

THE REFORM OF PUBLIC EXPENDITURE MANAGEMENT SYSTEMS IN OECD COUNTRIES

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1. Introduction

There are three major determinants of the fiscal outcomes of OECD member countries. The first is of course the general performance of the economy. There is no factor more responsible for the fiscal outcome than this. The second is the political commitment to fiscal discipline. The third major reason – and the focus of this paper – is the institutional arrangements for budgeting.

There are many examples of countries that have had a combination of economic growth and a political commitment to fiscal discipline but have not experienced successful fiscal outcomes.

The member countries which are currently experiencing the best fiscal outcomes are generally the same countries that have been the most active in reforming and modernizing their budget processes. The countries that started the earliest were the first to experience these successful fiscal outcomes, the ones that did the most comprehensive reforms are the ones that have had the most sustainable track record in this respect.

This paper identifies seven key institutional features that we believe play a key role in effectively controlling public expenditures:

- medium-term expenditure frameworks
- prudent economic assumptions
- top-down budgeting techniques
- budget transparency
- relaxing central input controls
- focus on results
- modern financial management practices.

The remainder of this paper is devoted to a discussion of them. Although they are identified as seven separate features, they do in fact build on each other and must be seen as a package. Each of these features is discussed below in detail.

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2. Medium-term expenditure frameworks

Medium-term budget frameworks form the basis for achieving fiscal consolidation. They need to clearly state the government's medium-term fiscal objectives in terms of high-level targets such as the level of aggregate revenue, expenditure, deficit/surplus and debt. They then need to operationalize these high-level targets by establishing hard budget constraints for individual ministries and programmes over a number of years. This lends stability and credibility to the government's fiscal objectives.

By their very nature, high-level fiscal targets are set in a medium-term context. They aim to achieve a certain fiscal outcome over a number of years. Budgets are however enacted for a time period of one year, and are notorious for their short-term focus. This short-term time horizon is often criticised for impeding effective expenditure management; decision on resource allocation are said to be made on an *ad hoc* or piecemeal basis with the implications of past and present decisions beyond the next year being neglected. This is not a new criticism. Medium-term budget frameworks aim to bridge this gap. Their successful implementation has been nothing short of a "cultural revolution" in governments.

Although the level of detail of such frameworks varies from country to country, they generally mirror the format of the budget, *i.e.* the medium-term frameworks are at the same level of detail as the annual budget. This means that a formal framework (or hard budget constraint) exists for each and every appropriation, most often for three years beyond the current fiscal year. These are rolling frameworks that are presented with the budget each year; year $t+1$ in the previous year's framework becomes the basis for the budget in $t+1$ and a new year $t+3$ is added. This has greatly increased the effectiveness of planning and eased the annual budget process. These frameworks are not, however, enacted into legislation; they are planning documents that reflect the political commitment to fiscal discipline.

It should also be emphasized that these are living document. The fact that a three-year budget framework is in place does not mean that no changes can be made to the document. In fact, shifting appropriations within ministries is key to successful fiscal discipline as is described in a later section of this paper. It is, however, imperative that all such changes be clearly depicted and explained, *i.e.* whether the changes are the results of changed economic circumstances or new policy decisions. Countries should publish detailed reconciliations between year $t+1$ in the previous year's framework and the current budget proposal.

The frameworks also serve to deter expenditures by illuminating the budget implications of decisions in next year's budget whose expenditure may not be fully reflected in the budget. This can refer to:

- 1) the operating costs of various capital projects being launched,
- 2) programs that come into effect late in the budget year thus not exposing their full costs in the initial year,

- 3) programs whose spending implications may not be fully reflected under the circumstance prevailing during the budget year but will become more actual in out-years.

These are all classic examples of budgeting games in member countries, which the medium-term frameworks aim to end.

From the point of view of agency managers, medium-term frameworks enable them to be in a better position to plan their operations as they have some indicative level of funding beyond the next budget. This is especially relevant when resources are being reduced. Many downsizing options involve more than one year in order to reap the full benefits. Prior to the advent of medium-term frameworks, such options were often not considered as the time horizon only extended to the next budget year.

2.1 Problems with medium-terms expenditure frameworks

Medium-term expenditure frameworks themselves are, however, not without their own problems. It is worth noting these. The United Kingdom was a pioneer in the area of multi-year budget forecasts in the Sixties and Seventies and encountered significant problems. These problems can be divided into three groups. Most of these problems have been experienced by other member countries as well.

- First, there was a tendency to overestimate the growth potential of the economy when making the multi-year forecasts. This made excessive resources available in the forecast period and created an upward pressure on public expenditure.
- Second, ministries and departments viewed their resource allocations in the forecast period as an entitlement. This made subsequent downward revisions in expenditures difficult, even when it became clear that the basis on which the allocations were made was not correct.
- Third, the multi-year budget forecasts were made in real terms rather than in nominal terms. In the Seventies, when economic growth subsided and inflation accelerated rapidly, the expenditure forecasts were adjusted automatically for increases in prices while revenues suffered. This created further pressure on public finances.

The above experience caused many to view medium-term expenditure frameworks with some suspicion. It must, however, be observed that the early medium-term frameworks took place in an environment of rapid expenditure growth, not expenditure retrenchment as is the case today. Regardless, action has been taken to rectify the specific problems identified above. First, member countries are systematically making use of more “prudent” economic assumptions in order to avoid having excessive resources made available. (This is discussed in the next section of this paper.) This has tended to eliminate the second problem identified above. Third, medium-term budget frameworks are now invariably made in nominal terms, not real terms.

Finally, it must be noted that there are examples of countries where the implementation of medium-term expenditure frameworks has been so poor as to essentially undermine them. This is the case when the budget and the medium-term expenditure frameworks are on “separate tracks”. In-year changes to the budget are not reflected in the frameworks, either in the current year or out-years and the annual budget process starts without reference to the medium-term frameworks. In essence, a new medium-term framework is created each year. For them to operate effectively, the annual budget must be driven from the medium-term expenditure frameworks, and not vice versa.

3. Economic assumptions

Deviations from the forecast of the key economic assumption underlying the budget are the government’s key fiscal risk. There is no single factor more responsible for “derailing” fiscal consolidation programmes than the use of incorrect economic assumptions. Great care must be taken in making them and all key economic assumptions should be disclosed explicitly. Sensitivity analysis should be made of what impact changes in the key economic assumptions would have on the budget. Furthermore, a comparison should be made between the economic assumptions used in the budget and what private sector forecasters are applying for the same time period where practicable. The establishment of an independent body to recommend the economic assumptions to be used in the budget may be considered as well. All this serves to place safeguards against the use of unrealistic, or “optimistic”, economic assumptions.

Two member countries, Canada and the Netherlands, have had especially harrowing experiences with the use of economic assumptions and have established safeguard features that are leading-edge practices among member countries.

In Canada, the government started using systematically-biased “prudent” economic assumptions and incorporating a contingency reserve. The previous perception of “optimistic” economic assumptions being used in the budget had significantly downgraded the believability of government-generated economic forecasts. Rather than relying on internally generated economic forecasts to be used in the budget, the government started employing the average of forecasts made by private sector economic forecasters – and then adjusting them downwards. This was done in order to achieve credibility, both in the eyes of the public and in the eyes of financial markets.

The Canadian Department of Finance systematically revises the private sector forecasts downwards as a further measure of prudence. This takes the form of the government adding 50-100 basis points (0.5-1.0 percentage points) to the average private sector economic forecasts for interest rates and then feeding this through its entire econometric model, thus producing lower forecast economic activity. This provides a buffer in order to maintain the government’s fiscal objectives. As a further buffer, the government established a significant contingency reserve fund –

2.5 billion-3.0 billion Canadian dollars each year. This fund can only be used to compensate for forecasting errors and unpredictable events. It cannot be used for any new policy initiatives. Recourse has never had to be made to the contingency reserve funds and they have been applied to deficit reduction (surplus) in their entirety in each year.

In the Netherlands, the government shifted its focus from controlling the level of deficits to controlling the level of expenditures. These expenditure caps were based on cautious economic assumptions for the economy. This was viewed as an “insurance policy” for shifting the focus from the deficit to expenditures, *i.e.* the risk of the budget outturn being worse than expected is mitigated. Any “surprises” are likely to be positive. The economic assumptions are made by the independent Central Planning Bureau (CPB). The CPB will present two economic scenarios to the government. The first one is what it considers to be the most likely level of economic growth. The second one is what it considers to be a cautious level of economic growth that should be used for budget policy purposes. The government then applies the cautious scenario. In political terms, the government would rather be faced with “good surprises” rather than with “bad surprises”.

Both these cases were the direct results of acknowledged use of poor economic assumptions in the past. The sustainability of using such special prudence factors can be called into question as time passes and they become internalised in the budget process. This is already happening in Canada.

4. Top-down budgeting techniques

Budgeting has traditionally operated on a bottom-up principle. This means that all ministries send requests for funding to the finance ministry. These requests greatly exceed what they realistically believe they will get. Budgeting then consists of the finance ministry negotiating with these ministries and agencies until some common point is found. This bottom-up system has several disadvantages to it. First, it is very time consuming and it is essentially a game; all participants know that the initial requests are not realistic. Second, this process has an inherent bias for increasing expenditures; all new programs, or expansion of existing programs, are financed by new requests; there was no system for reallocation within spending ministries and there were no preset spending limits. Third, it was difficult to reflect political priorities in this system as it was a bottom-up exercise with the budget “emerging” at the end of this process. This manner of budgeting is now being abandoned and replaced with a new top-down approach to budget formulation. This has been of great assistance in achieving fiscal consolidation.

The starting point for the new system is for the government to make a binding political decision as to the total level of expenditures and to divide them among individual spending ministries. This decision is made possible by the medium-term expenditure frameworks which contain baseline expenditure information, *i.e.* what the budget would look like if no new policy decisions were made. The political

decision is whether to increase expenditures for a high-priority area, for example education, and to reduce expenditures, for example transport programs. Only the largest and most significant programs reach this level of political reallocation. The key point is that each ministry has a preset limit on how much it can spend.

Practices vary on the specificity of these preset limits. In some countries, there is one aggregate limit per ministry encompassing all expenditures. In other countries, there may be sub-limits on operating expenditure (sometimes divided into salaries and other operating expenditures), transfers and capital expenditures. This is to prevent transfers and capital expenditures from being shifted into operating expenditure, especially salaries.

Once this decision on spending limits is taken, the finance ministry largely withdraws from the details of budgetary allocations for each ministry. The finance ministry concerns itself only with the level of aggregate expenditure for each ministry; not the internal allocations. "Each minister is his own finance minister", is the saying in some countries. Each ministry has a total amount and it can freely reallocate that money among its various agencies and programs. This has several advantages to it. It serves to hamper creeping increases in expenditures as new policies are funded by reallocations from other areas within the ministry. It creates ownership in the respective ministries for the actions that are taken. Decisions are also better informed as spending ministries are in the best position to judge the relative merits of their programs. The role of the Ministry of Finance is to verify that the offsetting cuts to finance new programs are real.

This is a remarkably simple budgeting system once it is in place. It does however involve considerable time to establish because the entrenched traditions of both spending ministries and finance ministries work against it. The finance ministry may be very suspicious of the real motives of spending ministries and have a tendency to exert their influence on the detailed allocations within spending ministries. This serves to undermine the basic premise of the system. Spending ministries on the other hand fear that any cuts in programs they make will be accepted by the finance ministry, but not the corresponding reallocations for new initiatives. This leads to spending ministries proposing unrealistic cuts in programmes that they know will not be accepted by parliament (or the finance ministry), and then the whole old-style bargaining starts again. Trust needs to be built between the two and this has varied greatly in different countries whether that is possible and how much time it takes. The end results however clearly indicate that it is well worth the effort.

5. Relaxing central input controls

Relaxing central input controls is another feature of successful fiscal consolidation strategies in member countries. This is based on the simple premise that the heads of individual agencies are in the best position to choose the most efficient mix of inputs to carry out the agency's activities. The end result is that an

agency can produce the same services at less cost, or more services at the same cost. This greatly facilitates fiscal consolidation strategies by mitigating their effects on services.

Relaxing central input controls operates at three levels. First, the consolidation of various budget lines into a single appropriation for all operating costs (salaries, travel, supplies, etc.). Second, the decentralization of the personnel management function. Third, the decentralization of other common service provisions, notably accommodations (buildings). This can be seen as the public sector's version of "deregulation".

The consolidation of budget appropriation lines is rather straightforward and simple. It is now common for agencies to receive one single appropriation for all of their operating expenditures. (It should be clear that this does not apply to transfers or capital appropriations, only to operating expenditures). This single appropriation is, however, not enough to generate managerial flexibility as various central management rules inhibit this flexibility.

It is in the area of human resource management where most of the central management rules exist. The cost of staff is generally the largest component of operating expenditures, and it makes little difference to consolidation budget lines if central rules in this area prevent any flexibility. All countries are increasing flexibility in this area, although to significantly varying degrees. The country that has gone the furthest in this area is Sweden.

Personnel management in Sweden has historically been decentralized with the outstanding exception of collective bargaining arrangements. Directors-general of agencies are, and have been, responsible for the recruitment, grading and dismissal of their staff. There are no restrictions on whom they may hire. There is no "civil service" encompassing the government as a whole. Vacancies are generally advertised in the press with all qualified applicants being treated equally. Staff are not tenured in Sweden. They can typically be dismissed at two- to twelve-month notice depending on how long they have been employed by the agency. In fact, there are essentially no differences between the labor legislation governing the public sector and the private sector in Sweden.

In 1994, collective bargaining was totally devolved to the agencies and is now the responsibility of the director-general of each agency. The cost of personnel is now one of the many items of expenditure that directors-general must manage within the limit of their single operating appropriation. There is no longer any automatic adjustment to their budgets to compensate for pay agreements that are concluded. The Ministry of Finance and Parliament no longer have any direct influence on the contents of the collective agreements establishing the salaries and other conditions of employment for government staff. The agreements are negotiated entirely by the agencies.

The experience with this new framework is predominantly positive. The agencies have welcomed their increased responsibility for wage formation, and employer policies in general. The pay agreements that have been reached have been

within the cash limits of agency appropriations. This is attributed primarily to the “immense” peer pressure that directors-general exert on each other for responsible settlements. There are, however, significant variations between agencies and it is estimated that over 90 per cent of government employees in Sweden now receive individualized salaries, *i.e.* based on their personal performance. Public sector unions have been constructive partners in this area.

Accommodations (buildings) is another area where common service provisions are being relaxed or abolished. In New Zealand, for example, agencies now have the freedom to choose their accommodation. They can simply give notice and get their accommodations supplied by the private sector. The freedom to choose accommodations, however, cannot be enjoyed equally by all agencies. Some agencies occupy very special accommodations, prisons and museums being outstanding examples. This can also create a conflict of interest between the agencies viewed in isolation (as they move to private sector accommodations) and the government as a whole (which may be left with surplus accommodations). This is especially the case when there is a downturn in the private sector property market. These problems should, however, not be overestimated and are in any case temporary transition costs on the way to a more efficient system in the long term.

Relaxing central input controls have as the goal to empower directors-general to operate their agencies in the most efficient manner possible. No longer can they claim that their poor performance is due to the fact that a budget, which was too detailed, or a set of central management rules, which were overly prescriptive, impeded them in the running of their agencies. Now, they have the power and they must deliver. The experience overwhelmingly shows that they have done so; agencies have become more efficient thus making fiscal consolidation efforts “less painful” from the point of view of customers of government services.

It is worth noting that detailed budgets and central management rules originally came into place to prevent corruption in government. The countries that have gone the furthest in reducing them are the smaller members countries where this is less of a potential problem than perhaps in other member countries. In other words, this reform may not work in all environments.

6. An increased focus on results

An increased focus on results is a direct *quid pro quo* for relaxing input controls as described above. Accountability in the public sector has traditionally been based on compliance with rules and procedures. It didn't matter what you did as long as you observed the rules. Now, when the public sector is deregulated, a new results-based system is needed to hold managers accountable. This is a fundamental change: holding managers accountable for *what* they do, not *how* they do it. Effectively implementing this is, however, very difficult in practice. The difficulties can be divided into several groups of issues.

At the most basic level, some government activities simply lend themselves to results measurement much more readily than others. For example, an agency that produces a single or a few homogenous products or services can be rather easily measured. An agency that issues passports is a good example. On the other hand, agencies that produce heterogeneous and individualized services can be very difficult to measure. The majority of government services fall into the latter category. Various social services are the outstanding example.

We are also faced with the choice of defining results either in terms of outputs or outcomes. Outputs are the goods and services that government agencies produce. Outcomes are the impact on, or the consequences for, the community of the outputs that are produced. An example highlights this. A government may wish to reduce the number of fatalities on highways caused by drunk drivers. This would be the outcome. In order to achieve this, it may launch a series of advertisements in the media highlighting the dangers of drink driving. It's easy to measure the output, *i.e.* that the prescribed number of advertisements were in fact shown in the media. Let's, however, assume that at the same time the number of fatalities went up, not down. The link between the advertisements and this outcome is very unclear, since many other factors than the advertisements would impact on the outcome. But what lessons do we draw from this. Do we abandon the advertisement campaign? Do we expand it? Do we try other outputs? Do we wait to see if this is a one-off or a sustained trend?

From an accountability point of view, the question arises whether you hold managers responsible for outputs or outcomes. Outputs are easier to work with in this context; but outcomes are what matters in the final analysis. Do we want an accountability regime based on outputs even though the outputs may not be contributing to the desired outcome? Or do we have an accountability regime based on outcomes, even though a number of factors outside the control of the director-general of the agency may have contributed to it? Of course, a combination of the two is the optimum choice, but experience in member countries shows that one will always dominate.

It is a well known phenomenon in management that "what gets measured, gets managed". As noted above, some activities lend themselves to measurement more readily than others. This also applies within agencies in that certain of their activities are more easily measured than others. If the agency's measurement systems are biased in favor of those activities that are more easily measured, there's every likelihood that management will focus its attention disproportionately on those activities since their accountability is based on that. This may lead to all sorts of unforeseen and undesired consequences. This creates a huge onus on those designing the agency's measurement system to ensure that it captures all aspects of their activities.

Somewhat contradictory to the above point is the problem of information overload. Agencies produce so much information that it's very difficult for outsiders to judge which are the more important pieces of information. The lesson here is for agencies to differentiate between the measurements they do for internal purposes

and those they perform for external purposes. A weighed index of various internal measures may be the optimum solution for an external audience.

The reliability and consistency of the performance information is also of primary importance. In some member countries, the performance information is audited together with the financial information by the Supreme Audit Institution. Time series of performance measurements are often the most revealing pieces of information. It is therefore important to maintain consistency over time, or to restate prior information if a change in the objects of measurement are deemed necessary. Such changes should however be few and far between. It is increasingly recognized as a *prima facie* evidence of there being something wrong with the operations of an agency if such changes are frequently made.

Building on the last point is the issue of whether explicit targets should be set at the beginning of the year, or whether the evolution of time-series data should be used to judge the performance of an agency. There are two schools of thought on this subject. The first says that any target will either be set so low that it's guaranteed to be fulfilled or so high that it can never be attained. The second school believes that target setting is a very important tool to ensure that agencies focus on those aspects of their operations that are deemed high priority from a political point of view. The jury is still out on this.

Notwithstanding these challenges, an increased focus on results is a most definite trend in all member countries. Reducing input controls plays a key role in increasing the efficiency of the public sector, and replacing them with an increased focus on results is the new and necessary basis of accountability. Robust results information is often of great value in improving results allocation as well.

Finally, there are many sceptics concerning this development, as a focus on results is not a new attempt for governments. This has been attempted since at least the Fifties with very mixed results. What gives more hope to it being successful this time is that it is a requisite for eliminating input controls, it replaces them rather than being a new layer of controls as was the case with previous attempts.

The buy-in from politicians is however a continual challenge. Their level of interest in results information is surprisingly little, although there are of course notable exceptions.

7. Budget transparency

Increased transparency in budgeting made significant advances in the late Eighties and early Nineties. This was a period associated with unfavorable budget conditions in most member countries; high annual deficits and increasing levels of outstanding debt. Governments needed to institute large fiscal consolidation programs. These were often painful and getting the public's understanding of the problems was necessary. The most effective manner for achieving that was simply to throw open the books and say to the public: "Look, things are really as bad as we

told you, we're not hiding anything". This may sound a bit sinister at first, but in actuality it is government at its best: Being honest with citizens, explaining the problem to them in order for an understanding to emerge as to the best course of action to take.

This time period also coincided with increased attention being paid to good governance in general. The budget is the principal policy document of government, where the government's policy objectives are reconciled and implemented in concrete terms. Budget transparency – openness about policy intentions, formulation and implementation – is therefore at the core of good governance agenda.

If we take a look at fiscal transparency in concrete terms, we can say that it has three essential elements:

- the first is the release of budget data. The systematic and timely release of all relevant fiscal information is what we typically associate with budget transparency. It is an absolute prerequisite, but it is not enough;
- the second element is an effective role for the legislature. It must be able to scrutinize the budget reports and independently review them. It must be able to debate and influence budget policy and be in a position to effectively hold the government to account. This is both in terms of the constitutional role of the legislature and the level of resources that the legislature has at its disposal;
- the third element is an effective role for civil society, through the media and non-governmental organizations. Citizens, directly or through these vehicles, must be in a position to influence budget policy and must be in a position to hold the government to account.

These three elements work together. The scrutiny of fiscal information by the legislature and by civil society can only take place if the information is released in the first place. Similarly, released budget information is only of value if it is effectively scrutinized by the legislature and by civil society. The legislature and civil society have a very similar function, one is responsible for shaping budget policy and for holding government directly to account while the other performs this role indirectly.

Although conventional wisdom is that a strong role for parliament equates an undermining of fiscal discipline, the experience in member countries simply does not show that to be the case. The OECD strongly believes that an effective role for the legislature is a key ingredient in establishing and maintaining fiscal discipline. It provides the necessary link with civil society and fosters accountability by the executive.

The OECD has recently elaborated a set of Best Practices for Budget Transparency. They are in three parts. Part 1 lists the principal budget reports that governments should produce and their general content. Part 2 describes specific disclosure to be contained in the reports. This includes both financial and non-financial performance information. Part 3 highlights practices for ensuring the quality, integrity and usefulness of the reports. The Best Practices are attached to

this paper in their entirety in the Appendix. The following box lists the major headings of the Best Practices.

The OECD Best Practices for Budget Transparency

1. Fiscal Reports

- 1.1 The Budget
- 1.2 Pre-budget Report
- 1.3 Monthly Report
- 1.4 Mid-year Report
- 1.5 Year-end Report
- 1.6 Pre-election Report
- 1.7 Long-term Report

2. Specific Disclosures

- 2.1 Economic Assumptions
- 2.2 Tax Expenditures
- 2.3 Financial Liabilities and Financial Assets
- 2.4 Non-financial Assets
- 2.5 Employee Pension Obligations
- 2.6 Contingent Liabilities

3. Integrity

- 3.1 Accounting Policies
- 3.2 Systems and Responsibility
- 3.3 Audit
- 3.4 Public and Parliamentary Scrutiny

A final example of the advancement of budget transparency – and its concomitant helpfulness in maintaining fiscal responsibility – comes from Finland. In Finland it was recently ruled that the country's Freedom of Information Act mandated that the original funding requests from spending ministries to the Ministry of Finance be published at the same time as the government's budget proposal is presented to Parliament. This had the impact that original funding requests from ministries became more reasonable. The reason was simple. As their more extreme requests would be rejected in any case, spending ministers did not want them

published since this would reveal them to be either fiscally irresponsible or politically impotent in following through on their initial requests. As a result, the original requests became more reasonable.

8. Modern financial management practices

The modernization of financial management within governments has made great advances in the recent past. The sheer scale of government means that such improvements had a material effect on fiscal outcomes. These include the introduction of accruals, capital charges, carry-overs of unused appropriations, and interest-bearing accounts. Each of these is discussed below.

8.1 Accruals

Cash and accruals represent two end points on a spectrum of possible accounting and budgeting bases. The cash end of the spectrum has traditionally been applied by member countries for their public sector activities. In recent years there has been a major trend towards accruals end of the spectrum in member countries. About half of member countries have now adopted accruals to one degree or another. This is a very rapid migration; it was only in the early Nineties that the world's first accrual basis financial statements and budget were produced by a government (New Zealand).

The objective of moving to accruals is to make the true cost of government more transparent. For example, accruals attributes the pension costs of government employees to the time period when they are employed and accumulating their pension rights rather than having this as an unrelated (and uncontrollable) expenditure once they have retired. Instead of spikes in expenditures when individual capital projects are undertaken, accruals incorporates them into the annual operating expenditures through an allowance for depreciation. Treating loans and guarantee programs on an accrual basis fosters more attention to the risks of default by those who have been granted them, especially if there is a requirement for such default risks to be prefunded. In a cash system, outstanding government debts can be designed in such a way that all interest expenditure is paid in a lump sum at the end of the loan rather than being spread through the years when the loan was outstanding as would be the case under accruals. All of these examples show how a focus on cash only, can distort the true cost of government.

A further objective for adopting accruals is to improve decision-making in government by using this enhanced information. This needs to be seen in a wider context. The countries that have adopted accruals have generally been at the forefront of public management reforms in general. These reforms have been highlighted in this paper. A key aim is to hold managers responsible for outcomes and/or outputs while reducing controls on inputs. In this context, it is expected that managers should be responsible for all costs associated with the outcomes and/or

outputs produced, not just the immediate cash outlays. Only accruals allows for the capture of these full costs, thereby supporting effective and efficient decision-making by managers. In short, when managers are given flexibility to manage their own resources (inputs), they need to have the necessary information to do this. The adoption of accruals is therefore an inherent part of these wider reforms.

There are a number of issues with accruals which are beyond the scope of this paper. This includes to what extent to adopt accruals, (for financial reporting only, or for budgeting as well; or for certain categories of transactions only). How to treat certain types of asset and liabilities that simply do not exist in the private sector (heritage assets, military assets, infrastructure assets and the treatment of social insurance programs). What valuation methods to be used (historical cost or current cost). Who should be responsible for setting accounting standards as a great number of judgements and assumptions need to be made in accrual environment.

It should, however, be noted that a significant number of countries have very serious reservations about the use of accruals. These concerns are on a number of levels. First, the introduction of accruals could undermine fiscal discipline. For example, governments could decide on expensive capital projects whose cost would appear in the budget over a number of years (as depreciation), rather than appearing fully at the same time as the political decision to go ahead with the project was made. Second, accruals depends on complicated technical assumptions that can be easily manipulated. Cash can be manipulated, but only in terms of timing at the margins. Third, accruals is poorly understood by politicians. From a democratic point of view, if politicians do not understand the numbers in the budget, which is the government's premier policy document, then accruals simply should not be in place.

8.2 *Capital charges*

Capital has tended to be viewed as a free good in the public sector. Once an asset was in place, there was no mechanism to track and charge for the cost of capital tied up in the asset. A number of member countries have been making headway in this regard.

Capital charging regimes generally operate as follows. The government decide to levy a charge on the cost of capital tied up in all assets in an agency. For example, if an agency has \$10 million in assets, the government will levy a charge (often equivalent to the long-term government bond rate), of 10 per cent. This means that the agency will have to pay the finance ministry \$1 million dollars annually. When the system is first introduced, the appropriations to all agencies will be increased by the amount of their capital charge, so there's no net impact on agencies or for the government as a whole. However, agencies will in future be allowed to dispose of the assets and thus relieving themselves of the capital charge while retaining the original appropriation to cover it (or part thereof). This creates the incentive. Thus, they could decide to sell excess assets or move from high-priced areas to lower-priced areas and use the amount of the capital charge they save for

other purposes. This has had a great impact on asset management in government, a field that was simply neglected previously.

8.3 *Carry-overs*

All countries operate on the principle of an annual budget. Previously, this meant that all appropriations lapsed at the end of the fiscal year thus creating a great and irrational rush to spend moneys before the end of the fiscal year. Not only because they would otherwise lose the money this year, but also because future years appropriations would take account of this underspending as well. You were losing what you did not spend in one year, permanently. This has now changed with operating expenditures generally being freely transferable (sometimes up to a certain limit) from one year to the next. Only in cases, where an agency continuously, year-on-year, builds up carry-overs does the Ministry of Finance intervene. The advent of medium-term expenditure frameworks also gives a benchmark for agencies to see that their appropriations are in fact being carried over.

8.4 *Interest-bearing accounts*

Some countries have also introduced interest-bearing accounts for agencies. This means, for example, that the appropriation of an agency is divided into twelfth (representing each month) and deposited into an agency's account (either within the finance ministry or with a commercial bank.) If an agency spends at less than this rate, they will receive interest on the difference. If they spend at a faster rate, they will pay interest on the difference. The ability of individual agencies to vary their spending patterns does of course vary significantly but they are now much more aware of cash management practices.

All of these practices – accruals, capital charges, carry-overs of unused appropriations, and interest-bearing accounts – serve to improve the information available for agency heads and giving them increased freedom to act on that information. Although a very technical area, the impact on the government's finances has been great due to its sheer size.

9. **Conclusion**

This paper has highlighted seven key institutional features of the budget process that we believe are essential for achieving sustained fiscal consolidation:

- medium-term budget frameworks,
- prudent economic assumptions,
- top-down budgeting techniques,
- budget transparency,
- relaxed input controls,

- focus on results,
- modern financial management practices.

As noted at the outset, economic growth and political commitment play the primary roles, but they are not enough. The institutional framework must be such that it fosters and reinforces fiscal discipline. This is recognized in member countries and all of them are moving in this direction: Different countries are starting from different positions and are moving at different speeds – but the direction is clear. The journey will take longer in countries with very entrenched traditions in the public sector. But the benefits are significant as shown by the success currently enjoyed by the early reformers.

APPENDIX

THE OECD BEST PRACTICES FOR BUDGET TRANSPARENCY

1. Budget reports

1.1 The budget

- The budget is the government's key policy document. It should be comprehensive, encompassing all government revenue and expenditure, so that the necessary trade-offs between different policy options can be assessed.
- 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 3 months prior to the start of the fiscal year. The budget should be approved by Parliament prior to the start of the fiscal year.
- The budget, or related documents, should include a detailed commentary on each revenue and expenditure programme.
- Non-financial performance data, including performance targets, should be presented for expenditure programmes where practicable.
- The budget should include a medium-term perspective illustrating how revenue and expenditure will develop during, at least, the two years beyond the next fiscal year. Similarly, the current budget proposal should be reconciled with forecasts contained in earlier fiscal reports for the same period; all significant deviations should be explained.
- Comparative information on actual revenue and expenditure during the past year and an updated forecast for the current year should be provided for each programme. Similar comparative information should be shown for any non-financial performance data.
- If revenue and expenditures are authorised in permanent legislation, the amounts of such revenue and expenditures should nonetheless be shown in the budget for information purposes along with other revenue and expenditure.
- Expenditures should be presented in gross terms. Earmarked revenue and user charges should be clearly accounted for separately. This should be done regardless of whether particular incentive and control systems provide for the retention of some or all of the receipts by the collecting agency.
- Expenditures should be classified by administrative unit (e.g., ministry, agency). Supplementary information classifying expenditure by economic and functional categories should also be presented.
- The economic assumptions underlying the report should be made in accordance with Best Practice 2.1 (below).
- The budget should include a discussion of tax expenditures in accordance with Best Practice 2.2 (below).

- The budget should contain a comprehensive discussion of the government's financial assets and liabilities, non-financial assets, employee pension obligations and contingent liabilities in accordance with Best Practice 2.3-2.6 (below).

The Best Practices define “government” in line with the System of National Accounts (SNA). This definition encompasses the non-commercial activities of government. Specifically, the activities of state-owned enterprises are excluded from this definition. Although the SNA definition focuses on general government, *i.e.* consolidating all levels of government, these Best Practices should be seen to apply to the national government.

1.2 Pre-budget report

- 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.
- The report should state explicitly the government's long-term economic and fiscal policy objectives and the government's economic and fiscal policy intentions for the forthcoming budget and, at least, the following two fiscal years. It should highlight the total level of revenue, expenditure, deficit or surplus, and debt.
- The economic assumptions underlying the report should be made in accordance with Best Practice 2.1 (see below).

1.3 Monthly reports

- Monthly reports show progress in implementing the budget. They should be released within four weeks of the end of each month.
- They should contain the amount of revenue and expenditure in each month and year-to-date. A comparison should be made with the forecast amounts of monthly revenue and expenditure for the same period. Any in-year adjustments to the original forecast should be shown separately.
- A brief commentary should accompany the numerical data. If a significant divergence between actual and forecast amounts occurs, an explanation should be made.
- Expenditures should be classified by major administrative units (e.g., ministry, agency). Supplementary information classifying expenditure by economic and functional categories should also be presented.
- The reports, or related documents, should also contain information on the government's borrowing activity (see Best Practice 2.3, below).

1.4 Mid-year report

- The mid-year report provides a comprehensive update on the implementation of the budget, including an updated forecast of the budget outcome for the current fiscal year and, at least, the following two fiscal years. The report should be released within six weeks of the end of the mid-year period.
- The economic assumptions underlying the budget should be reviewed and the impact of any changes on the budget disclosed (see Best Practice 2.1).
- The mid-year should contain a comprehensive discussion of the government's financial assets and liabilities, non-financial assets, employee pension obligations and contingent liabilities in accordance with Best Practices 2.3-2.6 (below).
- The impact of any other government decisions, or other circumstances, that may have a material effect on the budget should be disclosed.

1.5 Year-end report

- The year-end report is the government's key accountability document. It should be audited by the Supreme Audit Institution, in accordance with Best Practice 3.3 (below) and be released within six months of the end of the fiscal year.
- The year-end report shows compliance with the level of revenue and expenditures authorised by Parliament in the budget. Any in-year adjustments to the original budget should be shown separately. The presentation format of the year-end report should mirror the presentation format of the budget.
- The year-end report, or related documents, should include non-financial performance information, including a comparison of performance targets and actual results achieved where practicable.
- Comparative information on the level of revenue and expenditure during the preceding year should also be provided. Similar comparative information should be shown for any non-financial performance data.
- Expenditure should be presented in gross terms. Earmarked revenue and user charges should be clearly accounted for separately.
- Expenditure should be classified by administrative unit (e.g., ministry, agency). Supplementary information classifying expenditure by economic and functional categories should also be presented.
- 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 in accordance with Best Practices 2.3-2.6 (below).

1.6 *Pre-election report*

- A pre-election report serves to illuminate the general state of government finances immediately before an election. This fosters a more informed electorate and serves to stimulate public debate.
- The feasibility of producing this report may depend on constitutional provisions and electoral practices. Optimally, it should be released no later than two weeks prior to elections.
- The report should contain the same information as the mid-year report.
- Special care needs to be taken to assure the integrity of such reports, in accordance with Best Practice 3.2 (below).

1.7 *Long-term report*

- The long-term report assesses the long-term sustainability of current government policies. It should be released at least every five years, or when major changes are made in substantive revenue or expenditure programmes.
- The report should assess the budgetary implications of demographic change, such as population ageing and other potential developments over the long term (10-40 years).
- All key assumptions underlying the projections contained in the report should be made explicit and a range of plausible scenarios presented.

2. Specific disclosures

2.1 *Economic assumptions*

- Deviations from the forecast of the key economic assumptions underlying the budget are the government's key fiscal risk.
- All key economic assumptions should be disclosed explicitly. This includes the forecast for GDP growth, the composition of GDP growth, the rate of employment and unemployment, the current account, inflation and interest rates (monetary policy).
- A sensitivity analysis should be made of what impact changes in the key economic assumptions would have on the budget.

2.2 *Tax expenditures*

- Tax expenditures are the estimated costs to the tax revenue of preferential treatment for specific activities.
- The estimated cost of key tax expenditures should be disclosed as supplementary information in the budget. To the extent practicable, a discussion of tax

expenditures for specific functional areas should be incorporated into the discussion of general expenditures for those areas in order to inform budgetary choices.

2.3 Financial liabilities and financial assets

- All financial liabilities and financial assets should be disclosed in the budget, the mid-year report, and the year-end report. Monthly borrowing activity should be disclosed in the monthly reports, or related documents.
- Borrowings should be classified by the currency denomination of the debt, the maturity profile of the debt, whether the debt carries a fixed or variable rate of interest, and whether it is callable.
- Financial assets should be classified by major type, including cash, marketable securities, investments in enterprises and loans advanced to other entities. Investments in enterprises should be listed individually. Loans advanced to other entities should be listed by major category reflecting their nature; historical information on defaults for each category should be disclosed where available. Financial assets should be valued at market value.
- Debt management instruments, such as forward contracts and swaps, should be disclosed.
- In the budget, a sensitivity analysis should be made showing what impact changes in interest rates and foreign exchange rates would have on financing costs.

2.4 Non-financial assets

- Non-financial assets, including real property and equipment, should be disclosed.
- Non-financial assets will be recognised under full accrual based accounting and budgeting. This will require the valuation of such assets and the selection of appropriate depreciation schedules. The valuation and depreciation methods should be fully disclosed.
- Where full accrual basis is not adopted, a register of assets should be maintained and summary information from this register provided in the budget, the mid-year report and the year-end report.

2.5 Employee pension obligations

- Employee pension obligations should be disclosed in the budget, the mid-year report and the year-end report. Employee pension obligations are the difference between accrued benefits arising from past service and the contributions that the government has made towards those benefits.

- Key actuarial assumptions underlying the calculation of employee pension obligations should be disclosed. Any assets belonging to employee pension plans should be valued at market value.

2.6 *Contingent liabilities*

- Contingent liabilities are liabilities whose budgetary impact is dependent on future events which may or may not occur. Common examples include government loan guarantees, government insurance programmes, and legal claims against the government.
- All significant contingent liabilities should be disclosed in the budget, the mid-year report and the annual financial statements.
- Where feasible, the total amount of contingent liabilities should be disclosed and classified by major category reflecting their nature; historical information on defaults for each category should be disclosed where available. In cases where contingent liabilities cannot be quantified, they should be listed and described.

3. **Integrity, control and accountability**

3.1 *Accounting policies*

- A summary of relevant accounting policies should accompany all reports. These should describe the basis of accounting applied (*e.g.*, cash, accrual) in preparing the reports and disclose any deviations from generally accepted accounting practices.
- The same accounting policies should be used for all fiscal reports.
- If a change in accounting policies is required, then the nature of the change and the reasons for the change should be fully disclosed. Information for previous reporting periods should be adjusted, as practicable, to allow comparisons to be made between reporting periods.

3.2 *Systems and responsibility*

- A dynamic system of internal financial controls, including internal audit, should be in place to assure the integrity of information provided in the reports.
- Each report should contain a statement of responsibility by the finance minister and the senior official responsible for producing the report. The minister certifies that all government decisions with a fiscal impact have been included in the report. The senior official certifies that the finance ministry has used its best professional judgement in producing the report.

3.3 Audit

- The year-end report should be audited by the Supreme Audit Institution in accordance with generally accepted auditing practices.
- Audit reports prepared by the Supreme Audit Institution should be scrutinised by Parliament.

3.4 Public and parliamentary scrutiny

- Parliament should have the opportunity and the resources to effectively examine any fiscal report that it deems necessary.
- All fiscal reports referred to in these Best Practices should be made publicly available. This includes the availability of all reports free of charge on the Internet.
- The finance ministry should actively promote an understanding of the budget process by individual citizens and non-governmental organisations.

