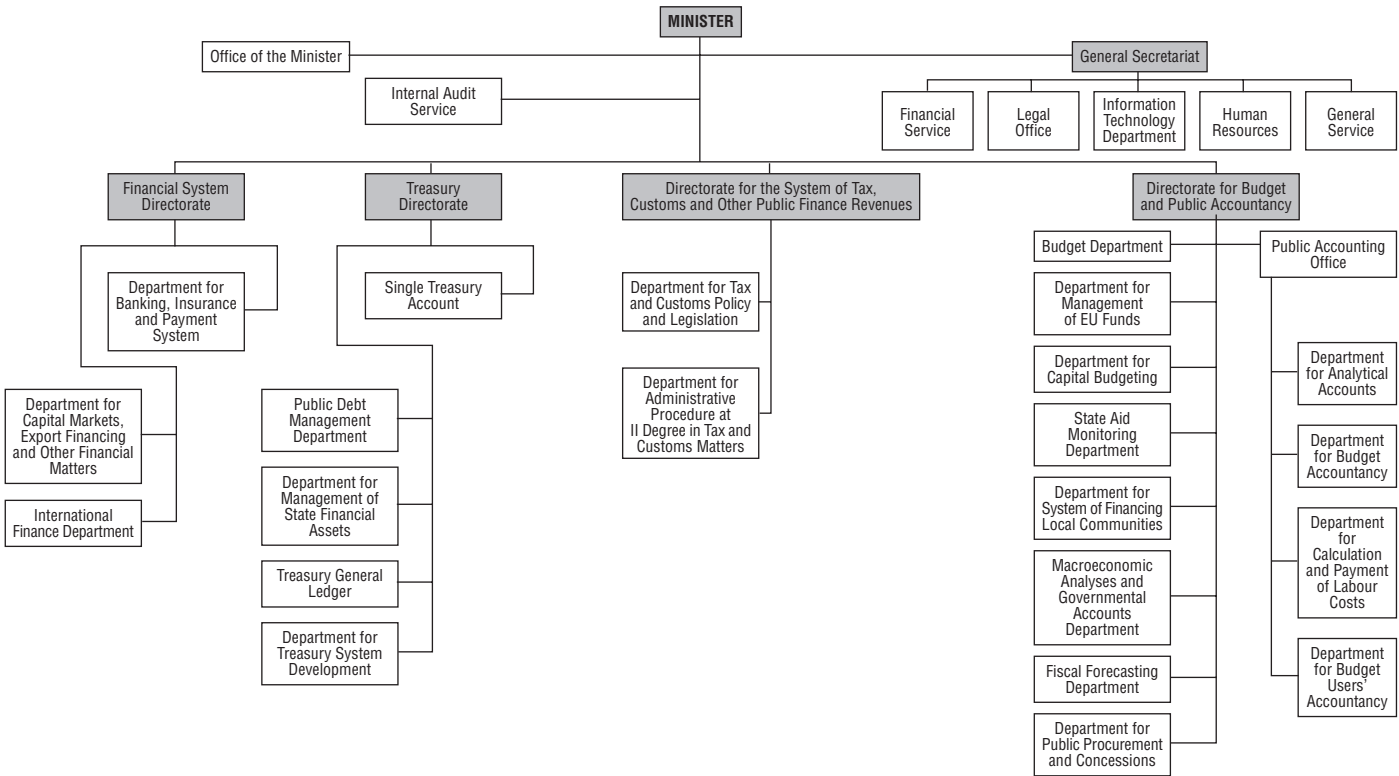
consolidated totals of expenditures and revenues by economic classification and the target amounts of the deficit or surplus for the following four years as well as the target level of the national debt for this period. The Budget Memorandum is drafted under the responsibility of the Prime Minister, the Minister of Finance and the Director of IMAD.

The expenditure framework included in the Budget Memorandum can be seen as a flexible multi-year expenditure framework as employed by most OECD countries. It can be adjusted from year to year on a rolling basis in the light of economic circumstances and new developments.

The Budget Department is responsible for expenditure forecasting, which is done on the basis of macroeconomic forecasts produced by IMAD and through preliminary collection of data from line ministries. These data have to take into account all legislation in force and envisaged legislation which has financial consequences. So the period up to 15 May is also used for discussions between the Ministry of Finance and the line ministries about their future plans. All the proposals of line ministries have to be transmitted to the Ministry of Finance and will be reflected in the draft Budget Memorandum in so far as they are approved by the Ministry of Finance and can be accommodated within the overall expenditure framework.

In the First Budget Session of the Government the cabinet discusses the draft Budget Memorandum. Apart from the overall expenditure framework, the Budget Memorandum contains the national development priorities and

Figure 3. The structure of the Ministry of Finance



Box 3. Long-term planning documents

The Decree on the Bases and Procedures for Preparation of a Proposed National Budget designates the Economic Development Strategy of Slovenia and other long-term development planning documents, together with the Budget Memorandum, as the strategic framework for the preparation of the annual budget.

The Economic Development Strategy of Slovenia contains long-term objectives and the target development scenario as well as basic operational policies in the separate areas of State activity. The strategy is described as a “comprehensive indicative document which takes account of social, spatial, environmental, regional, sectoral and other potentials, limitations and conditions”. The strategy is adopted and updated by the government on the proposal of the director of IMAD. The implementation of the strategy is monitored by annual development reports of IMAD to be released in February.

Apart from the Economic Development Strategy of Slovenia, there are a number of other long-term planning and development programmes in use: the Development Programme of the Republic of Slovenia, regional development programmes, other development programmes, spatial plans, the pre-accession economic programme and the Single Programming Document. The relationships between these documents and their relevance for fiscal policy are not always clear. A certain streamlining of long-term planning procedures could contribute to transparency.

the overall distribution of expenditures (estimates) for budget expenditure areas (24) and main programmes (95) for the next four years. This implies that the Cabinet determines the nominal expenditure ceilings and the deficit or surplus for the following four years as well as the priorities for the budget period.

After consideration of the Draft Budget Memorandum, the cabinet issues guidelines for “supplementing” (elaborating and adjusting) the Draft Budget Memorandum. This leaves some room for subsequent negotiations with ministries and budget users within the constraints of the overall expenditure framework.

Immediately after the First Budget Session of the Government the Ministry of Finance meets again with the line ministries in order to reach agreement about the estimates to be included in the budget. These meetings focus on the 24 budget expenditure areas and 95 main programme areas distinguished in the budget memorandum, as well as on the total amounts for budget users. This is the main period of budget negotiations.

Apart from the new budget (which is the year after the upcoming budget year), the discussions with the line ministries may also involve the required amendments for the upcoming budget (which has already been adopted by Parliament in the preceding year). Here the constraints are even narrower than for the new budget. Whereas the constraint for the new budget is primarily the overall expenditure framework adopted in the First Budget Session, the constraint for amendment of the budget for the upcoming year consists in the restricted criteria for amendment. These criteria are:⁶

- substantive changes in the economic development assumptions;
- changes in the guidelines of economic and public finance policy;
- substantial deviation of the assessed implementation of the current budget from the adopted budget (for the upcoming year).

These criteria imply that room for amendment only exists if and insofar as the cabinet has established such room.

The Second Budget Session of the Government has to begin by 15 June. At this session the cabinet decides about the distribution of expenditures (limits/ceilings) by budget user, budget expenditure area and main programme. The cabinet has to make this decision in the light of the national development priorities established in the First Budget Session. Furthermore the cabinet has to respect the overall expenditure framework established in the First Budget Session, so that as a general rule an increase in expenditures for a specific main programme requires a reduction of expenditures in other main programmes. In practice however, limited adjustments of the overall expenditure framework have occurred. The cabinet may also decide about amendment of the already adopted budget for the upcoming year.

After the Second Budget Session of the Government the Ministry of Finance will issue a circular prescribing the procedures and dates for preparation of the budget. The circular includes⁷ the agreed estimates by budget user, budget expenditure area and main programme and instructions and deadlines for the preparations of financial plans and plans of development programmes of budget users.

Financial plans have to contain the expenditure estimates up to the account (line item) level, categorised according to the economic and programme classifications. They have to take into account the distribution of expenditures by budget user, budget expenditure area and main programme as decided in the Second Budget Session of the Government.

Explanations of financial plans have to include:⁸

- a summary of the long-term objectives of the main programmes and sub-programmes of each expenditure area;

Box 4. **Budget formulation in the line ministries**

Line ministries prepare their budgets in three phases. The first focuses on the preliminary discussions with the Ministry of Finance. In these discussions, they present their overall priorities for the coming years. These include major initiatives for the reform of substantive laws and the budgetary consequences of these reforms. In the second stage, after the First Budget Session of the Government, the line ministries discuss with the Ministry of Finance the concrete expenditure estimates on the level of budget users and main programmes. This may concern the new budget, but also amendments to the budget for the upcoming year, already adopted in the preceding year. Finally, in the third stage, after the Second Budget Session of the Government, the line ministries prepare their financial plans and plans of development programmes on the line item level. Financial plans and plans of development programmes have to be consistent with the budget preparation circular of the Ministry of Finance. Financial plans of indirect budget users resorting under the ministry have to be discussed and agreed with the representatives of this funds, public institutions and agencies.

Financial plans are prepared by the financial division of ministries, but large agencies or divisions within a ministry and indirect budget users have their own financial divisions.

Since 2003, financial plans are communicated to the Ministry of Finance through the new SAPPrA software. After some initial difficulties, the software was improved and now provides a useful tool. The summer and autumn is also used to prepare the new substantive legislation, which is assumed in the budget. Sometimes this legislation has to be negotiated with the social partners in the Economic and Social Council. Other substantive legislation may require negotiations with representatives of executive establishments (hospitals, educational establishments, etc.).

- a review of the projects, activities and investment projects undertaken to reach the long-term objectives;
- physical, financial and descriptive indicators used to measure the realisation of the objectives;
- a report on the results achieved in the first part of the current budget year.

The government has to submit the Budget Memorandum and the proposed budget before 30 September to the National Assembly. However, this year (2004) no budget and Budget Memorandum have been submitted in view of the elections for the National Assembly that will take place in

October 2004 (there is already an approved budget for 2005). It is up to the new cabinet to submit a budget at a later date.

Within fourteen days after the publication of statistical data about the development of GDP in the second quarter of the current year or by 15 October at the latest, IMAD has to release the autumn economic forecast. The forecast should include estimates of macroeconomic aggregates for the current year and the following two years and the scenario for the next three years, as well as a risk assessment. The consequences of the autumn economic forecast should be taken into account in the formulation of the supplemental proposed budget during the parliamentary stage of the budget process (see Section 3).

2.5. Conclusions

Public expenditures and the general government deficit in Slovenia are firmly under control. This is mainly due to a two-stage budget formulation process in which an overall expenditure framework is established by the cabinet before the start of negotiations with line ministries. This amounts to an effective top-down steering mechanism which keeps expenditures in check and at the same time provides for sufficient flexibility to accommodate new priorities.

The Slovenian budget procedure has the unique characteristic that it requires the annual formulation of budgets for two consecutive years. This procedure provides tranquillity and a medium-term orientation to the budget process. In this respect it resembles somewhat the fixed medium-term frameworks that are in use in certain OECD countries. On the other hand it is explicitly not aimed at automatic stabilisation. The Slovenian authorities may consider limiting decision-making about the second year budget to expenditure ceilings for general government and a limited number of sub-sectors. This would remove the necessity to amend the second year budget at the line item level during the subsequent budget cycle and still maintain the tranquillity and medium-term orientation to the budget process. The Slovenian authorities may also consider whether they want to maintain their active anti-cyclical stance in expenditure policy rather than opting for a more acyclical stance as results from a fixed expenditure framework.

The aggregate levels of the budget classification provide a transparent picture of the spending programmes of the government and facilitate the decision making process during budget formulation. The input oriented line items guarantee at the same time that the cabinet and ministers hold a firm grip on spending. Nevertheless the Slovenian authorities may consider whether it is necessary for that purpose to maintain the present level of detail in the account structure. It seems possible to simplify the account structure substantially without losing control on spending on inputs.

It would be useful to integrate multi-year estimates at the line item level in the budget, rather than having them only on the more aggregate levels in the Budget Memorandum. This would contribute to the transparency of the budget documents but supposes a certain simplification of the account structure at the line item level.

The Institute of Macro-economic Analysis and Development is an excellent centre of economic expertise that belongs to the top-class of forecasting institutes in the world. It provides objective information of high quality to the budgetary authorities and ensures that the Slovenian budget is realistic and supportive of the economic development of the country.

The Slovenian Ministry of Finance may consider including an explicit prudence factor in its revenue forecasts.

The Slovenian authorities may consider the further consolidation of the budget. In particular it may contribute to transparency and to the effectiveness of the budget process to integrate the financial plans of the State funds, public institutions and agencies at the central level outside the State budget into the central government budget.

The Slovenian authorities may consider a certain streamlining of the arsenal of long-term planning documents that is presently in use. Some of these documents do not seem to be very effective.

3. Legislative approval

3.1. Budgetary powers and legal framework

The Public Finance Act requires the Government to table the draft budget in the National Assembly by 1 October preceding the commencement of the relevant fiscal year (Article 27). In accordance with the Act, the government also supplies a set of budget documents to the National Assembly (Article 13). These include the Budget Memorandum, the proposed central government budget, information on proposed planned sales of central government assets, financial plans for the health fund as well as the pension and disability fund, and the bill on budget execution. In the first few years after independence, the National Assembly formally adopted the Budget Memorandum, but this contributed to long delays and delayed approval of the budget. Under the current system the Budget Memorandum is no longer approved, although parliamentarians may still engage in commentary on its contents.

According to the Public Finance Act, the National Assembly is “obliged” to adopt the budget ahead of the start of the relevant fiscal year (section 29). However, should the budget not be approved in time for the beginning of the fiscal year, the Constitution (Article 148) and the Act (Article 32) allow interim spending in line with the previously approved budget. According to the Public

Box 5. The Slovenian Parliament

Slovenia has a bicameral Parliament consisting of the National Assembly (*Državni Zbor*) and the National Council (*Državni Svet*). The National Assembly is composed of 90 deputies elected by popular vote for four-year terms. In the 2000 elections, 40 deputies were directly elected and 50 were selected on a proportional basis. The ratio of directly elected and proportionally determined seats varies with each election. One deputy each is always elected from the Italian and Hungarian ethnic communities. The National Assembly appoints the Prime Minister. The Cabinet or Council of Ministers is nominated by the Prime Minister and elected by the National Assembly. The National Assembly is the pre-eminent chamber in budgetary and other legislative matters.

The National Council is primarily an advisory body based on corporatist principles. It has 40 members who represent social, economic, professional and local interests. Members are indirectly elected to five-year terms by an electoral college. The National Council may, within seven days of the passing of a law and prior to its promulgation, require the National Assembly to decide again on such a law. In deciding again, a majority of all deputies must vote for such a law to be passed unless the Constitution envisages a higher majority for the passing of the law under consideration. Such a new decision by the National Assembly is final. This procedure can in theory be applied to the Law on Budget Execution, but in practice this does not occur.

Sources: Constitution of the Republic of Slovenia; World Fact Book 2004.

Finance Act, such temporary financing is initially limited to a three-month period, which may be extended by the National Assembly on the proposal of the Government (Article 33). During the 1990s, the adoption of the budget was frequently delayed but in recent years approval has been timely.⁹

The powers of the National Assembly to amend the budget are restricted and disallow an increase in the deficit proposed by the Government. The Public Finance Act prohibits amendments to increase expenditures without offsetting increases in revenues or expenditure cuts elsewhere in the budget. Moreover, the act specifically disallows the financing of expenditure increases through cuts in the budget reserves (Article 30).

3.2. Parliamentary process

The Rules of Procedure of the National Assembly have been recently reformed and establish a strict timetable for the consideration of the budget (Rules 155-165). Following the presentation of the draft budget by the Minister

of Finance, it is referred without debate to the committees of the Parliament. For the 2000-2004 parliamentary term, the National Assembly appointed ten standing committees that generally correspond with individual ministries or cover inter-related areas. The various parliamentary committees have ten days to formulate proposals for amendments, but only to the relevant parts of the budget that fall within their jurisdiction. During the committee stage some spending ministers might attempt to convince Parliament to increase their budgets, although chances are small that they will succeed. Amendment proposals have to be tabled in writing and include a statement providing reasons for suggested changes. Although the Government is formally not allowed to table amendments during this process, sympathetic Members of Parliament might be co-opted to sponsor amendments.

Following the ten-day consideration period for sectoral committees, the Committee on Finance and Monetary Policy exercises a co-coordinating function. This committee has an additional five days to deliberate on and co-ordinate various amendment proposals. The finance committee consists of 19 members and is chaired by a member of the governing coalition. It has limited logistical backup. No specialised budget analysts are attached to the legislature, and the finance committee is served by only two staff members, a secretary and a consultant. The latter is not a budget expert, however, because the consultant also has to service the committee's wider remit that includes subjects such as banking and monetary affairs. Based on the committee's review of the budget and various amendment proposals, it prepares a report to the President of the National Assembly.

Thirty days after the tabling of the initial draft budget, the Government reacts to the report of the finance committee and tables a second budget proposal that responds to the amendments put forward by members. At this point, the Government will have to highlight which amendments it does not accept, and provide reasons for any objections. Different amendment rules apply during this second round of parliamentary considerations. Since the reform of the Rules of Procedure of the National Assembly in 2001, only the relevant committee, one quarter of Members of Parliament and party groups can propose amendments during this stage. Any amendments are voted on during a plenary session that follows within 15 days after the tabling of the Government's second budget proposal.

At the end of the plenary session, if there are doubts whether the budget is in balance, the finance committee and the Government are requested to submit an opinion. If the budget is not in balance, *i.e.* should there be a mismatch between revenue and expenditure totals, the Rules of Procedure of the National Assembly outline a separate procedure whereby the Government and the finance committee would work towards establishing a balance

(Rule 163). Should the budget not be approved, the Government must submit a new budget within a time period set by the National Assembly.

In particular during the first year of a new Parliament, members are eager to demonstrate activism and up to about 400 amendment proposals may be generated. As about one third of Members of Parliament are at the same time mayors of local authorities, the amendment process is seen as an opportunity for the mayors to direct spending, in particular investment spending, towards their constituencies. At the end of the process, however, only about five to ten of all proposed amendments are typically adopted. Members of the governing coalition are more likely to table successful amendments, and they may be able to exert more subtle influence on spending priorities. In practice, the Government is usually requested to support members in identifying a relevant source for financing the cost of increases in expenditure. Although Parliament has in theory more autonomy in drafting estimates to cover the cost of the parliamentary administration, even this part of the budget is not generally accepted by Government without negotiating changes. Therefore, the overall budgetary impact of Parliament is small. At the same time, the parliamentary process appears to generate public debate on the budget. Deliberations in the plenary as well as the committees are open to the public and the media covers proceedings.

The budget is given a formal statutory basis with Parliament's approval of the Law on Budget Execution. The Act differs from budget or appropriation acts used in many other countries in that it is mainly concerned with setting extensive and detailed parameters for the execution of the budget. It establishes a wide range of mechanisms and procedures which allow the executive to adjust spending in-year without recourse to Parliament (to be treated in the next section). Flexibility in budget execution is complemented with extensive in-year reporting from the Ministry of Finance including monthly budget implementation updates as well as a mid-year report. The parliamentary finance committee considers the mid-year report.

Parliament also has a role in deciding significant changes to approved budgets. Typically, the approved budget for the second year of the two-year period has to be amended to take account of economic developments or policy changes. For this purpose, the Public Finance Act (Article 13a) requires the Government to submit its proposed amendments by 1 October of the year preceding the implementation of the approved budget for the second year. This need not be the case, however. In 2004 the Government refrained from tabling any amendments to the second year budget ahead of the elections. Officials in the Ministry of Finance pointed out that in this way the two-year budget process pre-empts an electoral budget cycle effect with negative implications for fiscal prudence.

3.3. Conclusions

The parliamentary stage is unusual in that the Government has two opportunities to table a draft budget proposal. The more typical procedure would involve one executive budget proposal, but allow the Government to convey its point of view on specific amendment proposals either during the finance committee or plenary stages. The Slovenian process might seem convoluted to the outside observer, but it appears to work in this context, at least during times when the Government commands the support of a stable parliamentary majority. Nonetheless, there appears to be scope for rationalising the parliamentary process by cutting out the revised budget proposal stage and instead extend the review process in the finance committee.

In Slovenia, the use of parliamentary committees for budget scrutiny is paired with a strong co-ordinating function of the finance committee. This allows broad-based review while maintaining fiscal discipline. However, the overall timeframe for parliamentary scrutiny of the draft budget is short and amounts in total to a 45-day process under normal circumstances, whereas the OECD Best Practices for Budget Transparency envisage a minimum of three months.¹⁰

Parliamentary oversight and the quality of deliberation might also be strengthened if a formal pre-budget statement¹¹ was released several months in advance of the tabling of the draft budget. This would allow Parliament time to discuss the overall contours of budget policy, whereas the current focus appears to be mainly on small details that relate to particular constituency interests.

4. Budget execution and service delivery

4.1. Reallocation during budget execution

The Slovenian budget procedure provides for various possibilities to reallocate expenditures during budget implementation and to deviate from the budget approved by the legislature. These possibilities can be subsumed under two headings, namely adjustments to control the deficit and adjustments to accommodate new developments. The basic principles of both kinds of adjustment are laid down in the Public Finance Act. The specification of the ways these principles will be applied in each particular budget year can be found in the annual Law on Budget Execution.

Article 40 of the Public Finance Act makes it possible to suspend temporarily the implementation of the budget due to the occurrence of new commitments or changed economic circumstances. In this case the cabinet may decide on the proposal of the minister of Finance to halt the incurrence of commitments, to propose the extension of contractual terms of payment or

to halt the (re)allocation of budget appropriations necessary to incur commitments. The cabinet may also decide that prior consent of the Ministry of Finance is required to incur commitments. These measures should be reported to the National Assembly.

The same article of the Public Finance Act prescribes that the Government is obliged to propose a revised budget to the National Assembly if it should be impossible to balance the budget by the measures concerning the temporary suspension of implementation.

Article 8 of the Law on Budget Execution 2004-2005 (LBE 04-05) stipulates that if the cabinet concludes that, due to deteriorating economic trends as stated in the Spring Economic Forecast, the revenues will be below the planned level of the budget 2004 by more than 10 billion Slovenian tollar¹² (EUR 44 million) and by less than 25 billion Slovenian tollar (EUR 110 million), the government must apply the measure of a proportionate reduction of appropriations, in addition to applying the (other) measures of Article 40 of the Public Finance Act. This measure shall be applied to the amount of 15 billion tollar (EUR 66 million) with the remainder being provided by additional borrowing. However, the material and equipment of the army is excepted from this measure.

As far as new developments are concerned, the Public Finance Act makes it possible to reallocate appropriations, without legislative approval, under conditions stated in the annual Law on Budget Execution (Article 38). Reallocations should be reported every six months to the National Assembly. Such reallocations may be discretionary, as decided by the budgetary authorities, and mandatory, as prescribed by the Public Finance Act or the Law on Budget Execution.

In 2004-2005, discretionary reallocations can be decided by budget users, the cabinet or the Minister of Finance (Article 14-17, LBE 04-05). A direct budget user may independently reallocate budgetary appropriations within the same sub-programme in his financial plan, except that he may not reduce appropriations for co-financing of EU projects or financed by earmarked EU funds. All ministers and indirect budget users may independently reallocate budgetary appropriations within a main programme, without however restricting reallocation by direct budget users within sub-programmes, while reallocation between sub-programmes may not lead to a reduction or increase of the appropriation of each individual sub-programme of more than 15% compared to the adopted budget. Again appropriations for co-financing of EU projects or financed by earmarked EU funds may not be reduced. The cabinet may reallocate budgetary appropriations between main programmes and expenditure areas, without however restricting reallocation by budget users within main programmes and sub-programmes, while

reallocation between main programmes may not lead to the reduction or increase of the appropriation for each individual main programme of more than 5% compared to the adopted budget and reallocation between expenditure areas may not lead to the reduction or increase of the appropriation of each individual expenditure area of more than 3% compared to the adopted budget. The cabinet may also reallocate appropriations for co-financing of EU projects or financed by earmarked EU funds. The Minister of Finance may independently reallocate appropriations within the financial plan of the Ministry of Finance and its bodies required for discharging liabilities concerning public debt servicing. The Minister of Finance may also charge direct budget users for the interest costs of short-term borrowing incurred because of failure of the direct budget user to inform the Ministry of Finance within the prescribed term of amendments to the liquidity plan of the direct budget user (see Section 4.2).

Mandatory reallocations have to be made in the following cases. Liabilities concerning pension security (social insurance), public debt servicing and contributions to the EU and projects financed by earmarked EU funds, which exceed the appropriations for these purposes, have to be paid (after cabinet approval). These expenditures have to be financed by revenues higher than planned or additional borrowing, except projects financed by earmarked EU funds which will be financed by additional earmarked revenue (Article 9, LBE 04-05). Furthermore all (other) appropriations financed by earmarked revenues and one-off receipts, have to be increased by the amount of the actual revenues (PFA Article 43, paragraph 2). Earmarked revenues and receipts are enumerated exhaustively in the Law on Budget Execution (Articles 11 and 12, LBE 04-05).

Unexpected developments can also lead to mandatory or semi-mandatory reallocations financed by the general budget reserve and the budget reserve. The general budget reserve shall not exceed 2% of total revenue. This reserve is to be used for unplanned purposes for which no appropriations are made or for purposes for which it may become obvious during the year that insufficient appropriations have been made since they could not be planned in advance (PFA Article 42). One can think, for instance, of overspending on entitlements. The budget reserve shall not exceed 1.5% of total revenue. This reserve is to be used to finance expenditures covering the elimination of the consequences of emergency situations such as earthquake, floods, landslide, snowslide, snowdrift, hurricane, hail, sleet, frost, drought, mass outbreak of contagious human, animal or vegetal disease and other natural or ecological disasters (PFA Article 46). The use of the budget reserve fund can be decided by cabinet on the proposal of the minister of Finance up to the level of 2% of the fund and by the National Assembly for higher levels.

A special form of reallocation concerns the transfers of appropriations to the next budget year. All appropriations for co-financing EU projects shall be transferred at the end of the current budget year to the next budget year in order to complete a project (Article 13, LBE 04-05). Furthermore all appropriations financed by earmarked revenues, including earmarked EU funds, excluding the revenues earned by direct budget users through own activities, shall be carried over the next budget year (PFA Article 44).

In sum, the Law on Budget Execution 2004-2005, in connection with the Public Finance Act, provides the cabinet, the budget users and the Minister of Finance with a considerable arsenal of legal instruments to change the budget adopted by the National Assembly in the course of its execution. All of these changes have to be reported to the National Assembly, but most of them do not have to be approved by it through supplementary legislation.

4.2. Cash and debt management

In 2002 Slovenia introduced a Treasury Single Account (TSA) with the Bank of Slovenia that has led to the centralisation of the accounts of all budget users, the payments of all budget users and the liquidity management of all budget users.

The analysis made by the Treasury before the introduction of the TSA showed that average cash balances on general government accounts – where cash was held on non-interest earning sight deposits with commercial banks – exceeded 30 billion Slovenian tollars (EUR 130 million). An additional 90 billion Slovenian tollars (EUR 390 million) were placed in time deposits with commercial banks earning different rates of interest. These funds were independently managed by roughly 3 000 legal entities in the public sector. For the majority of these entities, the amounts were not significant enough to implement effective cash management.

With the introduction of the TSA, legal entities that were formerly managing their own cash lost their liquidity management independence. All their liquidity surpluses must be deposited in a special treasury sub-account at the Bank of Slovenia, managed by the Treasury. The Treasury also manages all funds left in sub-accounts of budget users (so-called sight accounts). The TSA consists of roughly 100 sub-accounts of direct budget users, 50 sub-accounts of the Pension Fund (social insurance), 30 sub-accounts of the Health Fund (health insurance), 70 other sub-accounts and the Treasury sub-account.

Centralisation of liquidity management implies that the Treasury manages both temporary surpluses and shortages of liquidity on separate sub-accounts. After the introduction of the TSA commercial banks have relations only with the Treasury (not with individual legal entities in the public sector). Because of this arrangement the Treasury can use its power (the size of its

Box 6. Systems of cash management

There are basically three models of cash management in central governments.

In the decentralised model (in place in Slovenia before the introduction of the Single Treasury Account), all budget users have their own account with the commercial banks. These accounts are funded by periodical cash advances supplied by the Treasury on the basis of cash flow estimates. Budget users make payment orders by drawing on their own accounts.

In the centralised model (now in place in Slovenia), budget users are not allowed to have their own accounts with commercial banks. There is only a single account usually kept at the central bank, which resorts under the Treasury. Since the Treasury is not allowed to borrow from the central bank, the Treasury handles borrowing by auctioning among the commercial banks. All budget users have to send payment orders to the Treasury in order to draw upon their sub-accounts.

In the hybrid model, budget users are allowed to have their own bank accounts with a single commercial bank, but the positive balances on these accounts are daily transferred to the Treasury account with the central bank and daily supplied with cash advances. The contract with the commercial bank is auctioned. Similarly, short-term borrowing is centralised at the Treasury. Budget users make payments by drawing on their own account with the commercial bank.

Both the centralised and the hybrid model realise efficiency gains through consolidation of *saldi* and centralisation of short-term borrowing at the Treasury.

funds) to negotiate better conditions for its surpluses or liquidity borrowing with commercial banks than separate legal entities could do. The Treasury can also use its extensive knowledge about market conditions.

The Treasury has organised its activities in two departments: the budget liquidity management department and the TSA liquidity management department. The first department handles the sub-accounts of the direct budget users. The second handles the TSA as a whole and is responsible for short-term deposits and loans with the commercial banks.

Budget liquidity management is divided in two key phases:

- planning and monitoring cash flows;
- managing budget liquidity.

Planning and monitoring cash flows is mainly a forecasting exercise but there is also some room for discretion. In general the Slovenian Treasury sees as the main objectives of planning and monitoring that the initial budget policy targets, especially the deficit or surplus target, are ensured and that the expenditures are smoothly financed as to minimise costs.

For the purpose of planning and monitoring cash flows, the Slovenian Treasury makes use of various cash flow planning and monitoring documents. As far as planning is concerned the starting point is the annual budget, based on the economic classification, which is broken down in monthly amounts. It is prepared after the budget has been approved by Parliament. Next an annual cash flow document is prepared on a monthly basis. It serves as a basis for the annual financing and debt management programme. During the budget year, monthly cash flow planning documents are prepared to find out temporary liquidity surpluses and shortfalls. Finally there are cash flow planning documents for a day or the next few days. As far as monitoring is concerned, cash flow documents are prepared for the rest of the year, for the rest of the month and for the past part of the year or the month. The latter documents provide a link to the accounting system (see next section). Planning documents are permanently updated in few of monitoring results. When deviations between the actual and forecasted situation analysed, questions such as: “Can deviations be explained?” and “Can they happen again?” have to be answered.

Cash flow documents have to distinguish between flows in domestic and foreign currency. In Slovenia the central bank handles external payment orders and also management of foreign currency.

If events unfold differently from expected, the room for discretion has to be used in an optimal way. Options include exploring of ways to speed up tax collection and the cutting or delaying of non-priority expenditures.

To create good quality cash flow planning documents, the Treasury makes use of historical information and past experience. Fixed payment dates are a reliable source of information. However, there are also factors such as irregular capital expenditure patterns and variation in timing that have to be considered. Uncertainty is reduced and room for discretion is used by a system of quarterly cash limits, which have to be approved by the cabinet. However, the cash flows of indirect budget users can not be controlled in this way and are more unpredictable. Since many of these funds, agencies and institutions do not make cash flow forecasts, their cash flows have to be estimated by the Treasury.

The budget liquidity management process is co-ordinated by the Liquidity Commission, in which participate: the Treasury, the Budget Department, the Debt Department, representatives of budget users, the Tax

Department and the Customs Department. The Liquidity Commission has to approve the monthly liquidity plan, the annual revenue estimates and the quarterly cash limits.

In the case of Slovenia deviations between the actual and forecasted cash flows are quite costly. The reason is that the internal Slovenian money market is relatively undeveloped compared to OECD countries, so poor quality of forecasts can have a strong effect on financing costs (commercial banks charge high interest on short-term borrowing). For this reason penalties can be imposed upon budget users that submit unrealistic proposals for monthly liquidity plans, or make last minute corrections in such plans.

The second phase of budget liquidity management consists in providing additional liquidity or investment of temporary surpluses. The TSA liquidity management department is responsible for the placement of liquid assets and liquidity borrowing for the TSA as a whole.

Apart from overnight deposits, which are relatively small at about 1% of the Treasury sub-account balance sheet, liquidity surpluses are placed to commercial banks by use of an auction system. Deposits are auctioned on the basis of the interest rate. Both deposit offers and bids are sent by e-mail.

The TSA liquidity management department also handles the central government short-term debt. For that purpose it organises the issuance of short-term government securities (treasury bills) and acts actively to foster the development of the domestic money market.

Long-term debt is managed by the Public Debt Management Department. This department also monitors public guarantees on loans provided by the private sector.

The total debt (short-term and long-term) of general government was 26.7% of GDP at the end of 2003 (see Figure 2). Of this amount, 1% consisted of debt incurred by local government and the Pension and Health Funds, and 25.7% consisted of debt incurred by the State (direct budget users). Interest is not more than 3% of central government revenue. The State debt was held at the end of 2003 for 61.2% by domestic creditors and for 38.8% by foreign creditors. Since 2002 debt is only taken up in the domestic market. At the end of 2003, the long-term domestic debt of the State was held for 96.6% by financial institutions and for 2.3% by public institutions. Enterprises and individual holders owned less than 1% of the debt. In sum, the debt situation of Slovenia gives no reason for concern.

Slovenia has an effective and transparent information system concerning public guarantees. The total amount of outstanding guarantees ultimo 2003 was about 430 billion Slovenian tollar (EUR 1.8 billion). Realisations per year since 1998 are 1 to 3% of outstanding guarantees per year (1% in 2003). Of these realisations, up to 10% have been recovered.

4.3. The structure of service delivery

The structure of public sector in Slovenia is rather complex. The State consists of the executive branch and some independent State organs, such as the judiciary, the Parliament and the Court of Accounts. The executive branch comprises the ministries. Within the ministries and under the ministerial responsibility there are some 50 bodies or agencies with some separate status. Outside the State, there are a number of public corporations with independent legal status. These include the Pension Fund, the Health Fund and some 20 other funds, institutions and agencies (roughly coinciding with the indirect budget users mentioned above). Furthermore there are some 50 “administrative units” which are regionally deconcentrated agencies of separate ministries or of combinations of ministries. Some 20 agencies and offices are directly responsible to the prime minister or to the Secretary General of the Government. A large number of public enterprises and other legal entities in which the central government has decisive influence upon the management (usually flowing from ownership of a substantial share of capital) also belong to the public sector. Apart from the central level of government, there are 193 municipalities, which can also establish independent legal corporations and own public enterprises.

This complicated structure is partially a heritage of the past. Particularly the large number of independent legal corporations seems to be a consequence of the philosophy of “self management” that prevailed in the former Republic of Yugoslavia. Similarly the large number of public enterprises is explainable by the historical development of Slovenia. However, since independence, important reform initiatives have been undertaken.

A State Public Administration Act was passed by Parliament in May 2002. The law treats the State administrative organs and administrative tasks, the separation between political and professional responsibilities of officials within ministries, a standard organisation structure for ministries and uniform position titles for officials and the relationship between public corporations and their parent ministries. At the same time a Public Agencies Act was passed. This law provides a general framework for establishing agencies with legal personality (public corporations) outside the State. It also contains provisions concerning independent regulatory agencies. An Inspections and Supervision of the Administration Act was passed by Parliament in June 2002. It provides autonomy to inspection functions, sets up specific authorities and inspection procedures, and regulates co-ordination among different inspection authorities.

Subsequent to the promulgation of the above-mentioned Acts on State Public Administration and on Public Agencies, the State Secretary for the Development of State Administration in the Ministry of the Interior has

Box 7. **Inter-governmental fiscal relations in Slovenia**

Slovenia has 193 municipalities that fulfil functions in a range of areas including: elementary education, culture, sports, social care, primary health care and other social services; public utilities, road works, housing, physical planning, environmental protection, and other similar activities; fire safety matters and protection against natural and other disasters; and other matters of local public interest such as mortuary services, tourism, agriculture, and small business promotion.

The 1998 Financing of Municipalities Act distinguishes two principal types of revenues. Articles 21 and 23 list municipal revenues where tax rates are determined by law. The most important of these is the 35% personal income tax share, which accounts for roughly three-quarters of total municipal revenue. Municipalities have more autonomy to regulate revenues under Article 22 of the Act, such as municipal rates and various fees.

In addition, municipalities might be entitled to financial equalisation from the State budget. For this purpose, the National Assembly defines an amount of “appropriate expenditure” per inhabitant of a municipality for the above listed functions when the State budget is passed. This amount is determined on the basis of a formula that is largely population based, with corrective factors that consider the length of local roads, surface area, and demographic characteristics. This yields an expenditure total for each municipality, with equalisation filling any shortfall of revenues calculated at average or legally stipulated rates. Municipalities also receive matching grants for certain investments, with the matching requirement varying on the basis of tax capacity.

Municipal debt may not exceed 10% of actual revenue in the year prior to the year of borrowing, and annual debt servicing costs may not exceed 5% of this revenue. Exceptionally, a municipality may incur a larger debt, but only for financing housing construction, water supply, and sewage or waste disposal. Public enterprises and public institutes that were co-founded by a municipality require approval to incur debts.

Source: Republic of Slovenia, www.sigov.si/loksam/distriban/munici/lofin.htm.

prepared secondary legislation. A Decree on the Bodies within Ministries was adopted in May 2003. It has reduced the number of currently existing bodies and rationalised their structure. A Decree on Internal Organization, Jobs and Titles, based on the State Public Administration Act as well as on the Civil Servants Act (to be treated below) was also adopted in May 2003. This decree regulates and simplifies the procedure for modifying the internal structure of ministries, whereby such decisions will be made by the minister or head of

agency, not by the cabinet, within the framework of the law. It also regulates the annual staffing plan in ministries and agencies. Still pending are decisions concerning the deconcentrated “administrative units” (see above).

These reform initiatives are important and have contributed to the clarification of the legal structure of the Slovenian Government. Less clear however, remains the economic principles that have guided these reforms. It is not clear for instance, whether Slovenia aims at a separation of policy advice and execution within the ministries, such as exist in the Nordic countries and has been pursued in the Netherlands and the United Kingdom. If not, what then are the criteria for the establishment of agencies within the ministries? It is not clear either for which kinds of service provision Slovenia wants to use public corporations outside the State. Which are the economic criteria for the establishment of such corporations? Has the distinction between executive agencies inside and outside government to do with the distinction between the provision of public and private goods? In which cases are private goods provided by public agencies (inside or outside the State) and when is that task relegated to the market, possibly in combination with market regulation and subsidisation? In which cases is the provision of public goods delegated to the municipalities or outsourced to the market? Clear policies on these questions still have to be formulated.

Slovenia has taken a cautious and gradual approach towards performance oriented budgeting. It has set up a programme oriented budget classification but it has also maintained input accounts and line items. The Decree on the Bases and Procedures of Preparation of a Proposed National Budget requires that the explanations of financial plans of budget users contain physical, financial and descriptive indicators used to measure the realisation of objectives and reports on the results achieved in the first part of the current budget year (see Section 2.4 above), but the quality of these data is diverse and not much effort seems to be put in the improvement of these data across the board. Thus far Slovenia has not either introduced a government wide system of programme evaluation. Given the stage of public sector reform in Slovenia this approach seems to be prudent. The Slovenian authorities have judged that other reforms are more urgent and should have priority. However, next steps in this area should still be envisaged.

A useful next step could be the introduction of a selective procedure of programme review. Such a procedure would aim at the annual evaluation of a limited number of programmes, say from five to ten, as defined by the main programme areas of the budget. The annual selection of programmes would be decided by the cabinet on the proposal of the Minister of Finance. The procedure would have to guarantee independence and objectivity of the reviews. The reviews would have to focus on the fundamental questions about the economic organisation of service delivery as mentioned above. The

Box 8. Procurement

The Slovenian Public Procurement Act (2000) has two thresholds. The low threshold (for works, approximately EUR 80 000; for goods and services, approximately EUR 40 000) determines the applicability of the national procurement procedure. The high threshold is in conformity with the EU Directive and determines the applicability of the EU procurement procedure. For low value contracts (under the low threshold), the law prescribes a few basic principles of open competition. For medium value contracts (between the low and the high thresholds), the law prescribes a rather strict procedure comparable to the European procedure. For high value contracts, the law basically reproduces the European Directive.

The procurement market had a value of EUR 1.35 billion in 2001, broken down in 320 000 contracts. About 97% of these contracts fell below the low threshold of the Public Procurement Act (total value EUR 430 million). Of the remaining 3%, approximately 2.9% fell between the lower and higher thresholds (EUR 490 million) and about 0.1% above the higher threshold (EUR 430 million).

A Central Public Procurement Organisation has been set up under the Secretary General of the Government (in the Office of the Prime Minister). It is staffed by nine employees. The Cabinet appoints its director. Its responsibilities include legal development, advice to purchasing units, capacity building, international co-operation and statistical data collection. Remedies are regulated by the Act on the Review of Public Procurement Procedures (1999). It provides for a two-stage procedure for the review of complaints. The first stage provides for an internal review procedure, in which the complaint must be addressed to the tenderer and in which an external procurement expert is required to submit an opinion. The second stage is a semi-judicial procedure before an independent National Review Council organised under the Parliament. The Secretariat of the Council consists of eight experts and administrative staff. The National Review Council reviews approximately 300 cases per year of which about 15-20% concern cases under the low threshold.

In a recent report by SIGMA,¹ the review procedure was assessed as very effective. It advised to restructure the Public Procurement Act which was considered as somewhat confusing, and to reform the procedure for medium value contracts which was considered as too rigid and conducive to evasion (by breaking up contracts in smaller parts).

1. Public Procurement Review – Slovenia Report: June 2003, www.sigmaxweb.org/libpubs/pubslovenia.htm.

reviews could also make proposals about the improvement of indicators. These indicators would have to focus on the quantity and quality of service provision, rather than on the more arbitrary realisation of objectives (or the even more arbitrary contribution of the programme to the realisation of objectives). Programme review procedures of this kind exist in Denmark, the Netherlands and the United Kingdom and have been relatively successful.

4.4. Human resource management

Public employment in Slovenia is regulated by two basic laws: the Civil Servants Act passed by Parliament in June 2002 and the Law on Salary Systems for the Public Sector passed by Parliament in April 2002. These laws replaced the former Law on Workers in State Organs (1990), and the Law on Relations of Salaries in State Organs, Local Communities' Organs and Public Institutions (1994). The new laws aim at a general modernisation of the civil service.

The Civil Servants Act is divided in two parts. The first part regulates common elements of public employment for the whole public sector except public enterprises: central and local government, the health sector, the social security sector, educational institutions and other public corporations outside government. The second part regulates in particular the sectors of central and local government. Specific bodies are regulated additionally by specific laws: Law on Police, Law on Defence (for the military), Law on Foreign Affairs (for the diplomatic corps) and Law on the Judicial Service.

Total employment in the public sector, except public enterprises, amounts to roughly 150 000 employees, which represent 17% of the active population. The second part of the Civil Servants Act applies to about 35 000 employees of which some 15 500 in the ministries, 2 000 in the independent State organs (Parliament, Presidency, Courts, Court of Audit, etc.), 3 000 in the municipalities and the remainder in other public corporations.

Subsequent to the promulgation of the Civil Servants Act, a number of pieces of secondary legislation were adopted. These decrees deal among other things with the systematisation of positions, ranks and titles, incompatibilities, disciplinary offences, evaluation of performance, restrictions on receiving gifts, employment plans, and examination of competences in public administration and technical work requiring special expertise.

The Civil Servants Act divides the civil service into two main groups: "officials" and "professional-technical public servants". Officials will occupy what the text refers to as "positions" (managerial posts). Positions will be determined by government decree. Officials will be appointed for a period of five years, they are selected through public competition and they are

classified in grades of several classes according to the level of education required. Positions are classified in several categories such as secretary general, director general and heads of administrative units. The number of officials in ministries is currently about 5 500. The professional-technical public servants are classified by a separate decree. Their number is currently about 10 000.

The Civil Servants Act aims at the creation of a professional civil service and a strict separation of political officials and civil servants. The civil service must carry out its duties in strict conformity with the Constitution and the law and in a strictly impartial way. The law prohibits civil servants to take part in any activity that would affect their impartiality or objectivity, create a risk of misusing information, affect negatively their efficiency or effectiveness or harm the reputation of their employer.

In practice, the situation evolves gradually. Until recently the higher layer of the Slovenian civil service used to be politicised to a certain extent. Presently, civil servants cannot be dismissed for political reasons but generous compensation in the form of severance pay is sometimes used to ease the situation. It is important that in the coming years the efforts aimed at professionalisation and depolitisation of the civil service are pursued with great energy and perseverance.

A Government Office for Prevention of Corruption, attached to the Prime Minister, was created in 2001. The Office is meant to act as an independent expert service, which advises the government about policies against corruption, prepares a national anticorruption strategy and ensures its implementation. The Office is staffed by a small number of experts. It does not investigate cases but forwards them to the police or the public prosecutors. The most common complaints received by the Office relate to building permits, public procurement and police abuses. In general, the record of Slovenia concerning the prevention of corruption is good.

An area that merits special attention is the legislation concerning public employees outside central and local government. So far the modernisation of this legislation seems to lag somewhat behind. It is important that reform in this domain is pursued with vigour, because there are indications that corrupt practices in for instance the health service are not entirely extinct.

Until recently the system of salary scales in the public sector was not transparent. Salaries were negotiated for many different groups of public employees with 18 different trade unions. There was a proliferation of special allowances and additional wage components for different groups. A new Law on Salary Systems for the Public Sector was passed by Parliament in April 2002 and went into effect in the beginning of 2004. However, implementation of the law is partly dependent on negotiations with the trade unions. The law is

applicable to the entire public sector, except public corporations outside the State and the municipalities. The new law fixes the salary components as basic salary, performance bonuses, and supplements. Basic salary will comprise many previous special components. The number of supplements has been reduced to eight (previously 80) and is defined by law. They refer to position, length of service, special expertise and academic degrees, command of foreign languages, difficult working conditions, dangerous or specific tasks, overtime and night shift work. There are 65 classes of basic salary from the President of the Republic to the lowest paid public employee, and encompassing mayors and members of municipal councils. The new system makes it possible to increase salaries of public employees in ten steps in a three-year cadence without promotion to a higher position. This provision is intended to correct the previous situation that employees were promoted for the sole reason of increasing their salaries. Performance bonuses, fixed at a maximum of two month's basic salary, are to be awarded twice a year. The criteria for payment of bonuses are established in the Civil Servants Act and will be further determined through negotiations with the social partners. Recently agreement was reached with the trade unions about next steps in the implementation of the law (see Section 1.2).

The Civil Servants Act makes performance appraisal and training the only criteria for promotion for officials. The envisaged performance assessment system is still in development and not yet fully implemented.

The Civil Servants Act aims to promote horizontal mobility within ministries and between ministries, but until now mobility between ministries is still limited.

Training for public employees is the responsibility of the Minister of the Interior. The Administrative Academy, attached to the Ministry is in charge of delivering training programmes.

The Government Personnel Office is answerable to the Secretary General of the Government. It is the civil service information system at the central level. It has a staff of about 40. Its main responsibilities are: appointments and nominations, organisation, personnel information service, co-ordination of human resource management across ministries and agencies, secretariat of the Civil Service Council. The Civil Service Council was created by the Civil Servants Act. It will set standards for managing officials (directors general, secretaries general and heads of agencies and divisions) and will nominate recruitment commissions for such positions.

The Government Personnel Commission, composed of ministers and secretaries general, nominates senior officials, assigns salaries to individual officials, decides on promotions of officials, authorises job descriptions proposed by ministries and co-ordinates personnel departments of ministries.

It is chaired by the Vice Prime Minister or the Secretary General of the Government and meets every week.

The Administrative Personnel Information System (APIS) contains information on staff numbers and personnel costs. This system is still in development. Until recently software concerning personnel information in the Government Personnel Office and in personnel administrations of ministries and agencies was not fully compatible which hampered the development of APIS. A fully operational central information system is not only relevant for human resource management but also for the budgetary control of personnel expenditures. It is therefore important that priority is given to additional efforts in this area.

4.5. Conclusions

The detailed account structure of the Slovenian budget makes reallocation during budget execution inevitable. The annual Law on Budget Execution makes such reallocation possible without recourse to supplemental budget legislation. On the other hand this law adds a layer of regulations to the already quite involved and complicated legal framework of the Slovenian budget process. The Slovenian authorities may consider eliminating this law, by transferring its more permanent provisions to the Public Finance Act, while simultaneously simplifying the account structure of the budget.

Slovenia has centralised its system of cash and debt management by introduction of a Treasury Single Account (TSA). The TSA has led to substantial efficiency gains. The system is well organised and functions properly. It is important that indirect budget users take more responsibility for their own cash flow forecasts. This reform could be part of a more encompassing reform aimed at the consolidation of the budget of the central government (see Section 2.5).

The structure of the Slovenian public sector is quite complicated. It has evolved from historical circumstances and is at present not based on clear principles. In the domain of service delivery there is clear scope for further reform.

Slovenia has an effective system of procurement contract review. The transparency of the Slovenian Public Procurement Act needs to be improved and procedures for medium value contracts need to be modernised.

Slovenia has in the last years made big steps forwards in civil service reform, particularly in the areas civil service remuneration policies, training facilities, recruitment and promotion policies. However, the aims are not yet fully achieved. It will be important to keep up the pace and to maintain these reforms at the top of the political agenda.

The Slovenian authorities may consider giving more priority to the development of a transparent and consolidated personnel information system in the public sector.

5. Accounting and audit procedures

5.1. Accounting

Until 2000 the old Yugoslav accounting legislation remained in force in Slovenia. In 1999 a modernisation process led to the adoption of a new Accounting Act. The Act prescribes cash based accounting for the Slovenian public sector (Article 15). A uniform Chart of Accounts has been introduced for all direct budget users. The Accounting Department of the Ministry of Finance is actively considering the potential benefits and pitfalls of moving towards accrual accounting. Slovenia pursues a pragmatic approach which includes actively following and participating in debates on accrual accounting in the public sector. Officials stated that a switch to accrual accounting is less of a technical problem but rather an issue of “mentality” with users of accounting information.

Bookkeeping is centralised in the Accounting Department of the Ministry of Finance. Only the defence and interior ministries as well as the courts run their own accounting services. The Accounting Department communicates with the accountants of direct budget users through a weekly bulletin that summarises all relevant transactions. A 1995 government resolution required the introduction of uniform accounting software for all direct budget users as a basis for a unified accounting system. This software was introduced in 1998 and has been rolled out to about 4 000 users. The software is designed in such a way that it disallows entries by direct budget users if they would result in expenditures in excess of authorised amounts. There is also a central check on relevant documentation, for which requirements vary depending on different categories of expenditures. Officials stated that the documentation submitted by direct budget users has improved in recent years.

The government is actively broadening training capacity for accountants in the public sector in order to address a shortage of relevant skills. A recent initiative is the creation of the Center of Excellence in Finance, which offers a two-year certified public accountant programme with support from international donors and accreditation by a London-based institution.¹³ For public sector employees with lower entry qualifications, a complementary continuing education initiative has been initiated.

The timeliness and quality of financial statements has been substantially improved in recent years and as a result of these initiatives. The Public Finance Act now requires direct budget users to submit draft financial statements to the Ministry of Finance by the end of February of the year

following budget execution (Article 97). The act also requires submission of the annual financial statements for external audit by the end of March. In recent years this deadline has not been missed significantly. Previously, at the time when a range of different accounting systems were still in use, there were frequent delays of up to one year in the preparation of financial statements and their quality was much poorer.

5.2. External audit

The annual financial statements are submitted to the Court of Audit of the Republic of Slovenia (CARS). Article 150 of the Constitution establishes the CARS as Slovenia's supreme audit institution (SAI) and gives it the mandate to supervise State accounts, the State budget and all public spending. It also requires legislation to regulate the organisation and powers of the CARS and enshrines its independence in the performance of its duties.

Table 3. **The timeliness of accounting and audit, 1994-2003**

Fiscal year	Submission of financial statements	Finalisation of audit report
1994	27 July 1995	3 February 1997
1995	31 December 1996	21 August 1998
1996	6 June 1997	3 March 1999
1997	23 June 1998	18 October 1999
1998	20 July 1999	27 July 2001
1999	16 May 2000	29 December 2000
2000	11 April 2001	21 December 2001
2001	5 April 2002	5 September 2002
2002	31 March 2003	9 September 2003
2003	1 April 2004	25 September 2004 ¹

1. Preliminary estimate.

Source: Court of Audit of the Republic of Slovenia.

The CARS was founded in 1994 and started operating in the following year. A significant reform was carried out with the introduction of new framework legislation for the CARS in 2001. The new Court of Audit Act lays the foundation for a shift away from the court type towards the office type of public sector audit.¹⁴ The new institutional setup has been influenced by the United Kingdom National Audit Office (NAO), which has supported the evolution of the CARS through twinning programmes. The President of the CARS is described by the Court of Audit Act as the State Auditor General of Slovenia (Article 12). It appears that the label of the Slovenian SAI as a "court" was only retained due to a translation error.

The Court of Audit Act governs the appointment of the President of the Court and two Deputies by the National Assembly for nine-year terms, which may be extended once. The new act enshrines the independence of the CARS and also significantly clarifies the audit procedure, focuses the reporting obligations of the court on the National Assembly, and establishes strong follow-up procedures, among other improvements. Officials from the CARS confirm that the court's functional independence is respected in practice. The budget allocation of the CARS has been sufficient; in fact, it has under-spent in the past three years. Officials from the CARS explained that one constraint is that the prerequisite skills are scarce and difficult to recruit and retain, as pay conditions for auditors in the public sector are not as attractive as in the private sector. Overall, however, the independence of the CARS is safeguarded by a constitutional mandate that is complemented with a modern legal framework and sufficient financial resources.

The CARS has the mandate to audit financial statements for regularity and it may also carry out performance audits. In 2003 it produced a total of 65 reports, 11 (or 17%) of which were classified as performance audits.¹⁵ The Court of Audit Act prescribes that the CARS shall independently decide its own audit programme (Article 25). However, the CARS has to consider proposals made by Parliament, government and local authorities. More specifically, the CARS must consider at least five proposals from the National Assembly from which at least two must be from opposition Deputies and a further two from its "working bodies", i.e. standing committees or commissions (see next section). The Court of Audit Act prescribes that when a draft audit report has been finalised, it is subject to a clearing meeting with the auditee in which disputed findings may be discussed (Article 28). Ultimately, the CARS is responsible for the content of audit reports, and its officials reported that clearing meetings typically take place in a co-operative atmosphere.

The CARS is obliged by the Public Finance Act (Article 97) to produce its report on the government financial statement by 1 October of the year following the execution of the relevant budget. Improved timeliness in the preparation of financial statements has had a positive knock-on effect on the timeliness of audit reporting, and in recent years the main audit report has been finalised within the deadline stipulated in the Public Finance Act. In addition to its report on the financial statements, the CARS may report other findings that are not subject to specific deadlines. All reports are publicly available on the CARS Internet site¹⁶ and submitted to the National Assembly, which initiates a process of review that is further discussed below.

One of the innovative new aspects introduced with the new Court of Audit Act is the post-audit procedure (Article 29). In an audit report the CARS may request the auditee to submit a report that outlines any remedial steps that were initiated to address disclosed irregularities and inefficiencies. The

time limit for such a response report, which is an official document, is 30 to 90 days. The exact content of the response report is defined by the Rules of Procedure of the CARS. The CARS then proceeds to assess the credibility and adequacy of the response report and measures taken, and reports on its findings in a post-audit report. If the obligation of operational efficiency is deemed to have been severely violated, the President of the CARS can issue a call for the dismissal of the responsible official as well as a press notice. Officials reported that in 2003 the CARS requested a response report in about one quarter of its issued audit reports. In about 80% of cases the remedial measures undertaken were deemed satisfactory, and in about 20% of cases the CARS attested a violation or a severe violation of operational efficiency.

5.3. Parliamentary accountability

In addition to its standing committees, the National Assembly can establish commissions to examine specific common issues or individual matters. One of these bodies is the Commission for Budgetary and Other Public Finance Control, which was established by a resolution of the National Assembly in 2000. The commission has a total of nine members. As is convention with Public Accounts Committees in many other countries, the chairperson is a member of the opposition. The Rules of Procedure of the National Assembly give the commission the mandate to supervise the implementation of the State budget, the budgets of the pension and health funds, the public broadcaster, local authorities and public enterprises on the basis of reports from the CARS. It is also to discuss relevant draft laws. The commission reports to the National Assembly and proposes necessary measures.¹⁷ The annual financial statement on the State budget and the relevant audit report are subject to a discussion in the commission as well as a plenary session of the National Assembly.

The actual capacity of the commission for audit scrutiny is extremely limited. The commission convenes on average about once a month. As its members serve on various other working bodies of the National Assembly, they have to juggle different demands and commitments. In addition, because meetings of working bodies may not overlap, there is only time to consider a small fraction of reports produced by the CARS. As a result, the commission discussed only 6% of all audit reports in 2002 and 10% in 2003. During public meetings on audit reports, officials from the CARS explain their main findings and a representative of the relevant auditee responds.

In practice, interaction between the CARS and the Commission for Budgetary and Other Public Finance Control has been largely dysfunctional, partly because of apparently poor relations between the previous chairperson of the commission and the former President of the CARS.¹⁸ This state of affairs may explain why the commission has focused much of its attention on

criticising the CARS and its working methods rather than using audit findings to scrutinise governmental compliance and performance. It remains to be seen whether recent changes in personnel in both institutions will result in an improved working relationship.

5.4. Internal financial control and audit

A budgetary inspection unit existed in the Ministry of Finance from 1995, but in 1999 the EU accession process required central harmonisation of internal financial control and audit. The Budget Supervision Service in the Ministry of Finance was set up in 2000 and recently renamed as the Budget Supervision Office. This office exercises a number of control functions relating to EU funds and interests, carries out budgetary inspections based on requests from spending ministers or whistleblowers, and plays a co-coordinating function relating to internal financial control and audit.

The section on Public Internal Financial Control issues guidelines for internal audit in the public sector and produces an annual report. In 2003 a certificate programme for public sector internal auditors was introduced in co-operation with the CARS. Slovenia's emerging system of internal audit is decentralised. Responsibility for setting up and running an appropriate system of public internal financial control rests with the heads of direct and indirect budget users. There are about 40 internal auditors distributed across the different direct budget users. At the local government level the function is less entrenched, and some authorities are running shared internal audit units or outsource the function. Internal auditors draw up audit plans based on a risk assessment. About one third of investigations by internal auditors are carried out on request of the responsible minister. In an annual report to the central unit in the Ministry of Finance, the results of these audits are presented together with a response from the relevant ministry.

As the internal audit function is still young, its role is perhaps not yet fully entrenched and appreciated. There have been incidents where the central unit was asked to mediate conflicts between internal auditors and spending ministries. At the same time, the independence of internal audit is safeguarded by the fact that the central unit has to be notified if the head of an internal audit unit is appointed or dismissed.

The Budgetary Supervision Office also has a Budgetary Inspectorate that can investigate complaints and anonymous reports from whistleblowers. Spending ministers often request the unit to investigate indirect budget users under their jurisdiction. In carrying out inspections, an inspector is independent and personally responsible for any findings. An inspection report is sent to the relevant minister, with a 15-day period within which objections to the findings may be lodged, which is not common in practice. The

inspectorate can order activities to be halted and, in cases involving indirect budget users, demand wrongly applied funds to be returned to the relevant direct budget user. Officials indicated that one problem area is procurement, where proper procedures are often disregarded and an “urgent” procedure with less onerous requirements is frequently applied in order to circumvent due process. Another typical tactic, which is not unique to Slovenia, is for contracts to be broken up into smaller units in order to evade proper procurement procedures. Salaries and travel costs are other areas of concern.

5.5. Conclusions

Improvements in the quality and timeliness of accounting in recent years are substantial, and provide a strong basis for *ex post* accountability. In the medium term, further improvements might be possible so that the audited financial statements can be presented to Parliament within six months after the end of the fiscal year, as is practice in many OECD countries.¹⁹ Slovenia’s pragmatic approach to the adoption of accrual accounting is sensitive to the needs of users of accounting information.

The CARS has undergone an impressive evolution towards an Auditor-General type SAI that is based on a modern legal framework and sound procedures. However, the new external audit system has yet to settle down and there would seem to be a disjuncture between the domestic and international recognition of the CARS. It appears that a move back to the court model of SAI is now actively being considered within the CARS. Such a move would most likely unsettle the institutional consolidation of the external audit function.

The use of audit findings for parliamentary scrutiny has been sub-optimal. A large volume of audit information that could be harnessed to improve government efficiency and performance is not used by Parliament. This is a crucial defect, as the office model of State audit is predicated upon sound and continuous interaction between the audit institution and the relevant parliamentary body.²⁰ One institutional reason is that the parliamentary schedule leaves little time for the Commission for Budgetary and Other Public Finance Control to adequately cover a more substantial number of audit reports. To overcome this bottleneck, Parliament might consider the upgrading the status of the commission to a specialised Public Accounts Committee in a way that allows more regular sessions throughout the year. Moreover, it appears that mediation between the commission and the CARS is urgently required to establish co-operative relations and to co-ordinate the flow of audit reports to Parliament throughout the year.

Notes

1. This survey was prepared shortly before new elections for the National Assembly were to be held in October 2004.
2. A third alleged advantage of fixed frameworks, namely that they facilitate the task of the Minister of Finance during budget negotiations, is less relevant for Slovenia because the position of the Minister of Finance is strong anyhow.
3. This distinction is relative though. In Slovenia the second year budget can be amended in the year after it has been established. Fixed frameworks usually have sub-ceilings for budget sectors or ministries, which also can be changed from year to year. The only difference, but an essential one, is that the ceiling of total expenditures of fixed frameworks is unalterable from year to year.
4. The object of adoption by the National Assembly is only the estimates for the budget year (Article 10, paragraph 6 of the Public Finance Act).
5. On the other hand, the Budget Memorandum contains multi-year estimates and a higher level of aggregation than the line item level (see Section 2.4).
6. Article 20 of the Decree on the Bases and Procedures for Preparation of a Proposed National Budget.
7. Article 14 of the Decree on the Bases and Procedures for Preparation of a Proposed National Budget.
8. Article 24 of the Decree on the Bases and Procedures for Preparation of a Proposed National Budget.
9. The budgetary role of the Slovenian Parliament in the past decade is discussed in Lance T. LeLoup (2004): "Uloga parlamenata u odredivanju proračuna u Mađarskoj i Sloveniji" [Parliamentary Budgeting in Hungary and Slovenia], *Financijska teorija i praksa*, Vol. 28, No. 1, pp. 49-72. An English version of the paper is available at www.internationalbudget.org/resources/library/hungsloubud.pdf.
10. OECD (2001), "Best Practices for Budget Transparency", *OECD Journal on Budgeting*, Vol. 1, No. 3, p. 8: "The government's draft budget should be submitted to parliament far enough in advance to allow parliament to review it properly. In no case should this be less than three months prior to the start of the fiscal year. The budget should be approved by parliament prior to the start of the fiscal year."
11. *Ibid.*, p. 9: "A pre-budget report serves to encourage debate on the budget aggregates and how they interact with the economy. As such, it also serves to create appropriate expectations for the budget itself. It should be released no later than one month prior to the introduction of the budget proposal."
12. A Slovenian tollar is EUR 0.0043.
13. www.cef-see.org/.
14. Rick Stapenhurst and Jack Titsworth (2001), "Features and Functions of Supreme Audit Institutions", PREM Notes No. 59, World Bank, Washington DC.
15. Court of Audit of the Republic of Slovenia (2004), *Annual Report 2003*, Ljubljana, p. 12.
16. www.rs-rs.si.
17. National Assembly (2003), *Commission for Budgetary and Other Public Finance Control*, Ljubljana.

18. This tension is the subject of the Foreword by the then President of the Court of Audit in the 2002 Annual Report issued by the CARS.
19. OECD/World Bank (2003), *Results of the Survey on Budget Practices and Procedures*, question 4.5.1; available at <http://ocde.dyndns.org/>.
20. David G. McGee (2002), *The Overseers: Public Accounts Committees and Public Spending*, Commonwealth Parliamentary Association and Pluto Press, London.

**Introductory Speech for the Meeting
of Senior Budget Officials
of central and eastern European Countries
10-11 November 2004, The Hague**

by
Minister of Finance Gerrit Zalm, The Netherlands

Building blocks for budget reform

Ladies and gentlemen, it is a great pleasure for me to have the opportunity to make some opening remarks on this conference.

Budget policy is a recurring theme in my career. In 1975 I started my career at the Ministry of Finance in the Budget Directorate. Later, as director of the CPB – the Netherlands Bureau for Economic Policy Analysis – I participated in the preparation of important reforms in our system of fiscal rules. And now, as Minister of Finance, I am more than ever convinced of the importance of a proper national budget policy. Not – or should I say, not only – because I like figures, but because these figures have a direct and serious impact on the well-being of our citizens. Without a sound budget policy there can be no sustainable social welfare system, no funds for a proper education policy, and no base for a durable economic growth. Therefore, I think that the effort to reform and improve national budget systems is one of the best things a social minded government can pursue.

In the past years a lot has happened in the field of budget policy. Especially in the central, eastern, and south eastern European countries many things changed since the transformation from centrally planned economies to open market economies. Tremendous efforts have been made to adapt budget systems to this new environment. For some countries additional requirements had to be met since they joined the European Union this year. The far-reaching transformations offered the opportunity to fully benefit from latest innovations in the field of budgeting and to introduce the most advanced budget systems. This is an appealing prospect, but there are some pitfalls on the road that I would like to touch upon.

Like any other topic where science meets everyday policy discussions, the debate on budget policy is heavily influenced by trends and buzz-words:

- Accruals is good, cash accounting is bad.
- Budgeting on input is bad, output is better, outcomes are best.
- Do not focus on short-term solutions, use medium-term budgets.
- Abolish special funds, integrate all expenditures in one comprehensive decision process.
- Introduce strategic planning, programme budgeting, agencies, a medium-term expenditure framework, etc.

You will probably hear a lot of these phrases today and tomorrow. And don't get me wrong: I think there is a lot of wisdom in these phrases. Most of this advice prescribes in fact valuable ingredients for a sound budget system. A critical evaluation of the pros and cons of these elements and their optimal design is therefore crucial.

However, for an effective budgetary reform more is needed than a focus on the final results only. A successful transformation also requires a focus on the transformation process itself and the priorities during the transformation.

I don't think universal recipes are available for an optimal transformation process. The timing and sequencing of the necessary steps depend on the budgetary, political, and administrative state of affairs, which of course varies widely among countries. Nevertheless, I think a few separate building blocks can be distinguished.

First, I think it is absolutely crucial to get the **basics** right before any sophisticated budget tool is implemented. And with these basics, I refer to issues like accounting practices and budgetary statistics, the integrity of the budget and tax administration, the actual control of the line ministries and the ministry of finance on government liabilities and cash spending, the abolishment of "off balance" budgeting practices. These and other basics are vital to any well functioning budget system. Efforts should be focused on these issues before a lot of energy is put into the development of more sophisticated innovations.

A second block is the improvement of **macro** budget efficiency. With this I refer to issues like the optimal design of fiscal rules, the strengthening of the position of the minister of finance within the cabinet, the improvement of forecasting techniques also for the longer term, the reinforcement of checks and balances in the budget process, and the introduction of a medium-term expenditure framework. These elements contribute to a sustainable development of public finances.

The third block is the improvement of **micro** budget efficiency. This includes the transformation to programme budgeting and an increased focus on output and outcome based budgets; the use of performance indicators and a systematic evaluation of government programmes; the adoption of accrual accounting principles. Also innovations in the field of management, such as the introduction of output contracts between central government and government agencies, and public-private partnerships could be used to enhance the micro efficiency of government spending.

Although I think there is no fixed recipe for successful transformation, I do think it is useful to make a distinction between these building blocks. **First** I believe that things should be done in the proper sequence. I think that, for example, introducing accrual accounting for central government when

accounting capacity still falls short and spending controls are weak is not the way to go forward. Yes, accrual accounting can improve efficiency since it delivers better information on the actual use of production factors. But it is difficult to implement for the ministries and difficult to understand for politicians, and thereby entails a budgetary risk if spending control is not firmly organised. The same is true when budgets are primarily based on outputs and outcomes while fiscal rules are non-existent and the position of the minister of finance is relatively weak.

The **second** reason why I think it is useful to distinguish separate building blocks is the need to focus on priorities. With all these promising innovations at hand, it is tempting to bite off more than one can chew. To prevent an overburdening of the ministry of finance and the line ministries, it is necessary to phase in the various transformation tracks properly. It is vital that a proper capacity of financial staff in all relevant ministries is ensured before sophisticated and difficult budget tools are implemented. As long as that capacity is not ensured I would advise to focus on the basics and to invest in human capacity. This prevents the risk of serious fiscal turmoil or a process that gets stuck in well-meant intentions without having any real effect except perhaps a general disappointment.

Ladies and gentlemen, I do not have the intention to start this conference with warnings that may curb your enthusiasm to reform. On the contrary, as mentioned before I am impressed with all the transformations that have taken place, or are taking place, in the countries you represent. But I think transforming national budgeting and financial management systems is a difficult process. To overcome these difficulties it is vital to ensure that investment in human capacity is tailored to the demands made by the transformation process. That is what I have learned from my experiences in the Netherlands. What I have also experienced is that it is vital to learn from lessons from the past and experiences in other countries. That is why I think it is so useful to share views in conferences like this one. And I hope that this meeting is the beginning of a lasting process of mutual sharing of experiences.

Ladies and gentlemen, I would like to end my introduction and to wish you a very pleasant stay in the Netherlands and a very fruitful discussion during this conference.

Typically Dutch

by
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1. Purpose and contents

This paper aims to identify a few features of institutions and policies in the Dutch public sector that can be characterised as “typically Dutch” and that, moreover, may be considered as worthy of further thought, or perhaps even as a source of inspiration, for countries that are presently thinking about the modernisation of their public sector. This aim implies two limitations that ought to be emphasised at the outset.

First, I have tried to select topics that are not very common in the OECD area. Partially under the influence of international organisations such as the OECD, many modernising developments nowadays take place more or less simultaneously in separate countries. This paper will not address such developments, however important they may be. This implies that I have not concentrated on themes such as the use of performance information in budgeting or the introduction of public-private partnership projects (PPPs). Rather it will address some “typically Dutch” characteristics of institutions and policies. Of course this does not mean that it would be impossible to find some similarities in other countries. When we address “arm’s length agencies”, for instance, it is clear that some other countries have gone in the same direction. Indeed, the United Kingdom has been an important source of inspiration in this respect for Holland. However, we can still say that Holland’s present policy has some unique features. The same is true for the other topics that will be discussed.

Second, I have tried to concentrate on features that have been improvements in Holland and that may lead to improvement elsewhere. Of course I also entertain some ideas about Dutch features that are uniquely bad. I shall not mention them here, but they certainly exist and it might even be useful to other countries to learn about them, but that is probably something for another occasion than this paper. Furthermore I have tried to concentrate on institutions and policies that are particularly relevant to Central, Eastern and South-Eastern European countries. In this respect I have assumed that these countries are still in a process of institutional build-up. This probably implies that they are more open to new ideas and to institutional innovation than many (other) OECD countries, where existing institutions and policies have become entrenched in vested interests. This means that I have not shied away from features that in Western European countries would have little chance of implementation.

The paper is organised as follows. In Section 2, I provide some basic facts about the organisation of the public sector in the Netherlands. This is necessary to place the following sections in the right perspective. In Section 3, I treat two institutional features of the budget process (the demand side of the public sector), namely: the multi-annual expenditure framework and the role of the Central Planning Bureau. In Section 4, I treat two institutional features of public service delivery (the supply side of the public sector), namely: the role of the non-profit sector and the role of arm's length agencies. Section 5 contains some concluding remarks.

2. The Dutch public sector

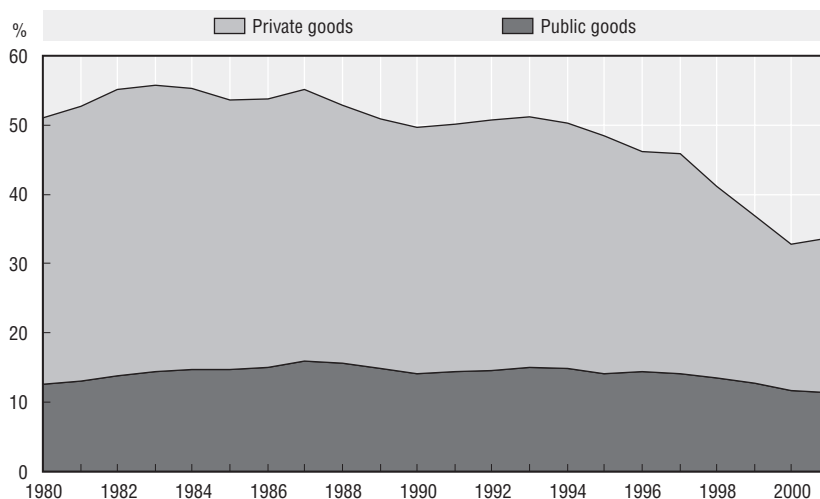
The Dutch public sector is comparable to that of France and Germany but larger than that of the United Kingdom. General government expenditure was EUR 200 billion or 47% of GDP in 2001. In France, Germany and the United Kingdom, general government expenditure was 52%, 49% and 41% respectively in 2001 (OECD, 2003). Like Germany, but unlike France and the United Kingdom, government is quite decentralised. Central government expenditure including social security and public health was EUR 131.4 billion or 31% of GDP in 2001 (France 47%, Germany 36%, United Kingdom 33%). In North America, central government is substantially smaller: central government expenditure was less than 30% of GDP in 2001 in Canada, Mexico and the United States (OECD, 2005).

The present size of central government net expenditures is the outcome of a long process of gradual retrenchment since the beginning of the 1980s. Originally this process was directed at the limitation of the growth of the share in GDP; since 1987 there is an actual decrease of the share in GDP, which has accelerated since 1997, but come to a halt in 2001.

Figure 1 shows this development and also makes clear that the retrenchments have almost exclusively taken place in the areas of private goods: subsidies, public contributions to the non-profit sector, social transfers, social services, health, and education. These services are typical for the welfare State. The level of net expenditure on public goods – defence, public safety and order, infrastructure, basic research, general public services, development assistance, general transfers to subnational government, and interest – has roughly remained stable as a share of GDP. These are the services that are characteristic for the more traditional tasks of the State.

In Holland, central government expenditure is divided into three budget sectors: social security, health, and the State sector. Social security is mainly covered by social insurance and mainly funded by social insurance premiums. However, there are also some parts of social security which are part of the State budget (but not of the State sector) and funded by taxes (mainly welfare,

Figure 1. **Central government net expenditures on public and private goods as share of GDP**

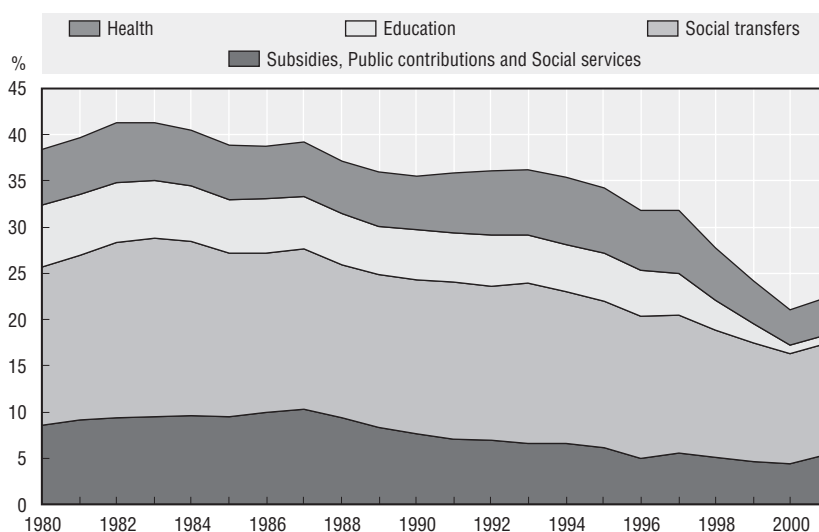


Source: OECD (2005), *Reallocation: The Role of Budget Institutions*.

for people without income who cannot claim other benefits, and benefits for war victims). Social security consists of insurances with universal coverage (old-age benefits, child benefits, widow and widower benefits, and a basic disability benefit) and those which only cover employees (unemployment benefits and an additional disability benefit). The insurances with universal coverage provide a benefit equal to the net minimum wage. The insurances for employees provide benefits related to previous income. The budget sector of health expenditure consists of two public compartments covered by social insurances. The first compartment consists of a basic package of cure expenditures. Approximately two-thirds of the population, defined by an income ceiling, are covered by the obligatory care insurance. The remaining third (the highest income group) is insured privately for the basic package (or not insured). Their coverage is not part of public expenditures. The second compartment consists of care expenditures (homes for the elderly, homes for revalidation, ambulatory care, psychiatric care). It is covered by an obligatory universal social insurance. In addition to these compartments, there is a third compartment of additional health expenditures for voluntary services, funded by additional private insurance and private contributions, which is not part of public expenditure. The third budget sector is the State sector. It is divided into approximately 20 chapters, roughly coinciding with the ministerial departments.

Public expenditures are authorised by annual budget laws and permanent social insurance laws. The budget laws cover the State sector and small parts of the social security and health sectors. A substantial part of expenditures for private goods (education, social services, subsidies and public contributions, social transfers) authorised by annual budget laws is based on substantive laws (entitlements). In these cases the budget authorisation is materially provided permanently by the substantive laws. The social insurance laws cover the largest part of social security and health expenditures. Figure 2 gives a more detailed picture of the developments since 1980 in the domain of private goods.

Figure 2. **Central government net expenditures on private goods as share of GDP**



Source: OECD (2005), *Reallocation: The Role of Budget Institutions*.

The retrenchments have mainly occurred in the area of subsidies to the market sector and social transfers. During the 1970s and early 1980s, many subsidies to the market sector were introduced or increased to support traditional manufacturing sectors such as shipbuilding, aircraft-building, the automobile industry and the steel sector. These subsidies were gradually phased out as it became clear that these industries were not sustainable in the Dutch circumstances. Presently there is hardly any industrial policy left in the Netherlands. The remaining subsidies to the market sector (approximately EUR 5 billion in 2000) are mainly for technological innovation, environmental

protection, and agriculture. The other sector where huge retrenchments have taken place is social security. There have been important policy changes, especially in the sphere of disability benefits, unemployment benefits, and welfare. The net disability and unemployment benefits were almost equal to the net former wage. For the disability scheme, the replacement rate was decreased to 70% for an elderly disabled person and to an even lower rate for a younger disabled person. Moreover, in the 1970s and 1980s, disability benefits were misused on a grand scale in Holland, as disguised unemployment benefits (because they were more favourable than unemployment benefits). Because of its political sensitivity, this problem has been a major theme of Dutch politics since the early 1980s. It is still not entirely solved, although the present cabinet has taken further important steps to normalise the situation.

3. Budget institutions

3.1. The multi-annual expenditure framework

Almost all OECD countries nowadays formulate multi-annual expenditure frameworks. These frameworks are statements about the targets for the major macro-budgetary variables: total expenditures, total revenues, and the deficit in the context of macroeconomic forecasts about the development of the national economy.

The expenditure frameworks are usually published and submitted to parliament every year either in advance of the budget or on the same occasion as the budget. Mostly they cover a period of three, four or five years, including the budget year, and are made up anew every year on a rolling basis. However, apart from these common features, practices concerning multi-annual frameworks differ in very fundamental respects, in particular:

- The integration with the budget: sometimes the numbers of the budget are consistent with the targets of the first year of the multi-annual framework, sometimes not; if the budget contains multi-annual estimates, this may also regard the out-years (the years after the budget year).
- The treatment of second-order effects: macroeconomic circumstances determine the budget targets, but budgetary and general economic policy also determine the macroeconomic circumstances; full integration with the budget implies that second-order effects are accounted for in the macroeconomic forecasts.
- The reconciliation with the numbers of the multi-annual framework of the last year: an explanation of the reasons for changes in the budget targets since the last year and a specified breakdown of these changes; a special case occurs when the the numbers of the last year have to be identical to

those of the present year (so that reconciliation is not necessary apart from exceptional pre-specified circumstances).

A multi-annual framework that is fully integrated with the annual budget, including second-order effects, and that cannot be changed from year to year apart from exceptional, pre-specified circumstances is called a fixed multi-annual expenditure framework (as opposed to a flexible one). Since 1994, the Netherlands has a fixed multi-annual expenditure framework. This is not entirely unique in the OECD area: Sweden, the United Kingdom and the United States (until 2002) also had such frameworks. The Dutch one, in contrast to the Swedish and British ones, is not rolling, but periodical: it is decided at the beginning of each parliamentary period (usually once in four years).¹ The expenditure ceilings of the framework cannot be adjusted, but the EMU deficit is not allowed to exceed a pre-specified signaling value, presently 2.5% of GDP. This implies that expenditures have to keep distance from the ceiling of the framework if the signaling value of 2.5% of GDP is reached. This occurred in the budget year 2003.

Various aspects of the fixed expenditure framework as it applies in the Netherlands are worth noting:

- It is not enacted in law, but is part of the coalition agreement that is established at the beginning of each parliamentary term. This implies that the coalition parties which form the government are bound to it and cannot change it without putting the entire coalition agreement and thereby the cabinet in jeopardy. This gives the framework a status that is even stronger than a law: law can always be changed on its own merits by a parliamentary majority.
- The targets of the framework cover the total of net public expenditure, including mandatory expenditure, such as health, education, and social security. This implies that all setbacks have to be compensated, if necessary by changing the law when setbacks are due to macroeconomic circumstances under existing legislation; thus the framework is more inclusive than those practiced in the United Kingdom and the United States. In the United Kingdom, mandatory, so-called annually managed expenditure (AME) is excluded from the targets and subject to a separate regime of bi-annual review. In the United States, mandatory spending and tax revenues are subject to a regime that requires only compensation for legislated changes, not for setbacks and shortfalls under existing legislation.
- The status of targets varies: the target for total net public expenditures is unalterable. However the framework also contains subtargets for the three budget sectors of State, social security and health and for the chapters of the State budget (roughly coinciding with the ministries). Reallocation among the budget sectors, among the chapters of the State budget, and

among gross expenditure and non-tax revenues is possible and occurs frequently. This feature is of course necessary to maintain flexibility and adjustment to new developments or changing political priorities during the cabinet period, but is often overlooked.

- The targets of the framework are expressed in real terms. Every year the numbers are translated in nominal terms in view of the most recent inflation estimates of GDP by the Central Planning Bureau.

It should be emphasised that a fixed expenditure framework is fundamentally different from a flexible framework as practiced in most other OECD countries. It is not a document that is accidental or complementary to the budget, but an essential part of it. In fact it functions like a fiscal rule, namely an agreed constraint on the annual budget (including multi-year estimates) that is supposed to apply annually for at least a number of years. This particular kind of fiscal rule has a number of advantages in comparison to the more common structural or nominal deficit rules applied in other OECD countries:

- In contrast to nominal deficit rules, it retains the automatic stabilisation effect at the revenue side of the budget, in particular as regards tax receipts, as long as the deficit remains below a pre-specified level (in the Dutch case, below the signaling value of 2.5% of GDP, which is based on the EMU ceiling of 3%).
- In contrast to structural deficit rules, it is easy to understand and not subject to the complicated and somewhat arbitrary computation methods required to determine the structural deficit.
- It provides tranquility in the budget process and a long planning horizon for the ministries. In principle, ministers know their budgets long in advance; annual budget discussions with the ministry of finance and in the cabinet can be limited to reallocation proposals. This contrasts positively with the annual upheaval which is characteristic for the budget process in many countries that practice nominal or structural deficit rules.
- It puts the responsibility for budgetary discipline on the shoulders of the spending ministers, rather than on the minister of finance alone. This changes the character of budget discussions in cabinet. There is less tendency to gang up against the minister of finance, and more scrutiny of fellow ministers' budgets (in order to explore the possibilities for reallocation). In coalition cabinets, that usually have "weak" ministers of finance (not able to impose savings on spending ministries unilaterally), this is an important advantage.

There are also consequences that may be considered as more problematic, although not necessarily as disadvantages, and that are worth mentioning:

- Since spending ministers cannot appeal to existing laws or policies to defend their budgets, they need to be free to respond to changing circumstances quickly and decisively. This means an increased role of supplementary appropriations law and a decreased role for the guarantees embodied in entitlement legislation. It also means a diminished role for parliament, because policy changes have often already been implemented long before the supplementary appropriations proposals reach parliament. Of course changes in entitlements cannot be implemented without parliamentary approval, but here the room for maneuver for parliament is often very small because parliament too is bound to the coalition agreement and has to find its own compensatory savings if it wants to dispute changes in entitlements proposed by ministers, on penalty of putting the cabinet in danger.
- The very inclusive character of the expenditure targets in the Dutch multi-annual framework, in particular the inclusion of mandatory expenditures, diminishes the automatic stabilisation effect. Some social security expenditures tend to fluctuate with the economic cycle, and their inclusion leads to room for new expenditures during economic upswings and to retrenchments during recessions. On the other hand, there are also many entitlements that do not fluctuate with the cycle, like those for health, education, and social security other than unemployment and social welfare, so that this aspect has to be nuanced.
- Fixed expenditure frameworks provide an incentive to loop around budgetary discipline by enacting subsidies and benefits in the form of tax expenditures. Indeed, the Netherlands have seen a considerable increase in tax expenditures since the introduction of fixed expenditure frameworks in the beginning of the 1990s. This problem is being addressed but not yet really resolved.

Fixed expenditure frameworks are not really an “advanced” or “sophisticated” budgetary institution. Indeed, it may be argued that they are much simpler to implement and easier to understand for the political community than many other fiscal rules or policies practiced in the OECD area. Simultaneously they concentrate the mind on the most elementary problem of financial management: that of budgetary discipline. This is important not only for the old democracies of the West but also for many young democracies and countries that are in a state of transition.

3.2. The Central Planning Bureau

The Dutch Central Planning Bureau was established shortly after World War II, with a task rather different from what it soon became. Indeed, its conception was very much influenced by pre-war ideas about planning of the entire national economy that existed in circles of the Labour Party, and about corporatist ordering of the private sector that existed in circles of the Catholic People's Party. Although the planning task of the Central Planning Bureau was from the outset designed as advisory and indicative, the idea was certainly that the Bureau would advise about every ministerial initiative in the social-economic-financial domain in order to guarantee central co-ordination. Furthermore, the Bureau would function as the top advisory body for the production plans in the branch-wise ordered private sector. In practice this did not happen (Drees, 1959).

Under the influence of Keynesian ideas, the whole idea of central planning of the private sector was soon abandoned, although specific forms of regulatory interference such as general price and wage regulation continued until the 1970s, and milder forms of intervention through subsidies and tax expenditures continue until today (industrial policy, later technological policy, agricultural policy). The main changes in the tasks of the Bureau that occurred already under its first director, Prof. J. Tinbergen, were: a) the Bureau advised only on specific policy proposals, either at the request of the government or on its own initiative, rather than on all proposals in the social-economic-financial domain, so that the pretended advisory role concerning the central co-ordination of policy in this sphere never took hold; and b) the "central plan" that the Bureau published annually was never (advice for) a central plan but rather a forecast of macroeconomic developments resulting from policies already decided rather than being proposed. Instead of being an advisory body, the Bureau developed almost into its opposite: in its forecasting role, it takes great care in avoiding all normative language or expressions that could be interpreted as recommendations or policy advice. Recommendations only occur in special studies, but there too the Bureau operates very cautiously and tries to make sure that its arguments are based on broad consensus in the scientific community and that its reasoning cannot be criticised as partisan or politically biased. The Bureau can follow these policies because it is based on formal law that guarantees its independence. Indeed, its director is nominated purely on the basis of economic expertise, and it regularly occurs that he (no women so far) is a member of a political party that is not included in the government coalition (which is also the case at present). It seems plausible that it is precisely because of these policies, adhered to meticulously by subsequent directors, that the Bureau has developed into a unique feature of the Dutch institutional arrangement.

How does the Bureau operate presently? I shall concentrate here on the forecasting role, as that is the most interesting part of the Bureau's activity from an international perspective. That role is closely connected to the budget cycle, but also to the quadri-annual establishment of a new multi-annual expenditure framework.

As far as the budget cycle is concerned, the Bureau publishes twice a year a macroeconomic forecast, misleadingly called the "Central Economic Plan (CEP)", and the "Macroeconomic Explorations (MEV)". Both are based on the same short-term macroeconomic model of the economy. The MEV is submitted to parliament and published in September simultaneously with the budget for the upcoming year (coinciding with the calendar year). It contains forecasts for all important macroeconomic variables (output, employment, inflation, imports, exports) including the effects of economic, social and financial policies that have been decided since the last year, including the upcoming budget. In order to allow cabinet to adjust its policies in the light of their effects, the Bureau sends in the beginning of June its provisional views in a confidential report to cabinet, the so-called Queen's MEV. At that date, the outline of the budget (including the net expenditure totals for the budget sectors and chapters of the State budget), including major policy initiatives, has been decided, but adjustments at both the expenditure and revenue side are still possible.

The CEP is published in March. In contrast to the MEV, it does not include the effects of the upcoming budget, which at that time has not yet been decided, but rather provides the basis for the budget discussions through a macroeconomic forecast on the basis of current policy. For that purpose, it updates the forecasts of the previous MEV about the effects of current policies that may turn out differently than earlier expected or that may have been changed by new initiatives or in response to external circumstances (including compensation measures). In addition, the macroeconomic situation may have changed. Preceding the CEP, there is again a confidential "provisional CEP", sent to cabinet in January or February, that is used by the minister of finance during the preparation of his/her expenditure targets. The cabinet decides about the outline of the expenditure side of the upcoming budget (the totals of the budget sectors and chapters of the State budget) in March or April on the basis of an outline letter of the minister of finance which responds to the budget requests by the spending departments.

The Bureau also plays an important role during the design of the coalition programme and the multi-annual expenditure framework, which takes place at least every four years (at a smaller interval if the cabinet falls before completing its term). This role consists of three parts. First, almost a year before the elections, the Bureau puts up a medium-term forecast, assuming unaltered policies. Second, before the election campaign starts, the Bureau

forecasts the economic consequences of the platforms of the major political parties. Third, after the elections, the Bureau forecasts the consequences of the coalition programme and the multi-annual expenditure framework.

The Bureau's medium-term forecast is available at the time the political parties start writing their platforms. Since medium-term forecasting is a more uncertain activity than short-term forecasting, the Bureau often presents various scenarios which represent favourable or less favourable external circumstances. The political parties put up their platforms starting from the Bureau's base projections and aiming at policies that improve the outcomes in the eyes of the voters they want to attract.

Since the elections of 1986, it has become customary that each major political party asks the Bureau to forecast the economic consequences of its draft election platforms (Graafland and Ros, 2003). The Bureau starts from the base assumptions of the medium-term framework and adds to it the measures contained in the party's electoral platform. The results are returned and may lead to adjustments, until outcomes are reached that the party finds acceptable. The Bureau publishes its reports on the election platforms in advance of the elections. These reports play a certain role during the election campaign ("The Central Planning Bureau says that my party will create 15 000 more jobs than your party when in government", "Yes, but only in the public sector, and since your party will increase the deficit by 1.7%, your policies are not sustainable, whereas my party will decrease the tax burden by 0.85% of GDP so that GDP will grow by 2.3% next year and 3.1% in later years"). Whereas in other countries dismissing an opponent's claims about the wonderful economic consequences of his/her proposals is often a favoured weapon of attack, this weapon is more or less cut out now in Dutch politics. Political debate on economic matters has become remarkably technical, but also more responsible (some would say dull). The latter is not so much caused by the fact that debate about consequences has become impossible. That could also have led to more politicisation because politicians have to distinguish themselves by different policies, rather than by different alleged consequences of basically similar policies. Responsibility (and dullness) has rather increased because the more extreme ideas tend to be removed from party platforms, after the Central Planning Bureau has shown not only their beneficial effects, but also their adverse effects, particularly on incomes of specific groups. Another consequence of the involvement of the Bureau with the election programmes is that election programmes have become more precise. Indeed, the Bureau can only make a forecast if a measure is spelled out quite clearly. If a measure is vague in the draft that the Bureau receives (for instance, "increase support for" instead of a precise percentage increase in a concrete subsidy in a concrete law), it will indicate that the party has to make it more precise and that otherwise it will be neglected. This practice has proved to be effective in forcing parties to be precise in their electoral promises.

One could ask why Dutch political parties are willing to have their proposals analysed by the Bureau. Of course it is not only curiosity about what the Bureau has to say about them, but also electoral considerations. The parties seem to fear more the accusation of not daring to face the consequences of their proposals than the possibility of getting a mediocre grade. Submitting their proposals seems to be the less risky strategy, especially since the process is confidential so that proposals can be adjusted until an acceptable outcome is obtained before the Bureau report is published. A party that did not submit its proposals in the parliamentary elections of 2002 was the List Pim Fortuyn. Apparently this did not harm the party because it became in one blow the second largest party in parliament, even though its leader was murdered a few days before the vote. Since then, the List Pim Fortuyn has declined and, some say, been incorporated into the traditional political culture of the Netherlands. Perhaps the party will even submit its programme to the Bureau at the next elections! Nevertheless, the political discontent that suddenly erupted in 2002 has not entirely disappeared and may surface again. It remains to be seen whether the discipline on the side of the parties that makes possible the role of the Bureau will be proof against the political struggles of the future, which may be of a rougher kind than we have seen in the last two decades.

After the election, the Queen nominates an adviser, called “informateur”, who has to negotiate with the party leaders in order to reach agreement about a coalition programme including a multi-year expenditure framework. The adviser will ask the Central Planning Bureau on several occasions during his/her work to make forecasts about the economic consequences of the proposals on the table. This information might be reason for the negotiating parties to change their minds. Sometimes Bureau information is so damaging for a draft agreement that has been hammered out in a long and painful process that the intended coalition breaks down and other parties have to be brought into the negotiating process. This happened on the occasion of the last cabinet formation (beginning 2003), when the Labour Party was removed from the intended coalition after two months of negotiations and was replaced by the Liberal Party. At the end of the process, the coalition programme will be published, including the Bureau’s forecasts for the cabinet period. The coalition programme will also contain the expenditure framework (total net expenditure and net expenditure per budget sector and State chapter for the entire cabinet period). The coalition programme is an important document because it cannot be changed partially without undermining the entire structure and thereby the cabinet as such. Over the last 20 years, there have been partial revisions of coalition programmes, but only rarely, and under very particular external circumstances.

Having an independent bureau responsible for the official economic forecasts of the government has the advantage that the forecasts cannot be influenced by the cabinet of the day. Cabinets always tend to paint black scenarios about the course of affairs they found when taking office, and rosy scenarios about the consequences of their own policies. This is impossible in Holland, as far as economic forecasts are concerned. Other OECD countries sometimes lean on private sector research institutes to attain the same objectivity, for instance Germany and the United States (for a comparative perspective on institutional arrangements, see the work of Hagen²). However, research institutes use different models which lead to different results. Taking averages as is done in Germany and the United States is a solution, but makes it impossible to have a discussion about the theoretical backgrounds of the numbers that are actually used (because different models may have different theoretical backgrounds). Of course, lively competition in macroeconomic modeling and forecast information in a country helps to improve quality, but for that purpose it is not necessary to do away with an official forecast institute. The fact that an official forecaster is held accountable in the scientific community for its errors, especially in the presence of alternatives, tends to work as an effective incentive as well.

4. Delivery institutions

4.1. The non-profit sector

Holland has a uniquely large private non-profit sector. This goes back to the 19th century when the large confessional communities (Catholics, various kinds of Protestants) established their own schools and pre-welfare State health and social security organisations. In the beginning of the 20th century, the labour movement established its own non-profit sector. Later in the 20th century, the welfare State was built upon the existing “pillar structure” in the private sector rather than being raised from the ground in the public sphere, as happened in other countries. The welfare State led to a large extension and public funding of the services of these organisations, but the organisations themselves remained in the private sector.

Funding is given in the form of subsidies (in the legal sense), but because the organisations are non-profit, these flows are not considered as subsidies in the economic sense. Hence they are denoted here as public contributions.

Private, non-profit organisations usually exist alongside public, often municipal organisations that provide the same services and that are funded on an equal basis by the central government. These flows, too, are denoted as public contributions. The private, non-profit sector dominates primary and secondary education (70% of public funding in 2003 went to private schools). It also dominates the health sector (for instance, 100% of public funding for

hospitals, residential care for the elderly, and residential and daycare for the handicapped goes to private suppliers). In general, approximately 25% of net central government expenditure (including social security and health care) goes to the private, non-profit sector.

The private, non-profit sector provides services that have the character of “private goods” in an economic sense. In principle these goods could also be provided without public contributions, but that would reintroduce the equity problems that existed before the development of the welfare State. Public funding solves these problems. However, keeping the service providers in the private sector has two advantages.

First, because they are private, these providers own their assets and can decide autonomously about their budgets. Regardless of legal status (usually foundations or associations), a financial surplus can be said to be owned by “residual claimants”. This implies that private, non-profit organisations are subject to an efficiency incentive that public organisations are lacking. This motive has regard to cost efficiency (producing goods at minimal costs) as well as to allocative efficiency (producing goods that maximise consumer welfare). The profit motive, which consists in the transferability of profits to the private income of owners, is not necessary for that purpose.

Second, because free choice among clients may be maintained, service providers are often (not always) subject to competition. Competition strengthens the efficiency incentive implied by private ownership. This is the case because competition implies that high price or bad quality not only decrease demand for the service of the provider but in principle abolish it.

The example of primary and secondary education gives an illustration. Roughly two-thirds of schools in these sectors are private. Private and public schools are financed on an absolutely equal basis by the central government. This applies to all employment costs. If a public school receives a certain amount per pupil for cleaning of the school building, a private school receives exactly the same amount. In a certain sense the funding arrangement is even more favourable to private than to public schools because municipalities are not allowed to provide discriminatory additional funding to their own schools. Every euro the municipality spends on its own schools in addition to the central government contribution has to also be given to all private schools within the municipal borders on the same basis. In contrast, private schools are free to spend on their own schools in addition to the public contribution. In practice, most private schools limit their fees to the funding for fringe benefits: excursions, sports facilities, teaching of voluntary subjects, and sometimes a smaller average class size. Private schools generally do not pay higher salaries to teachers.

This arrangement works exactly like a voucher system. Whereas in other countries (France, Germany, United Kingdom, United States) public funding of private schools remains a highly controversial issue, in Holland equal funding of private schools exists since 1917 (when it was laid down in the constitution) and has since then not been disputed. Public funding of private schools has been accompanied by full parental choice and competition. However, here there is some room for policy. In principle, parental choice would entail the right to establish a new school if minimal attendance standards are fulfilled and the closing down of schools if attendance falls below minimal standards. Indeed, school establishment rights and minimal attendance standards are laid down in the law, but in practice municipalities are keen to avoid the closing down of schools and may delay the establishment of new schools, especially if they are judged to contravene ethnic integration policy (for instance, Islamic schools). Municipalities can do this because they are responsible for the construction of schools, both private and public (investment in the outside as opposed to the inside of schools). In view of the constitution and the law, such maneuvering must take the form of voluntary co-operation between schools, but this does not always work smoothly. In the last few years, this has led to some new discussion about certain aspects of the equal funding principle, but it is not plausible that this will lead to a major revision given its constitutional anchoring and the vested interests of the private sector.

The education example also shows that private service provision in combination with competition is not an absolute guarantee for efficiency and quality. Indeed, during the last 40 years (starting in the mid-1960s), Holland has seen a similar degradation of its educational system, particularly in secondary education, as have many other European countries. However, this had to do with the regulation of course structure and content, which is the same for public and private schools, and not with funding methods. In Holland, as in other countries, educational policy has fallen prey to progressive educational reformers who thought that children with gifts for practical work could best be educated by keeping them away from anything practical in order to allow them the privilege of prolonged contact with their more intellectually inclined peers. Similarly, the government has weakened selection, has not extended school budgets in proportion to increased demand, has retrenched on teacher salaries, has let performance and examination standards deteriorate, and has encouraged school mergers.³ In all these aspects, Holland is not different from other European countries. Nevertheless, it can be said that the voucher system and competition have had a certain mitigating effect on these adverse developments. Although private schools are subject to the law, they have proved creative in interpreting it, thus attracting pupils. Also the dominating presence of the private sector has induced a sentiment, both on the part of the private school

unions and on the part of parents, that “the school belongs to us and not to the politicians”, which has shored up resistance against too bizarre proposals.⁴ Furthermore, in recent years increased recognition of what has happened has brought the ideals of social reform through educational reform into disrepute. This has also led to a certain recognition by politicians that schools now need tranquility for a number of years.

4.2. Arm’s length agencies

Executive agencies at arm’s length distance from the central government are a relatively recent phenomenon in the Dutch public administration.⁵ Arm’s length agencies – henceforth called agencies – were first proposed in an interdepartmental policy study of 1991. This report was influenced by the ideas of New Public Management. The central argument was that efficiency could be improved when managers of executive agencies would obtain more liberties concerning inputs, such as personnel formation, contracting out, and cash management (including borrowing and saving). In return, agencies should be entirely transparent about their prices and the quality of their products. Such transparency would require an accrual system of accounting, the definition of products, and the computation of prices per product. The minister would remain fully responsible for service provision by the agency. The report was also inspired by the development of Next Step agencies in the United Kingdom that in 1991 had already been under way for some time.

In reaction to the report, the cabinet decided to establish four agencies, namely by defining the status of agencies in administrative rules and by attributing this status to four departmental divisions. In the following years, the number of agencies gradually grew. Many ministerial divisions wanted to obtain the new liberties, and many saw that the new control regime on outputs was less constraining than the former one on inputs. In the beginning of 2004, there were 30 agencies, and 16 departmental divisions were in procedures to become an agency. Present cabinet policy is that gradually all executive divisions of ministries have to be agencies. The reorganisation has led to a complete overhaul of the central government. When it is complete, 80% of central government employees will work in agencies and only 20% will remain in the core ministries. It will have been one of the most far-reaching reforms to have taken place since the establishment of the Kingdom in the early 19th century.

In general it can be said that both agencies and core ministries are reasonably content with the results obtained so far. Agencies appreciate their new freedoms and would like to have them even further expanded. Core ministries appreciate the output and price information that has become available, however precarious its quality and coverage. Particularly, core ministries feel that the increased distance from the agencies enables them to

consider more objectively the performance of the agencies against the background of the alternatives: decentralisation to subnational government or contracting out. At the same time, the availability of the alternatives enables them to put more pressure on agencies to improve cost efficiency and to decrease prices.

Less enthusiastic so far have been the Court of Accounts and parliament. Already in 1998 and 1999, the Court of Accounts criticised many shortcomings in the financial management of agencies. In particular the Court considered the quality of information about costs and service quality as insufficient, as well as the way the core ministries used that information. Cabinet reacted to this criticism in 2000 with new regulations. Moreover, under pressure from parliament, cabinet was obliged to announce a moratorium on the establishment of new agencies until the shortcomings were corrected. In 2002, the regulations for the financial management of agencies were stepped up again. What is conspicuous in this process is that in all its reports the Court of Accounts is very critical about the financial management of agencies but does not challenge the main direction of cabinet policy. Indeed, it underscores time and again that it fully agrees with the basic ideas, namely:

- the separation of the financial management of executive agencies from that of the core ministries and the transfer of authority for the production process to the agencies;
- funding of agencies on the basis of outputs;
- adoption of an accrual system of accounting for the agencies.

What the Court criticises is that the cabinet proceeds full speed with the establishment of new agencies and the abolition of input controls whereas the conditions are not fulfilled:

- There is no complete separation of financial management from the core ministry: agencies keep using ministerial facilities without being charged for these services.
- Agencies are in many cases not funded on the basis of outputs, but on the basis of a lump sum only weakly related to performance.
- The accrual system in many agencies is still in its infancy and does not work properly.

It seems likely that the problems identified by the Court of Accounts will be solved in the near future. However, there are two other, more fundamental problems that may be harder to solve. These problems are:

- Agencies do not differ from the former ministerial bureaus as far as efficiency incentives are concerned: such incentives are lacking in both cases.

- In general, quality of outputs cannot be specified before the start of the production process.

These problems are of a microeconomic nature and have not always been recognised in the new public management literature that has inspired the agency initiative.

As far as the efficiency problem is concerned, there is often a naive idea in the new public management literature that the separation of financial management will lead to a cost efficiency incentive because it would imply that the agency can “keep the efficiency profit”. Although it is true that the separation of accounts would allow the agency to keep the efficiency profit,⁶ it has no incentive to do so. The reason is that managers of agencies cannot take home profits and there are no other “residual claimants” in the agency who might have an interest in profits. Therefore it is always preferable to agency managers to drive up production costs by increasing salaries and non-salary benefits to employees than to create an efficiency profit. Indeed, if a minister discovers persisting efficiency profits under existing unit or lump-sum prices, he/she might be tempted to diminish the price or the lump sum. Instead of being subject to an efficiency motive, agency managers are subject to an inefficiency motive, namely to maximise benefits to employees, including themselves. In this respect, there is no difference at all between traditional ministerial bureau chiefs and agency managers. Perhaps the opportunities of agency managers to divest money towards employee benefits are even larger. Without adequate remedies, it is thus to be expected that agencies are less rather than more cost efficient than regular ministerial divisions.

As far as the output specification problem is concerned, the problem is well known from the private sector. In branches where competition works, efficiency is enforced by competition, not by the specification of outputs. In branches where there are hold-up problems due to product-specific assets or uncertainty, efficiency is enforced through an iterative process of output specification, in subsequent stages of the production process. This holds for the entire private service sector, for instance, catering, construction, software services. Although the contract starts with a price and a roughly indicated performance, the real specification of performance takes place only during contract execution. The original contract is called an open contract. The most obvious example of an open contract is the labour contract, which only specifies a salary and a job description. Concrete tasks are only assigned during the contract execution. In the microeconomic literature, the process of filling in an open contract is called “relational contracting” (Williamson, 1985). It is the main mechanism for efficiency control in the presence of a monopolistic supplier. This body of theory is entirely applicable to the public sector where agencies also enjoy monopolistic advantages. Any attempt to fix quality criteria in advance of production will lead to the syndrome of soviet

economics, in which the incentive to serve clients is replaced by the incentive to achieve planning targets. It is remarkable that this insight, which is more or less common sense among economists, has had so little impact on the new public management movement and, for that matter, on the debate about performance budgeting.

If residual claimants and competition are lacking, cost efficiency and service quality must be controlled by the client. For that purpose it is essential: a) that the client receives good information on costs; and b) that the client is allowed to interfere at any moment in the production process to bring down costs or specify quality, even if this means renegotiating the contract (including the price). The value of the agency initiative consists in the improvement of the information on production cost, not in improved incentives. Information is improved because the financial administration of the agency is completely separated from that of the core ministry and overhead is included in agency costs. Furthermore, the accrual system allows the computation of a unit price or a lump-sum cost-price for the services the agency produces.

Iterative quality control through relational contracting is thus by far the least developed part of the agency initiative. Nevertheless, this aspect is now the top priority of the co-ordinating ministry of finance, and its importance is gradually recognized by the wider financial management community. Basic ideas that are more or less agreed are:

- Relational contracting requires expertise and should be concentrated in (a) special unit(s) in the spending ministries.
- Relational contracting requires permanent negotiations between agencies and core ministries about the quality of price information and the quality and quantity of services delivered.
- Core ministries should hold specific legal competences to inspect and monitor the production process in agencies.
- Within spending ministries, two different roles with respect to agencies can be discerned: the ownership role which focuses on cost efficiency, and the client role which focuses on quality of services (allocative product efficiency⁷). The ownership role can best be taken on by the financial division of the spending ministry, the client role by the policy-making division (the division that has made the policy that the agency is executing).

A point that is still being discussed is where the interface unit(s) in charge of relational contracting should be located within the spending ministries and, related to that, who should take the lead in the supervision of agencies: the financial directorates or the policy-making directorates. In view of efficiencies of scale, it seems attractive to concentrate the supervisory role in a single unit in the financial directorates, but if this solution is chosen, it is

essential that the policy-making directorates are given a clear auxiliary role in the actual control and contracting task, because they are the only ones who really can judge service quality.

5. Conclusions

Fixed multi-annual expenditure frameworks and the strong role of the Central Planning Bureau are two features of Dutch budget institutions that are uncommon in the OECD area. Both institutions might – in some form, modified and adapted to local circumstances – be useful and attractive to countries in a transition process.

The single largest advantage of fixed expenditure frameworks is that they bring tranquility to the budget process and that they allow spending ministers to plan in advance. The most difficult aspect of the frameworks is that they require strict budgetary discipline and a certain flexibility in existing expenditures in order to adapt to new developments through reallocation. This tends to weaken the position of parliament and to strengthen that of spending ministers. However, in political systems with a “weak” minister of finance, which is usual in multi-party parliamentary systems, this should be seen as an advantage rather than a disadvantage.

The establishment of an independent central forecasting bureau might also be a useful step for countries in transition. In order to avoid risks of political bias, a forecasting bureau in a transition country should probably focus on forecasting and relinquish an advisory role. Even if political parties are initially suspicious and reluctant to consult the bureau on the consequences of policies, the mere existence of the bureau may lead in the longer run to a more disciplined debate about financial and economic policy.

Perhaps the main idea to remember about the huge Dutch non-profit sector is that there is an alternative for State-dominated service delivery in education, health and social services, without sacrificing solidarity with low-income groups. The modern name for this idea is vouchers, but in Holland this idea goes back to the 19th century. It simply means that there is competition between alternative suppliers and that public funding follows the client rather than the supplier.

Finally, as far as agencies are concerned, it is important to keep in mind what the essence of the reform is, what it will achieve, and what it will not achieve. The essence is that the financial management of the agency is fully separated from that of the core ministry, that the agency produces cost-price information on the basis of accrual accounting, and that it is financed on the basis of a unit or lump-sum cost-price. What the reform achieves is good information on service costs, which makes it possible to assess cost efficiency and to compare agency performance with market alternatives. What it does

not achieve is providing an incentive for cost efficiency or service quality to agency management. For that purpose, relational contracting is essential. Given that the task of relational contracting requires expertise, it may be advisable to concentrate it in a special unit of the financial directorate of the spending ministries. The actual supervision of agencies requires the expertise of the policy-making divisions of the spending ministries. A way to bring this expertise to bear is to include representatives of these divisions in the teams that are charged with the monitoring and renegotiating of agency contracts.

Notes

1. The United States had periodical expenditure frameworks as well under the Budget Enforcement Act (1990). This Act specified ceilings for discretionary expenditures for a number of years and required compensation for all policy changes in revenues and mandatory expenditures. Revisions and extensions of the ceilings took place towards the end of the periods. The Act expired in 2002. The present administration wants to revive the Budget Enforcement Act and make its planning period equal to that of the president's term in office (Blöndal et al., 2003).
2. For instance: Hagen (1992); Poterba and Hagen (1999).
3. For years school mergers were openly advocated on the basis of "economies of scale", flowing from the prevailing funding systems. This was of course flawed reasoning, since economies of scale cannot be derived from funding systems. Indeed, optimal school size is very hard to determine, but parents, children and teachers seem to prefer schools that are quite small and such preferences should not easily be discarded.
4. In the United Kingdom, for instance, the grammar school was abolished in the 1960s, thus effectively closing down a recognised expressway for smart children from low-income families to the academic top. In the Netherlands, a similar proposal to abolish the "gymnasium" (with an emphasis on the classic languages in addition to the regular programme preparing for university) has been defeated. Now the gymnasium is one of the fastest increasing and flourishing forms of secondary education.
5. Arm's length agencies should not be confused with independent public corporations funded by government. Independent public corporations are a common phenomenon in the entire OECD area. However, the problems described with respect to the financial management and supervision of agencies also apply to public corporations. In Holland, the developments in this domain are more or less similar for agencies and public corporations.
6. Agencies are allowed to "own" (in an administrative sense) assets to the value of 5% of their average income in the last three years.
7. There is also allocative factor efficiency, which is part of cost efficiency.

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