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Lessons from the crisis

by
Allen Schick*

The Great Recession has been an unplanned but critical stress test of contemporary fiscal policy and financial management. This article seeks to draw lessons from this crisis, whose final chapters have yet to be written. The lessons fall into two broad, overlapping categories: fiscal and economic policy; and budget procedures and practices. Section 1 looks back at the crisis in search of markers that distinguish between fiscally strong and weak countries. Section 2 looks forward to consider how national governments may avert future fiscal meltdowns by incorporating risk assessment and other early warning signals into routine budget work, and by devising more effective rules and procedures to ward off fiscal mischief. The concluding section reflects on how the practice of budgeting might be altered by shocks to established procedures.

JEL classification: H300, H500, H600

Keywords: Great Recession, financial crisis, cyclical weakness, fiscal management, public finance, Europe, fiscal institutions, fiscal rules, financial risks, asset bubbles, modern budgeting

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The Great Recession has been an unplanned but critical stress test of contemporary fiscal policy and financial management. Its destabilising impact on public finance and devastating aftershocks have challenged OECD countries to re-examine settled doctrines and established practices. Regardless of their views on the causes of the crisis or of the remedies that should be applied, it behoves OECD countries to objectively review recent financial upheavals, both to avoid future policy mishaps and to build sturdy fiscal and governance institutions that can avert or better withstand financial shocks.

National budgets have been at the epicentre of the crisis and on the front lines of recovery efforts that, more than four years after they were initiated, still are far from complete. In the most heavily impacted countries, budget surpluses or small, seemingly manageable deficits rapidly mushroomed into large, destabilising imbalances. Budget processes which for decades focused on allocating expenditure increments for programme enhancements have been transformed into politically difficult decisions on austerity and cutbacks. Debt burdens which once were mere after-effects of revenue and spending outcomes have become key drivers of budget decisions, narrowing government options and inflaming political conflict.

In many OECD countries, crisis-shrouded budgets are not just bearers of bad news; they also are essential means for national governments to stabilise the economy and put public finance on a sustainable course. Ideally, a country's post-crisis budget should be a process for translating lessons about what went wrong into policies and actions that restore confidence in capital markets and political markets, promote economic recovery, and enable government to finance authorised programmes and benefits.

This article seeks to draw lessons from a crisis whose final chapters have yet to be written. It has been composed with due regard for ongoing debates over the sturdiness of the European Economic and Monetary Union (EMU), the appropriateness of austere policies, the urgency of returning beleaguered economies to growth, and the effects of credit derivatives and other modern financial instruments on public finance. It may be premature for journalists and scholars to write first drafts of current budget history, or for budget experts to extract conclusive findings from the babble of clashing views about what went wrong and how to make things right. Nevertheless, political leaders and public managers cannot wait for history's verdict; they must act in the next budget that awaits them and in the budgets that follow. Supranational institutions cannot be sidelined by controversy or incomplete data; they must guide and assist distressed countries to find their way out of crisis.

The lessons drawn in this article fall into two broad, overlapping categories: fiscal and economic policy; and budget procedures and practices. Section 1 looks back at the crisis in search of markers that distinguish between fiscally strong and weak countries. This is a difficult task because countries do not neatly fall into fiscally sound and unsound categories, and because a country's pre-crisis condition is not always a reliable harbinger of how severely it became impacted. Section 2 looks forward to consider how national governments may avert future fiscal meltdowns by incorporating risk assessment and other early warning signals into routine budget work, and by devising more effective rules and procedures to ward off fiscal mischief. This, too, is a difficult assignment because some innovations that once appeared to be promising were ineffective or irrelevant when crisis struck. The concluding section reflects on how the practice of budgeting might be altered by shocks to established procedures.

1. What happened: Cyclical weakness or fiscal mismanagement?

A useful starting point for deriving lessons from the Great Recession is to investigate how country budgets fared before and during the crisis. If all of them experienced similar fiscal and economic stresses, we may have a justifiable basis to conclude that, regardless of its fiscal policies or economic condition, no country has been able to withstand global pressures that transcend national boundaries. The persuasive explanation would be that interlocked capital markets have overwhelmed national policies and destabilised the budgets of all advanced countries – those with prudent pre-crisis fiscal positions along with those that had unsustainable imbalances. Arguably, the most economically developed countries in the world are tightly linked to international financial flows and thereby have become hostage to a global financial market that is beyond the effective control of national governments. Vast amounts of money electronically migrate into and out of countries and to or away from financial institutions in response to the latest news or rumour, triggering wide fluctuations in interest rates and in the ease and cost of financing sovereign debt. Euro-denominated countries have been highly vulnerable to new global financial pressures because they share a common currency and cannot act wholly independently when financial conditions deteriorate.

To make matters worse, a huge, weakly regulated market in credit swaps and other derivatives emerged, ostensibly to enable creditors to hedge against potential default. In practice, this market is dominated by speculators who neither hold nor issue debt, but nevertheless bet on the prospect of default. One effect has been to greatly magnify the amount of money at risk and the volatility of sovereign debt yields.

1.1. Cycles versus crises

The term "Great Recession" denotes that the turmoil in public finance has not been due principally to cyclical weakness that diminished tax revenues and unbalanced government budgets. Rather, a deeper, more pervasive malaise has spread fiscal havoc among a broad swath of countries, including those that maintained sturdy fiscal constraints and prudent budget policies. Lesson 1 draws from OECD data to conclude that, although most countries have experienced an ordinary recession – albeit one that has been more severe than typical downturns – a few have suffered extraordinary shocks that differ from cyclical swings.

Lesson 1. All member countries have experienced deterioration in fiscal balances, but there is significant variation in the extent to which government budgets have been impaired, ranging from small imbalances in the least impacted countries to profound destabilisation in the most impacted.

Table 1 compares average government financial balances during 2008-11 with those achieved in 2007, the last pre-crisis year. The data suggest that the "all in the boat together" explanation has some validity but does not account for truly wide disparities in the fiscal

Table 1. **General government financial balances, 2007-11**

% of GDP

	2007	2008-11	2007 trough change
Australia	1.8	-3.5	-6.5
Austria	-1.0	-3.0	-3.5
Belgium	-0.1	-3.6	-5.5
Canada	1.4	-3.7	-6.8
Czech Republic	-0.7	-4.0	-5.1
Denmark	4.8	-2.7	-7.6
Estonia	2.4	-0.9	-5.3
Finland	5.3	-0.5	-8.1
France	-2.7	-5.8	-4.9
Germany	0.2	-2.1	-4.4
Greece	-6.8	-11.7	-8.8
Hungary	-5.1	-4.3	0.6
Iceland	5.4	-9.8	-18.9
Ireland	0.1	16.4	31.0
Israel	-1.6	-5.0	-5.1
Italy	-1.6	-4.1	-3.8
Japan	-2.1	-7.1	-7.2
Korea	4.7	0.9	-5.8
Luxembourg	3.7	0.3	-4.5
Netherlands	0.2	-3.6	-5.8
New Zealand	4.5	-3.5	-12.4
Norway	17.3	13.6	-6.7
Poland	-1.9	-6.0	-6.0
Portugal	-3.2	-7.0	-7.0
Slovak Republic	-1.8	-5.7	-6.2
Slovenia	0.0	-5.0	-6.4
Spain	1.9	-8.7	-13.1
Sweden	3.6	0.4	-4.6
Switzerland	1.0	0.9	-0.7
United Kingdom	-2.8	-8.6	-8.1
United States	-2.9	-10.0	-9.0

Note: Financial balances include one-off factors, such as those resulting from the sale of the mobile telephone licenses. As data are on a national accounts basis (SNA93/ESA95), the government financial balances may differ from the numbers reported by the European Commission under the excessive deficit procedure for some EU countries. For more details, see *OECD Economic Outlook,* Sources and Methods (*www.oecd.org/eco/sources-and-methods*).
Sources: OECD (2012), *OECD Economic Outlook,* Vol. 2012/2 (No. 92, November), Annex Table 27, OECD Publishing Paris, *http://dx.doi.org/10.1787/eco_outlook-v2012-2-en*, and author's calculations.

fortunes of OECD countries. On the one hand, only one country (Hungary) escaped deterioration in its fiscal position during the period 2008-11; its good fortune may be partly explained by its very high pre-crisis deficit. Every other OECD country experienced either a larger deficit or a smaller surplus in at least one year during this period than it had in 2007, the last pre-crisis year. On the other hand, there is a fundamental difference between Switzerland's slight 0.7 percentage point (relative to GDP) drop in its fiscal balance and declines in excess of 8 percentage points in the most impacted countries. (These amounts measure the deterioration from 2007 to the trough years during 2008-11.) In almost half of the countries, the drop was less than 6 percentage points, a decline that was due mostly to economic weakness, automatic stabilisers or discretionary fiscal stimulus. The few outliers that had oversized imbalances have triggered anxiety of a financial tsunami that might damage the economies of fiscally sturdy countries.

Countries that had positive fiscal balances in the year(s) immediately preceding the crisis were not inoculated against crisis-induced deterioration. According to Table 1, half of the OECD countries had positive balances in 2007; yet they averaged almost a 10 percentage point drop in fiscal balance between that year and the trough year of the crisis. However, excluding outliers (Iceland, Ireland, and Spain) that had pre-crisis surpluses but nevertheless experienced profound financial shocks, the average decline was a more modest 5 percentage points. Countries that entered the crisis in sound fiscal condition generally navigated the crisis more smoothly only if they were not shocked by collapsing asset prices or insolvent financial institutions. The shocked countries experienced severe financial turbulence regardless of their pre-crisis fiscal condition.

Extending the frame of analysis from the period immediately before the crisis to a full decade provides some clues, but does not conclusively explain why some countries have faced financial collapse while others have been relatively unscathed. Countries that accumulated surpluses during the pre-crisis decade generally have come out of the crisis in better condition than those that routinely incurred deficits. Table 2 identifies 11 countries that had positive fiscal balances in more than half of the years 1998-2007, and a much larger number that ran deficits in eight or more of the years. The pattern that emerges from these data is bipolar, not bell-shaped. Few countries are clustered in the middle of the distribution, with surpluses in 4-6 of the years. A dozen countries failed to achieve a single surplus during the decade, but ten had surpluses in eight or more years. It appears that some countries became habituated to surpluses and others to deficits. The former aimed for surpluses when they undertook each year's budget work; the latter began the process accepting deficits. A country that strives for positive fiscal outcomes will obtain them, not just one year but most; a country that assumes deficits are the norm will close the books year after year with spending in excess of revenue. Whether because of differences in governmental institutions, political culture or economic circumstances, the two sets of countries obviously went their separate ways on budget policy during the pre-crisis decade.

The surplus countries have generally survived the crisis in better financial condition, but once again there are some surprises, notably Ireland which had surpluses in nine of the years and Switzerland in only two years. A similar sprinkling of anomalies emerges from an analysis of average country performance across the decade. A dozen countries averaged positive fiscal balances during 1998-2007, but 19 averaged imbalances. Norway tops the list of fiscally sound countries, followed by Finland and Korea. But this group also includes Iceland and Ireland, while the deficit countries include Germany which has endured the crisis in fairly sound financial condition.

The anomalies are not simply outliers that do not comfortably fit the standard explanation of how imprudent fiscal policies open the door to financial ruin. The fact that some countries (including the outliers) that appeared to be fiscally sound on the eve of the crisis were among the worst performers during the Great Recession suggests that the nominal fiscal position is not a sufficient measure of a country's capacity to withstand economic adversity. During boom times, fiscal outcomes may be distorted by asset bubbles that produce temporary surges in tax revenues, induce governments to boost spending, and generate pressure to increase pensions or other social benefits whose costs will fall on future budgets. More will be said about asset bubbles later in this article; for the present, it suffices to emphasise that countries and the international community need deeper insight into fiscal strength and vulnerability than is provided by a single year's nominal budget outturn.

Table 2. **General government financial balances, 1998-2007**

% of GDP

	Number of years in surplus	1998-2007 average
Australia	10	1.7
Austria	0	-1.9
Belgium	2	-0.4
Canada	8	1.9
Czech Republic	0	-4.0
Denmark	8	2.1
Estonia	6	0.6
Finland	10	3.7
France	0	-2.7
Germany	2	-2.0
Greece	0	-5.1
Hungary	0	-6.6
Iceland	5	1.5
Ireland	9	1.7
Israel	0	-5.6
Italy	0	-2.9
Japan	0	-6.1
Korea	10	3.4
Luxembourg	9	2.8
Netherlands	4	-0.6
New Zealand	8	2.9
Norway	10	11.6
Poland	0	-4.1
Portugal	0	-4.1
Slovak Republic	0	-5.9
Slovenia	0	-2.3
Spain	3	-0.5
Sweden	8	1.2
Switzerland	2	-1.0
United Kingdom	3	-1.3
United States	3	-2.0

Note: Financial balances include one-off factors, such as those resulting from the sale of the mobile telephone licenses. As data are on a national accounts basis (SNA93/ESA95), the government financial balances may differ from the numbers reported by the European Commission under the excessive deficit procedure for some EU countries. For more details, see *OECD Economic Outlook*, Sources and Methods (*www.oecd.org/eco/sources-and-methods*).
Source: Author's calculations based on OECD (2012), *OECD Economic Outlook,* Vol. 2012/2 (No. 92, November), Annex Table 27, OECD Publishing Paris, *http://dx.doi.org/10.1787/eco_outlook-v2012-2-en*.

The nominal balance is not only a measure of cash flows but is also a proxy measure of underlying economic and financial conditions. These conditions may be a legacy of debt that burdens future budgets, of bubble-inflated revenue that produces ephemeral surpluses, of rigid labour markets or regulatory regimes that discourage investment, or of other practices that affect government revenues or expenditures. When a fiscal downturn mutates into a full-blown crisis that endangers a country's financial stability, it is essential to probe beneath the headline budget numbers to identify underlying problems.

Lesson 2. To understand why the recession was so damaging, it is essential to review pre-crisis economic conditions and fiscal outcomes during the decade preceding the crisis.

A necessary step in assessing what went awry is to examine cyclically adjusted data – that is, to gauge fiscal outcomes through the performance of the economy, not just through the performance of the budget. Cyclically adjusted data measure fiscal outcomes in terms of the potential GDP rather than actual GDP. Table 3 reveals that approximately two-thirds of OECD countries had cyclically adjusted deficits during the decade 1998-2007. Their public expenditures exceeded the revenues that would have been generated by a robust economy.

Table 3. **General government cyclically adjusted financial balances, 1998-2011**

% of potential GDP

	Number of years in surplus, 1998-2007	1998-2007 average	2008-11 average
Australia	10	1.5	-3.3
Austria	0	-2.4	-2.8
Belgium	1	-0.7	-3.6
Canada	7	0.4	-3.4
Czech Republic	0	-3.7	-4.4
Denmark	6	0.8	-0.2
Finland	10	3.2	-0.4
France	0	-3.4	-5.3
Germany	1	-2.1	-1.6
Greece	0	-4.8	-10.8
Hungary	0	-6.9	-3.7
Iceland	5	0.4	-8.3
Ireland	4	-1.0	-13.9
Israel	0	-5.1	-5.5
Italy	0	-3.8	-3.0
Japan	0	-5.6	-6.4
Korea	10	3.5	1.1
Luxembourg	8	2.0	0.3
Netherlands	3	-0.8	-3.7
New Zealand	9	2.8	-3.0
Norway[1]	4	-0.4	0.2
Poland	0	-3.9	-6.2
Portugal	0	-3.9	-6.0
Spain	3	-1.0	-7.1
Sweden	7	0.7	1.1
Switzerland	2	-0.9	0.9
United Kingdom	3	-1.8	-8.2
United States	1	-2.7	-8.8

Note: For more details on the methodology used for estimating the cyclical component of government balances, see *OECD Economic Outlook*, Sources and Methods (*www.oecd.org/eco/sources-and-methods*).

1. As a percentage of mainland potential GDP. The financial balances shown are adjusted to exclude net revenues from petroleum activities.

Source: Author's calculations based on OECD (2012), *OECD Economic Outlook*, Vol. 2012/2 (No. 92, November), Annex Table 28, OECD Publishing Paris, *http://dx.doi.org/10.1787/eco_outlook-v2012-2-en*.

The cyclically adjusted deficit averaged 2.5% of GDP for the OECD area and 2.4% for the euro area. It is almost always the case that a structural deficit incurred during expansionary times will grow larger when the economy stagnates or declines. Not surprisingly, few countries had a better structural outcome during the years 2008-11 than during the previous decade. However, most of the countries that maintained structural balance during the pre-crisis decade weathered the downturn in better shape than those which had structural shortfalls. The countries that maintained structural balance during the period 1998-2007 averaged cyclically adjusted deficits of 2.3% of GDP through the crisis years of 2008-11, less than half of the 6% average for all OECD countries. Evidently, fiscal prudence made a difference, but outliers had a disproportionate effect on fiscal results.

In many OECD countries, the seeds of fiscal trouble were sown during the pre-crisis years. Table 4 shows that the OECD area (as well as the euro area) enjoyed real GDP growth every year from 1999 through 2007. In five of those years, every OECD country had positive growth; in the other years, three or fewer had stagnant economies. Despite favourable conditions, in every one of these years at least half of the countries had cyclically adjusted deficits. Evidently, many national governments spent the dividends of economic growth through tax relief or programme enhancements. They encountered only weak constraints on deficits because fiscal targets did not distinguish between the growth and contraction phases of economic cycles. This defect was an invitation for governments to incur deficits when the economy was relatively strong.

Table 4. **Real GDP: Percentage change from previous year**

1999-2007 averages

	1999-2007 average	Number of growth years
Australia	3.5	9
Austria	2.6	9
Belgium	2.3	9
Canada	3.1	9
Czech Republic	4.3	9
Denmark	1.9	9
Estonia	7.9	8
Finland	3.6	9
France	2.2	9
Germany	1.7	8
Greece	4.1	9
Hungary	3.4	9
Iceland	4.5	9
Ireland	6.5	9
Israel	3.9	7
Italy	1.6	8
Japan	1.3	8
Korea	5.8	9
Luxembourg	5.1	9
Mexico	2.9	9
Netherlands	2.5	9
New Zealand	3.5	9
Norway	2.4	9
Poland	4.2	9
Portugal	1.8	8
Slovak Republic	5.0	9
Slovenia	4.5	9
Spain	3.7	9
Sweden	3.4	9
Switzerland	2.1	8
Turkey	4.3	7
United Kingdom	3.2	9
United States	2.8	9
OECD	2.8	9

Source: Author's calculations based on OECD (2012), *OECD Economic Outlook*, Vol. 2012/2 (No. 92, November), Annex Table 1, OECD Publishing Paris, *http://dx.doi.org/10.1787/eco_outlook-v2012-2-en*.

In 2007 – the year when signs of financial distress emerged in the United States before spreading to other countries – every OECD country had positive GDP growth that averaged 3% across the area. The median growth rate was 3.7% and exceeded 5% in a dozen countries. By 2007, the last OECD-wide economic contraction had been more than a decade earlier, a long-enough stretch to forget or disregard the damaging impacts of even mild recessions on public budgets. This favourable performance, capping a decade of uninterrupted growth in almost all OECD countries, fuelled the notion that national governments now have the tools and know-how to sustain economic expansion and therefore no longer need to be concerned about cyclical downturns. Economic euphoria was the order of the day; it was reinforced by a global capital glut that enabled low-cost financing of public and private debt. Weak political, legal and market constraints gave vote-seeking politicians a clear path to approve budget deficits that may have been appropriate when the economy was weak, but had little justification for economies going through a protracted growth spell.

It should be noted, however, that though it was protracted, growth was much weaker during the two pre-crisis decades than it had been during the post-war boom. The economies of OECD countries averaged 2.7% growth in each of the pre-crisis decades; the average was lower in the euro area, only about 2.2% during these decades. Growth was not sufficiently buoyant to turn budget deficits into surpluses and to finance built-in increases in public expenditure while responding to fresh demands from voters and interest groups. Significantly, some countries that experienced relatively low growth during the pre-crisis decade fared better than some which had stronger growth. For example, Germany and Switzerland averaged 1.7% and 2.1% respectively, one-half or less than the rate in Greece, Iceland or Ireland. The former countries had one year of zero or negative growth during the decade; the latter did not. Germany and Switzerland never reached 4% growth, whereas Greece, Ireland and Spain did. Arguably, modest but sustained growth may produce less bubble-induced distortion in political behaviour and fiscal accounts than temporarily high economic expansion. However, the fact that this pattern does not hold for all OECD countries suggests that growth trends do not by themselves account for different economic and fiscal outcomes.

Lesson 3. Fiscal discipline must be maintained during growth periods in order for governments to stabilise public finance when the economy weakens.

This lesson is not new, but it is hard to learn and even harder to apply, especially when interest rates are low and lenders eagerly finance the rising stock of public debt. During the pre-crisis decade, the once widely accepted notion that, when aggregate demand is strong, deficit financing of public expenditure drives up interest rates and crowds out private investment was effectively discredited by the easy money available to finance government ambitions. It took a crisis to remind political leaders and policy advisors of the necessity for fiscal prudence during buoyant times. Without effective constraints on fiscal opportunism, this lesson probably again will be forgotten when economic prospects brighten. It should not be forgotten, for the fiscal missteps of the good times contributed to turning what might otherwise have been a conventional recession into the Great Recession.

In some countries, norms of good fiscal behaviour have been internalised in a political culture that fortifies government leaders who are committed to reduce or stabilise debt burdens, and to consider proposed changes in revenues or expenditures in terms of estimated impacts on future budgets. The many countries that lack sufficient normative constraints should consider institutions such as fiscal rules and medium-term frameworks to safeguard their fiscal future.

Lesson 4. Elevated public debt ratios should alert governments to the prospect of future fiscal distress.

During the pre-crisis years, many OECD countries were concerned about elevated debt burdens, largely in terms of the long-run demands (30 or more years ahead) of ageing populations and rising health and pension expenditures. Although the main focus was on future sustainability, current debt levels also drew attention, although few (if any) governments doubted their capacity to roll over existing debt or to finance new liabilities. The European Union's Stability and Growth Pact (SGP) set a 60% of GDP ceiling on the public debt of member countries, but enforcement was weak. On the eve of crisis in 2007, general government gross public debt in the euro area amounted to 72% of GDP, with two countries above 100% and seven in breach of the SGP limit. What is most troubling about these levels is that they were so high after a decade of uninterrupted economic growth. In fact, during the growth spell, there was only a slight dip in aggregate debt among euro countries – from 76% of GDP at the start of the millennium to the 72% level.

Table 5 reveals that gross financial liabilities of the entire OECD area rose from 70% of GDP in 2000 to 74% in 2007. However, this trend masks wide variation among member countries; ten had 2007 debt levels below 40% but eight were above 70%. In most countries, pre-crisis debt levels influenced subsequent fiscal outcomes. The least indebted countries averaged financial imbalances of 4% of GDP during 2008-11; the most indebted averaged imbalances of 5.4%. Excluding Ireland – its public debt ballooned from less than 30% of GDP in 2007 to more than 110% four years later – the least indebted countries averaged imbalances of only 2.7% during the crisis years covered here, only half the rate of the countries with the highest debt levels.

A recent influential study of centuries of financial crises found that a country's economic potential is significantly diminished when public debt exceeds 90% of GDP (Reinhart and Rogoff, 2010). Judging from the contemporary economic performance of countries that have reached or are close to this tipping point, it appears that other economic conditions as well as political institutions also determine a country's capacity to finance public services and to finance its debt. Although an elevated debt load does not always do immediate damage, it certainly signals trouble ahead. A country with favoured access to financial markets may have more breathing space than one that lacks this advantage, but for all countries there is a time of reckoning. Current conditions do give ample cause for alarm. Gross financial liabilities of OECD countries have jumped more than 30 percentage points since 2007; they now exceed 100% of GDP. The obvious lesson is that a country that does not reduce its debt ratio during favourable periods risks having dangerously high burdens when the economy weakens.

It requires sustained political will and strong fiscal discipline for debt-burdened countries to pare public debt to manageable size. Maintaining a small primary balance may not suffice, especially when risk-averse financial institutions demand high interest rate premiums and when debt service claims a rising share of national budgets. Clearly, governments will have to resist pressure to relax discipline when economic and budget conditions improve, and some may have to maintain an austere fiscal posture in the face of economic stagnation. Beyond this short- to medium-term concern, future financing of accrued pension and health obligations will challenge many highly developed countries, and may be an impossible mission for those which already have excessive debt levels. The crisis

Table 5. **General government gross financial liabilities, 2000-11**
% of nominal GDP

	2000	2007	2011
Australia	25.0	14.5	26.7
Austria	70.8	63.4	79.8
Belgium[1]	113.6	87.9	101.9
Canada	80.5	65.0	83.4
Denmark	60.4	34.3	61.5
Estonia	9.4	7.3	9.8
Finland	52.4	41.4	58.0
France	65.7	73.0	100.0
Germany[2]	60.8	65.6	86.4
Greece	115.3	115.2	175.2
Hungary	62.2	73.6	86.1
Iceland	72.9	53.3	128.4
Ireland	39.3	28.7	112.2
Israel	84.8	78.5	74.0
Italy	120.8	112.4	119.8
Japan[3]	137.6	162.4	205.3
Luxembourg	13.4	11.3	25.8
Netherlands	63.8	51.5	75.9
New Zealand	37.0	25.6	48.3
Norway	32.7	56.8	33.8
Poland	45.4	51.7	63.3
Portugal	62.4	75.5	118.1
Slovak Republic	57.6	33.5	48.0
Spain	66.5	42.4	76.9
Sweden	64.3	49.8	49.2
Switzerland	51.2	45.1	40.2
United Kingdom	45.2	47.0	99.9
United States	54.5	66.5	102.2
Euro area	76.0	71.9	95.2
OECD total	70.2	74.2	102.9

Note: Gross debt data are not always comparable across countries due to different definitions or treatment of debt components. For more details, see *OECD Economic Outlook*, Sources and Methods (*www.oecd.org/eco/sources-and-methods*). For euro area countries that have asked for assistance from the European Union and the IMF (Greece, Ireland and Portugal), the change in 2011 in government financial liabilities has been approximated by the change in government liabilities recorded for the Maastricht definition of general government debt.

1. Includes the debt of the Belgium National Railways Company (SNCB) from 2005 onwards.
2. Includes the debt of the Inherited Debt Fund from 1995 onwards.
3. Includes the debt of the Japan Railway Settlement Corporation and the National Forest Special Account from 1998 onwards.

Source: OECD (2012), *OECD Economic Outlook*, Vol. 2012/2 (No. 92, November), Annex Table 32, OECD Publishing Paris, *http://dx.doi.org/10.1787/eco_outlook-v2012-2-en*.

and its legacy of debt will almost certainly impel afflicted countries to review long-term commitments and to take decisions that were virtually unthinkable a few decades ago.

During favourable times, many countries rolled over a large volume of maturing debt each year and issued new bonds to cover budget shortfalls. This was a low-risk, low-cost strategy for governments as long as lenders were willing to play along. Despite low yields, lenders were sedated by decades of economic expansion to believe that sovereign defaults do not occur. They also were calmed by the strong expectation that countries sharing a common currency – namely the euro – would willingly aid any euro-area country in distress.

In retrospect, we know that things have not worked out as expected. The borrowing window has narrowed for a few countries, and their cost of financing debt has soared. Greece, Iceland, Ireland, Portugal and Spain have been the most impacted countries; despite economic contraction and high unemployment, all have been compelled by financial *force majeure* to adopt austere budgets.

Lesson 5. Governments and supranational institutions need additional measures of a country's economic condition and of its capacity to adjust to fiscal shocks and other disturbances.

The 2007 fiscal position of the five most impacted countries was an unreliable indicator of the crisis-induced troubles they would soon face. Three (Iceland, Ireland, and Spain) had positive financial balances, one (Portugal) had a moderate imbalance (3.2%), and only Greece had a large financial gap (6.8%). Evidently, to obtain an accurate picture of fiscal vulnerability, it is necessary to supplement the standard budget metrics with other measures of a country's economic condition and its capacity to deal with profound shocks. The current account may be a useful starting point for assessing a country's economic standing, for it measures all financial flows, both public and private. A country may show a fiscal surplus because external debt accumulated by households and enterprises pumps up home prices and company profits, thereby augmenting public revenues. In other words, a government may appear to be living within its means even though the country itself is not. At the eve of the crisis, four of the impacted countries had double-digit current account deficits; only Ireland escaped this predicament, though it did have a large imbalance in excess of 5%. Estonia was the only other OECD country to have a double-digit current account deficit, but it acted decisively to turn a 16% deficit in 2007 into a 3.4% surplus two years later.

Although it is a valuable tool for fiscal policy makers, the current account is not always a reliable indicator of short-run conditions, even in tandem with standard fiscal measures. The United States has incurred large fiscal and current account imbalances over an extended period, but interest rates have been low and the federal government has easily financed its vast stock of debt. Of course the United States is a special case, for the dollar's status as the main reserve currency and other factors have thus far shielded the country against the costs of fiscal mismanagement. Australia is another special case: it has had persistent current account deficits, but it has benefited from a protracted boom in mineral prices as well as from its favourable fiscal condition. The point is that neither the current account nor fiscal aggregates can be relied on as the sole harbinger of a country's economic prospect. Regulatory policies, labour market conditions, the transparency of financial institutions, the competitiveness of enterprises, and the quality of government also need to be taken into account when assessing a country's economic health. Some of these characteristics and others have been distilled into comparative rankings, such as the World Bank's "Ease of Doing Business" Index, the Global Entrepreneurship Monitor, and the Global Competitiveness Index.

At the end of the day, what matters most in determining a country's capacity to carry debt is the willingness of investors/speculators to underwrite debt. For them, the current account and other metrics are pieces of a complex, interlocking puzzle that includes the fiscal condition, the structure and volume of debt, the assessment of risks and the cost of hedging against them, confidence in political leaders and government institutions, and many other factors. When other vital signs are favourable, a fiscal or current account

Table 6. **Current account balances, 1998-2007**

% of GDP

	1998-2007 average
Australia	-4.8
Austria	-2.1
Belgium	-4.2
Canada	1.5
Chile	-0.1
Czech Republic	-3.7
Denmark	2.1
Estonia	-9.8
Finland	5.7
France	0.9
Germany	2.4
Greece	-7.6
Hungary	-7.8
Iceland	-9.7
Ireland	-1.3
Israel	0.3
Italy	-0.3
Japan	3.2
Korea	3.5
Luxembourg	10.2
Mexico	-1.7
Netherlands	3.9
New Zealand	-5.4
Norway	12.0
Poland	-4.4
Portugal	-9.0
Slovak Republic	-6.9
Slovenia	-1.9
Spain	-5.0
Sweden	6.7
Switzerland	11.1
Turkey	-2.5
United Kingdom	-2.2
United States	-4.6

Source: Author's calculations based on OECD (2012), *OECD Economic Outlook*, Vol. 2012/2 (No. 92, November), Annex Table 51, OECD Publishing Paris, *http://dx.doi.org/10.1787/eco_outlook-v2012-2-en*.

deficit probably will not deter financial institutions from acquiring a country's sovereign debt. But a country that has multiple vulnerabilities may have difficulty issuing or rolling over debt when it is in dire need of cash to pay its bills.

Lesson 6. A financial crisis takes more time and resources to resolve than a conventional recession, and generally requires different policies and remedies.

Why has the fall been deeper than in other recent recessions, and why has recovery been so slow and tepid? And why, in the face of economic stagnation and elevated unemployment, have many governments abandoned economic stimulus in favour of fiscal consolidation? True, during the early stages of the crisis, most OECD countries allowed automatic stabilisers to pump up demand, and some also adopted stimulus packages that increased public investment and consumption or gave temporary tax relief to workers or employers. These initiatives generally had salutary effects, as indicated by the resumption of growth in all but a few countries by 2010 or earlier. However, growth has been weak compared to previous post-recession recoveries, averaging only 3% in 2010 and less than 2% the following year. Economic results have been even less favourable across the euro area, with growth peaking at 1.9% in 2010 and disappearing in 2012. Apparently this has been a recovery that ran out of steam shortly after it got under way. Recent forecasts of sub-par growth in the years immediately ahead justify the view that this crisis is fundamentally different from anything experienced by member countries since the OECD was established.

The Great Recession started as a financial crisis that halted a long expansion, and quickly mutated into a severe recession with declining output, rising unemployment, and fiscal shortfalls. This is the typical trajectory of financial crises, but its causes and after-effects have greatly complicated policy responses by national and supranational institutions. The textbook formula for recovery from recession is to stimulate demand by allowing automatic stabilisers and temporary stimulus to imbalance the budget. As noted, early government responses hewed to this approach, but as the crisis deepened and as the risk of sovereign default escalated, international and regional organisations – as well as quite a few national governments – shifted from stimulus to austerity.

International and regional institutions conditioned aid to heavily impacted countries on the adoption of austere budgets – tax increases and spending cuts that further depressed demand. The financial crisis seized priority over the economic crisis.

Viewed from the perspective of severe recession, giving primacy to fiscal stability was untimely; from the vantage point of financial crisis, it may have been necessary. When a recession drains households of income and the economy of demand, the generally accepted remedy is stimulus that boosts the deficit. If the remedy works, the economy bounces back within a year or two and deficits (should) recede. But when a financial crisis drains a country and key institutions of confidence and of willingness to take risks, adding to the deficit may further weaken the economy and prolong financial instability. It takes much longer to restore confidence than demand, especially when deleveraging has become the order of the day and credit has become scarce. Reinhart and Rogoff (2010) have found that it typically takes years to wash away the adverse after-effects of financial collapse. Arguably, therefore, treating the financial crisis as a recession would have retarded recovery and would have put both financial institutions and governments at greater risk.

How government responds to a crisis may depend on the mobility of capital – that is, on whether money is flowing to or fleeing from a fiscally distressed country. Since the onset of the crisis, the United States and Greece have been near the opposite ends of this spectrum. The United States has benefited from such a large inflow of money that trillion-dollar deficits have coincided with record low yields on treasury bonds. Greece has experienced a large outflow of money and credit that has driven up interest rates and disabled the government from servicing its debt. This difference between the two countries in money flows and credit availability mirrors the sharply different experiences of affluent and lower-income countries during economic downturns. Money often migrates to highly developed countries during recessions, enabling them to debt finance stimulative expenditures or tax cuts. However, when money and credit are scarce, lower-income countries often must tighten their belts, even at the cost of deepening social misery and widening the fiscal gap. In recent decades, the harsh effects of this double standard were confined to other continents; now they have spread to Europe. Although the causes of the different fiscal fates of countries derive principally from the behaviour of financial markets, international organisations should not be blind to the perception that lower-income countries may be more disadvantaged by fiscal stress than affluent countries.

Regional and international organisations can derive lessons from the financial crisis to promote recovery and reduce misery. Perhaps the least contestable lesson is that when the onset of a crisis is due more to financial than fiscal causes, bold measures that are rapidly applied may reduce the risk of collapse and contagion. In different ways, the United States and Ireland acted decisively to provide sufficient resources to stabilise severely impaired financial institutions. Shortly after the collapse of Lehman Brothers, the United States established a USD 700 billion relief programme that made available more money than was needed by financial institutions (and certain assisted enterprises), but certainly much less than would have been required if political leaders had not acted. Interestingly, the United States government has recouped all the money provided to financial institutions, and (disregarding the loss of output and incomes due to the crisis) has actually made a small profit. Ireland's story is somewhat different. When the country's large banks became illiquid, Ireland committed to cover all bank losses, even before it was able to reliably estimate the magnitude of the obligations it was incurring. The actual cost turned out to be significantly higher than expected when political leaders acted, leading to an extraordinary spike in public debt. But Ireland appears to be on the way to recovery, and will probably regain access to capital markets much earlier than if it had procrastinated.

The response to crisis in some countries has been to do as little as immediately necessary, in the hope that conditions will improve without requiring affected governments to take forceful action. When the economy stagnated and debt burdens soared, regional and international organisations intervened with conditioned financial aid. They, too, generally took a minimal approach, in part because of political difficulties and in part because of the expectation that acting in this manner would compel distressed countries to correct fiscal imbalances. Of course, there are numerous differences between a country that acts unilaterally to aright its finances and one that cannot act on its own and must reach out for external assistance. But the lesson that delay and minimalism retard recovery and add to the cost of financial stabilisation applies to a broad swath of countries. The rapid resolution of the east Asia financial crisis and Mexico's peso crisis near the close of the millennium bolster the argument that recognising the magnitude of the problem produces much better outcomes than interventions which slice off progressively larger slivers.

Lesson 7. Shocks from recessions differ in severity and impacts, and have characteristics that are distinctive to each affected country.

The Great Recession shocked economic and political institutions. It endangered global financial institutions and, in highly stressed countries, resulted in fiscal deficits and unemployment that greatly exceeded the decline in output. Admittedly, the line between ordinary recessions and shocks is thin, but there is no difficulty distinguishing between countries that have experienced mild downturns and those whose unemployment levels exceed 20%. There are, for example, obvious differences in the economic discomfort experienced by Luxembourg, Norway and Sweden and the lingering problems that have beset Greece, Ireland and Spain. Shocks have deeper troughs and long-lasting effects, such as chronically high unemployment and debt burdens.

The shocked countries face financial distress that cannot dissipate until the cost of servicing sovereign debt recedes to more normal levels; the recession countries face a loss of output that can be recovered when growth resumes. One of the casualties of fiscal shock is that established budget practices tend to be bypassed, as beleaguered governments lurch from one crisis to the next and devise *ad hoc* rules and procedures to calm capital markets and respond to external demands. As will be discussed in the next section, modern fiscal institutions such as fiscal rules and medium-term frameworks have not averted or mitigated shocks. Improvisation has become the order of the day, with each country acting on the basis of its own interests or those of others who have leverage over it. The shocks to Iceland and Ireland were generated by the insolvency of vital financial institutions. Ireland covered bank losses, but Iceland did not. Why the difference? One probable reason is that Ireland is a euro country, whereas Iceland is not. Another explanation is that most of Iceland's bank liabilities were held by foreign institutions, while most of Ireland's were held within the country. The important point is that shocks evoke different responses because countries differ in economic and other circumstances. Greece has been a special case: it lacked political capacity to correct embedded economic weaknesses before the crisis, and it has been driven to act by a combination of strong conditions and massive external aid.

The after-effects of financial shocks damage not only the economy, but political capacity as well. In quite a few countries, the government that presided over a financial collapse was driven from power or lost the next election. In some countries, the new government was able to act decisively because it was not tainted by the crisis; in others, the new government was as enfeebled as its predecessor. There is reason to believe that the electoral system has a lot to do with post-crisis capacity, but other factors also come into play.

Lesson 8. Austerity does not suffice to stabilise public finance or to restore public confidence. The international community needs new insights and tools to facilitate and underwrite both fiscal consolidation and growth initiatives.

If only because of the risk of contagion, the international community cannot be, and has not been, a bystander to financial disarray. Perhaps external aid has been insufficient or tardy, but it certainly has been on a vast scale. The strings attached to it have more tightly bound recipient countries to retrenchment than recovery, but both have to be combined in order for a shocked country to get back on its feet. The case for austerity is compelling, but no more so than the case for growth. Resumption of economic growth and a marked decline in unemployment and misery are essential to bolster political will and legitimacy, and to stabilise the country's finances. Recent experience has conclusively demonstrated that it is exceedingly difficult for a country to comply with challenging deficit and debt targets when output and public revenue are falling while unemployment and social unrest are rising.

Balancing retrenchment and growth is a difficult task, for the relative weight given each objective should vary as economic and other conditions change. Arguably, the more forcefully government acts during the depth of crisis, the faster it will be able to consider growth-promoting policies. For good reason, it may be easier and more prudent to shift to a growth strategy when a country has sturdy budget institutions, reliable financial practices, and political support for fiscal stabilisation. When these conditions are lacking, austerity programmes will fail, deficits and debt will persist at unsustainable levels, and growth will be aborted.

The textbook remedy for a country that has depressed output and fiscal deficits is to combine temporary stimulus with long-term structural reform. Because it is temporary, the stimulus does not add to structural imbalances, and because structural changes would take effect only when economic recovery is already under way, they would not dampen short-term economic performance. The stimulus part of this formula was applied during early stages of the crisis, but as growth resumed in most countries and the risk of sovereign default escalated in a few others, it was displaced by fiscal consolidation. Thirty OECD countries experienced GDP decline in 2009, but the same number grew in each of the next two years. However, growth brought only modest improvement in fiscal outcomes. Approximately 20 countries had fiscal imbalances in excess of 3% of GDP in 2012. With the prospect of increased budget pressure as their populations age, many countries regard consolidation as the appropriate policy even though the crisis has not fully passed.

But at the same time that many countries have been recovering, the few that have not begun to recover require massive assistance to stabilise their fragile financial systems. It is not hard to understand why countries that have disciplined their own finances expect highly troubled countries to embrace austerity. The fiscally sturdier countries that have been called upon to assist fragile economies have generally adopted the view that austerity is essential for countries beset with oversized deficits that will likely persist at elevated levels long after recovery has commenced. Although those providing assistance have not been indifferent to the plight of those who have lost jobs, homes and hope, they sometimes give the appearance that they are. In their view, the best way to uplift those whose economic well-being and social status have been severely damaged by the Great Recession is to take the tough measures needed to restore confidence in that country's damaged financial system.

To be sure, these policies have been coloured by political and other considerations, as well as by the conviction that some distressed countries have mismanaged their finances and have bloated public expenditures and inadequate tax systems, along with rigid labour markets and regulatory policies. Pressuring beleaguered countries to correct these critical defects has been deemed essential for them to make effective use of external aid. Nevertheless, fiscally strong countries and international organisations should strive to combine consolidation with measures that protect vulnerable populations and to ease the inevitable hardships of those severely afflicted by adverse economic conditions and constrictive fiscal policies.

1.2. Europe as a special case

The European Union's great success in establishing a common currency has brought enormous economic and social benefits to EMU countries. This accomplishment occurred despite weak co-ordination of fiscal policy during the euro's first decade. Prior to the crisis, policy co-ordination was sought through the Stability and Growth Pact (SGP) which set limits on annual budget deficits and on aggregate debt. However, frequent breaches and inadequate enforcement impaired the SGP. Since the onset of crisis, the EU has established a sturdier fiscal compact with closer monitoring of fiscal developments and stronger sanctions for violations. Fiscal rules are discussed in Section 2; this sub-section considers how the common currency has affected the capacity of affected countries and the European Union to deal with the crisis.

Lesson 9. The incompleteness of Europe's fiscal institutions has increased the risk of contagion and has impeded the response to the crisis.

When financial crisis unfolds, effective policy responses can come either from the impacted countries or from supranational authorities. In the current crisis, both have had their hands tied: euro-area countries because they could not act independently, supranational institutions because they lack fluid policy processes and essential monitoring and enforcement tools. The result has been a series of deadline-driven negotiations and agreements that has stretched more than four years, and probably will continue until the threat of sovereign default has been fully extinguished and new arrangements have been implemented.

A country that exercises full sovereignty over its money can seek to stabilise a crisis-stricken economy by devaluing its currency or restructuring its debt. There are, of course, significant risks and costs to either approach, including elevated inflation and impaired access to capital markets. Moreover, there is no certainty that once it has taken these measures, the country will act decisively to remedy economic shortcomings and aright its fiscal position. A country that is weighted down by a bloated public sector and unaffordable social commitments, has widespread tax evasion and chronically large fiscal and current account deficits, and has weak political parties may lack the fortitude to reform the economy and rein in public profligacy once it has devalued and restructured. However, as demonstrated by recent events, there are countries that have the political determination to act on their own, but the effects of their initiatives may be blunted or delayed by dependence on EU institutions.

Supranational action, directed by EU institutions, is the necessary alternative for the inability of euro countries to act on their own. Before the crisis, these institutions were not sufficiently completed to co-ordinate fiscal policy among member countries or to enforce compliance with agreed norms. When the crisis took hold, the EU institutions struggled to take corrective action, combining financial assistance with demands for fiscal prudence. But the assistance often was too little and the demands too weak and, as is now widely recognised, conditions were allowed to deteriorate in the most distressed country. The EU has recognised these shortcomings and is moving forward through its new fiscal compact and financial stability mechanism to co-ordinate policy across countries and to accelerate assistance. It is likely that additional measures will be forthcoming in the years ahead as Europe inches toward a more integrated fiscal regime.

1.3. Has the crisis vitiated social protections financed by the state?

Some politicians and observers have argued that the crisis provides strong evidence that national governments must roll back expensive social benefits, especially for pensions and health care. These politicians and observers argue that an ordinary recession was transformed into a financial trauma because overextended governments could no longer afford the entitlements they had promised to current and future beneficiaries. This line of reasoning is based on the notion that capital markets assess financial vulnerability not simply in terms of current fiscal imbalances and debt levels, but in reference to the accrued liabilities that have not yet been recognised on country budgets but will have to be paid in the future.

According to this view, governments must trim promised benefits not only to ease short-term budget pressures, but to correct fundamental imbalances that will not vanish when the crisis abates.

Lesson 10. The size of government expenditure and the scale of social benefits do not explain variances in the severity of the crisis among OECD countries. What determines a country's fiscal sturdiness is its citizens' willingness to pay for the benefits received from government.

The key issue is not how much a country spends on welfare benefits, but whether citizens are willing to pay the taxes required to finance them. Northern European countries generally came through the crisis in sound fiscal condition, while some countries with relatively small expenditure footprints fared relatively worse. The critical factor is twofold: whether a government has the political strength to extract sufficient tax revenue from voters and to adjust transfer payments when necessary to keep them on a sustainable path. In fact, some countries with very large public expenditures exceeding or nearing 50% of GDP took decisive action before the crisis to bolster intergenerational financial stability. They acted not to shrink the welfare state, but to safeguard its future.

The crisis was not triggered by concern that governments will be unable to finance long-term commitments when they come due a decade or more from now. It was caused by the pending incapacity of some countries to finance current deficits or debt. Admittedly, the crisis has widened long-term fiscal gaps by lowering prospects for future growth and revenue, and it has spurred governments to adopt programme changes to ease current budget pressures and reduce future obligations.

The welfare-state model that has been called into question does depend on sustained growth, as well as on a tax system that mobilises sufficient revenues to cover the cost of intergenerational commitments. Both are essential, but growth cannot itself perennially compensate for structural imbalances in entitlement programmes, and tax increases cannot fully offset shortfalls from weak growth.

2. Can governments avert the next Great Recession?

The foregoing review of the current crisis provides fundamental lessons for averting or cushioning future fiscal shocks. First, government behaviour in good times is critical in determining how governments weather the bad times. Accumulating debt, establishing long-term commitments without regard to financial means, and regarding routine deficits as sound fiscal management all weaken a country's capacity to deal with cyclical disturbances. Second, it is important to gauge whether the country – not just the government – is living within its means. Household and business debt can do as much damage, and sometimes more, than government profligacy. Third, it is necessary to take account of the fiscal risks taken on by government, for it is almost always the case that risks taken when the economy is strong become due when the economy weakens. Fourth, governments' asset bubbles damage both the economy and public finance: the economy through overleveraging, public finance by distorting government revenue and spending decisions.

These lessons provide a useful framework for exploring steps to avert future meltdowns. The following discussion begins with rule-based barriers to fiscal misbehaviour, then considers mechanisms for regulating fiscal risks, and concludes with the difficult question of how to curb asset bubbles.

2.1. Designing and implementing effective fiscal rules

The best – and possibly only – way for a government to maintain fiscal balance over the course of an economic cycle is to accumulate surpluses when the economy is strong by forgoing popular spending increases or tax cuts. This is much more easily said than done, for when surplus funds are available (and often even when they are not), the natural instinct of politicians is to reward voters by expanding programmes and lowering taxes. Fiscal rules aim to inhibit this tendency by making it easier for politicians to pursue prudent policies and by constraining them when they do not.

Lesson 11. Fiscal rules must constrain revenue and spending policies when the economy is buoyant; if they do not, rules will not be enforceable when growth slows or vanishes.

During the past two decades, fiscal rules generally have been both popular and ineffective. Beginning in the last decade of the 20th century and continuing in the first decade of the 21st, more than 80 countries adopted formal limits on deficits, debt, aggregate expenditure, or some other fiscal variable. However, lax rules tied to nominal rather than cyclical outcomes permitted deficits in good times, and lax enforcement permitted breaches in bad times. Governments spent the dividends of economic growth when resources were plentiful, and they spent borrowed funds to stimulate the economy and finance programme commitments when resources were scarce.

In line with the argument made earlier that the seeds of fiscal distress were planted when economic conditions were favourable, rules are effective only to the extent that they counter the inclination to dissipate surpluses. Maintaining a surplus when warranted by economic conditions can be abetted through several devices: a structural formula that targets a surplus; an expenditure rule that limits spending increases to trend GDP or some other indicator; a formula for mandating reductions in public debt; or a reserve fund that holds surpluses and serves as a counter-cyclical stabiliser. Combining these features into a strong fiscal regime may be more effective than a stand-alone rule that merely sets an upper limit on deficits or debt.

A robust fiscal rule should have several characteristics that generally were absent in the pre-crisis period. It should: target both fiscal balances and spending levels; have reliable monitoring and enforcement procedures; and have a medium-term horizon. It is not necessary to repeat the argument made earlier that rules which target nominal balances are doomed to fail. They provide too much slack when the economy is strong and not enough when the economy is weak, and they inevitably yield to political and economic realities when growth stalls and built-in stabilisers push the deficit above permitted levels. While properly designed structural rules may be more permissive when the economy stagnates, they definitely have more bite when the economy booms. A rule that is sensitive to changes in economic conditions can be devised to require debt reductions during boom periods. This type of rule would be bolstered by attaching an expenditure constraint that limits real or relative (to GDP) spending increases.

Standard rules have a one-year span that corresponds to the fiscal calendar and that is thereby linked to the annual budget cycle. This short time frame exposes a government to out-year risks during both economic expansions and contractions. The expansionary risk is that the government will launch initiatives whose costs fall principally on future budgets; the contractionary risk is that the government will incur stimulative deficits without taking steps to eliminate the imbalance when the economy recovers. This myopic perspective encourages tactics that shift structural deficit increases to future years and discourages longer-term action to contain budget shortfalls. Ideally, a fiscal rule should be embedded in a medium-term expenditure (or budget) framework that establishes fiscal policy for the next 3-5 years. The framework integrates fiscal targets and budget policy, and inhibits tactics that shift expenditures or deficits to future years. It should be noted, however, that medium-term constraints are provisional, and often are revised when the framework is rolled forward to the next budget cycle.

Whatever the time frame, a fiscal rule is effective only if it is enforced. Enforcement is not just a matter of sanctioning countries that breach preset targets, but entails commitment and capacity to closely review the economic and programme assumptions on which the budget is based, to guard against bookkeeping tricks that misrepresent the budget's true condition, to monitor revenue and spending trends throughout the fiscal year, and to take corrective action when indicated by actual or expected results. Although budget officials have a critical role in assuring the integrity of information, the primary responsibility for keeping the rules falls to political leaders in the affected countries. Without political support, fiscal rules are hollow gestures; with support, even relatively weak rules – such as those established through annual fiscal responsibility policies – can cushion countries against excessive build-up of debt.

2.2. Accounting for and controlling financial risks

All governments hold financial risks that are not recognised in the budget but that have a significant bearing on how governments are affected by economic difficulties. Some countries adversely impacted by the Great Recession had large off-budget (or off-balance-sheet) contingent or implicit liabilities, such as government guarantees of bank deposits and home mortgages, that came due when key financial institutions collapsed or were nearly insolvent. Managing risk before crisis strikes will reduce the government's exposure, but doing so requires new accounting and budget instruments.

It is useful to distinguish three types of risk to the government's fiscal position. One risk arises out of inherent uncertainty about future revenues and (to a lesser degree) expenditures that vary with the performance of the economy and other unknowns such as natural disasters; another risk derives from contingent liabilities that may require payouts if certain events (such as default) occur; and the third risk is rooted in financial benefits provided by governments through open-ended entitlements. The first type inheres in the fact that government has imperfect knowledge when it prepares economic projections and budget estimates; the second and third types of risk result from government decisions. The first set of risks can be mitigated by basing the budget on prudent economic and other assumptions; the second and third can be reduced by due diligence in taking on obligations that have low (or no) immediate costs but potentially large long-term costs.

Lesson 12. The onset of crisis typically is characterised by wide variances between budgeted and actual revenues or expenditures. It would be useful to strengthen early warning systems that alert government to these variances, along with procedures for identifying their causes.

Budget variances generally are small and easily manageable during stable times, but can be very large when the economy veers off its projected course, especially when destabilising conditions make it difficult to forecast how the economy will perform. Although there are instances when variances are due to unrealistic economic assumptions, the more prevalent problem occurs when well-grounded projections are rendered erroneous by unexpected swings in economic fortunes.

This type of risk occurs both when the economy overperforms or underperforms, and when revenues come in above budget or below. An unbudgeted surge in revenues is typical during bubbles, and can spur a government to take on new programme obligations that will require large future expenditures and to issue guarantees in the expectation that it will never be called upon to make payments. On the other hand, a shortfall in revenue typically signals economic weakness, and may compel the government to revise its budget during the fiscal year.

There is no sure antidote for the budget's uncertain fiscal future, but some measures can be taken to mitigate the problem. One option is to establish an independent (or legislative) fiscal council to produce economic and budget projections or to review those issued by the government. Few countries have taken this step, but all can improve fiscal management by being transparent about key economic assumptions on which the budget is based and by publicly explaining the risks to projected revenues, expenditures, interest rates, and other variables. It is also good practice to closely monitor budget outturns during the year and to intervene when these veer from projections.

Supranational institutions have become active in monitoring government budgets and advising countries on risks to their budgets: the OECD through country economic surveys, the IMF in Article IV consultations, the World Bank in public expenditure reviews, and the EU in its ongoing review of member country finances. Though extremely useful, these activities do not substitute for prudent budgets that give due regard to fiscal risks.

> **Lesson 13.** Fiscal crises intensify when the government is exposed to large risks taken when the economy is strong but that compel payouts when it weakens. Future crises may be mitigated by exercising due diligence before assuming contingent risks and by avoiding actions that increase moral hazard.

The second type of risk includes contingent liabilities that expose the government to potential future payments. These liabilities usually are incurred outside the budget process, through legislative or administrative actions that seek to protect risk takers against possible losses. Although budget considerations may be neglected when the government issues guarantees, the budget will have to account for ensuing payments unless (as sometimes happens) losses are financed by off-budget funds.

It is futile to argue that governments should not enter into contingent liabilities. In all developed countries, the national government has become the chief risk holder for society, indemnifying citizens against a vast portfolio of cradle-to-grave adversities including illness, unemployment, old age, home loans and other types of credit, man-made or natural disasters, environmental damage, and changes in interest or exchange rates. The shift of risk to the state has brought enormous gains, especially the willingness of financial institutions to extend credit to households and enterprises. Economic stability and widespread affluence have ensued from the pooling of risk in public hands, and from the willingness of governments to be the shock absorber for homeowners and others.

The financial crisis has taught an obvious lesson that is nevertheless routinely ignored: guarantees are not free. If they were, there would be no incentive to seek them from the government. Every guarantee has costs, either to society through distortion of market decisions, or to government through expenditures triggered by default or other contingencies. In fact, risk shifting really is a form of cost shifting, and should be treated as such when a government takes responsibility for contingencies. Ideally, it should expense estimated future costs (on a present value basis) in the budget, accounting for them along with other expenditures and subjecting them to fiscal rules. The United States expenses the discounted costs of guaranteed loans in the budget, but does not expense non-loan contingent liabilities such as insurance programmes.

Recognising contingent liabilities as costs would likely induce greater caution before assuming these liabilities. However, prudence in issuing explicit contingent liabilities would have done little to soften the financial impact of the current crisis. Far greater damage was done by obligations assumed by governments after economic conditions had deteriorated, and by financial commitments made after banks and other financial institutions had collapsed or were technically insolvent. These generally were implicit liabilities for which governments had no legal obligation but for which they were motivated to act by concern that failure to do so would trigger economic ruin.

Taking responsibility for implicit liabilities can have a mammoth impact on the government's fiscal position, especially when the risks are concentrated in a few very large financial institutions. This was Ireland's fate when it opted to underwrite bank losses, and to a lesser degree that of the United Kingdom and the United States. In the aftermath of crisis, at-risk governments have come to realise that rather than being "too big to fail", very large institutions may be "too big to save". The risk is especially worrisome when financial institutions have assets that are a multiple of the country's GDP. In response to this threat, some governments have moved to reduce future exposure by limiting the size of institutions and the types of risks they can take. Risk mitigation may also entail separating banking from investment, boosting minimum capital requirements, changing pay incentives for risk takers, and regulating bank activities more strictly.

Lesson 14. Before establishing or expanding entitlements that lock them into open-ended commitments, governments should test their long-term sustainability (30 years or longer) under different economic and demographic scenarios, including lower growth trends and lengthened life expectancy.

The third type of risk is embedded in statutory commitments for social security, medical care and various income-support schemes. These obligations are typically prescribed in permanent legislation that sets eligibility standards and payment formulas but does not specify the amounts to be spent. Regardless of the condition of the economy or other spending requirements, the budget must accommodate the annual costs of entitlements. Before the onset of crisis, the ageing of populations stirred concern that OECD countries will not be able to fulfil all of their long-term commitments. The crisis and less buoyant growth prospects have obviously shortened the time frame for remedial action.

A number of OECD countries have tinkered with entitlement rules to shift some of the risk for income support back to households. Interestingly, countries leading this movement, such as Germany and Sweden, generally fared comparatively well during the crisis. Some crisis-stricken countries have folded reductions in income support into austerity packages. The reversal of risk accumulation by governments is a truly historic shift that has yet to run its full course. Nevertheless, the bulk of income-support risks still are held by the state, if only because proposals to roll them back usually generate strong political protest.

2.3. Asset bubbles

Like many other financial crises that have occurred over the centuries, the Great Recession was preceded by a bubble economy which drove up the prices of certain assets, gave risk takers a false sense of well-being, pumped up government revenue and (in some countries) expenditures, encouraged households, enterprises and governments to take on more debt, and undermined financial institutions when asset prices declined. The bubble was fuelled by new financial instruments that bred overconfidence and overleveraging, befuddled investors and regulators, and spurred short-term misbehaviour that provoked the crisis in some countries and aggravated it in others. In the United States and some European countries, bubble-induced risk was centred in the housing market. Easy money, and the misguided notion that home prices always rise, deceived purchasers and lenders to ignore telltale signs of trouble ahead.

A perennial problem in dealing with bubbles is that it is difficult to detect or contain them while they are under way. Not every run-up in asset prices is the result of irrational exuberance, and not every steep rise is followed by collapse. Another problem is that it may be exceedingly difficult for democratically elected politicians to try to cool an overheated market through constrictive policies that not only dampen asset prices but also depress economic growth. Bubble-suppressing policies turn winners into losers, reduce output, add to unemployment, and open governments to the charge that they have mismanaged the economy.

Lesson 15. Governments and international organisations should strive to develop early-warning indicators of excessive asset price appreciation, along with policies to shelter the budget from bubble-generated distortions in revenues and expenditures.

Bubbles usually emit mixed signals – exuberance together with anxiety – and stir controversy over the causes and sustainability of asset appreciation and the need for corrective action. Almost four centuries after "tulip mania" wracked Dutch society, some insist that the very high tulip prices were rational, not a speculative binge. To cut through the babble of conflicting claims, governments would benefit from indicators that alert them to whether asset prices have been inflated by undue speculation. To be useful, indicators must be alert to shifts in the assets or sectors prone to speculation, and they must provide timely signals for policy makers.

Because they have been at the centre of financial turmoil in various OECD countries, home prices can be a test case of the feasibility of advance indicators. The OECD regularly publishes data on changes in home prices and in price-to-rent and price-to-income ratios. Data presented in Table 7 show home price distortions in some heavily impacted countries, but the pattern is not sufficiently unambiguous to permit firm conclusions. The rise in home prices and the decline in relative rental costs have occurred in a few countries, such as Australia, that have not gone through boom-to-bust bubbles. To make them more useful, housing indicators have to be supplemented with other information, such as the percentage of homes purchased by speculators/investors rather than by residents, the volume of housing debt and the quality of this debt, the percentage of home purchase costs financed by debt, the percentage of capital allocated to the housing sector, and the percentage of bank assets in the housing sector. The multiplicity of relevant measures indicates that it is feasible to construct an early warning system focused on the volume and quality of debt, but also suggests that no single measure suffices to alert governments to the danger signs.

Home financing was the past decade's bubble asset; some other good might be a future decade's prize. To detect shifts in speculative fancy, the concentration of assets held by financial institutions may be a better indicator of bubble-driven risk than sector-specific data. Of course, financial stability may also be at risk when institutions hold a diverse portfolio of assets, as when their holdings are overweighted in a single sector or class of assets. Although it is impossible to safeguard the budget against all economic uncertainties, it is sensible to protect it against blatant speculation. After all, all bubbles come to an end, and in pretty much the same way.

Table 7. **Home price trends, 2000-10**

Long-term average = 100

	Price-to-rent ratio			Price-to-income ratio		
	2000	2005	2010	2000	2005	2010
Australia	94	141	156	95	126	138
Belgium	99	130	158	95	127	147
Canada	94	121	147	90	110	126
Denmark	103	130	127	107	128	123
Finland	102	124	136	97	102	101
France	83	129	134	84	125	130
Germany	90	79	78	94	79	75
Greece	89	110	101	94	110	99
Ireland	146	194	131	109	139	112
Italy	82	113	107	87	113	118
Japan	96	74	66	96	78	69
Korea	83	96	108	64	64	63
Netherlands	123	142	136	122	142	143
New Zealand	79	142	149	90	131	126
Norway	109	126	154	102	104	124
Spain	91	154	135	89	145	134
Sweden	85	110	140	96	115	133
Switzerland	81	86	91	79	85	89
United Kingdom	92	139	139	92	131	129
United States	98	125	102	93	114	90

Source: OECD (2012), *OECD Economic Outlook*, Vol. 2012/2 (No. 92, November), Annex Table 60, OECD Publishing Paris, *http://dx.doi.org/10.1787/eco_outlook-v2012-2-en*.

National governments usually experience a surge in revenues when bubble behaviour inflates both asset prices and confidence in economic prospects. Whether due to rising incomes or rising consumption, the revenue surge has the potential to alter short- and long-term budget policy. For the current or forthcoming fiscal year, governments may be inclined to adopt pro-cyclical policies that cut taxes and boost spending, thereby putting additional upward pressure on asset prices. Governments may also expand income supports in ways that add little expenditure in the period immediately ahead, but have large long-term budget impacts.

It is difficult – not impossible – to wall off the budget from the potentially adverse effects of asset price surges. Chile has had considerable success diverting excess copper revenues into a stabilisation fund; this model can be adapted for revenues that deviate from trend or derive from a particular class of assets. However, it is hard to lock away revenue when the economy is experiencing a bubble but the budget is nevertheless in deficit.

The most damaging impact of bubbles occurs when they burst and the economy suffers a hard landing, leaving many with reduced incomes and a legacy of debt, the government with soaring deficits, and financial institutions with the need to write off losses. As discussed earlier, although this situation should call for stimulative budgets, the country's shaky financial predicament may demand austerity. Recent experience reminds us that the best – possibly the only effective – way to abort bubbles is watchful vigilance that deters overleveraging and reckless risks. The bubble that does not occur does least damage to the budget.

3. Budgeting in the shadow of the Great Recession

During the decades preceding the crisis, many OECD countries modernised their budget systems by adopting fiscal targets that constrain budget decisions, along with medium-term frameworks that extend the budget horizon 3-5 years ahead and performance budgets that seek to base spending decisions on actual or expected programme results. In addition, through programme and impact evaluations, accrual-based accounts, output and outcome measures, and long-term fiscal sustainability analyses, governments greatly enriched the quantity and quality of information available to policy makers and programme managers.

Evidently, these innovations have not averted fiscal crisis or the breakdown of orderly budget procedures in impacted countries. In the face of economic contraction and financial trouble, many OECD countries have set aside medium-term spending plans and previously approved budgets, and have sought to stabilise public finance by disregarding established budget procedures and rushing emergency stimulus or austerity packages to adoption. Fiscal rules have been breached in many countries by deficit and debt levels well above preset targets, time frames have been shortened to treat only the problems immediately ahead, and evidence on performance and results has carried little weight in determining spending cuts. It is hard to claim that fiscal results would have been more favourable if governments had modern budget techniques.

Lesson 16. Contemporary budget instruments proved too weak to blunt the crisis, though they may be effective in more normal circumstances.

Arguably, there is (or should be) a logical sequence in reforming budget institutions, beginning with changes in information content or structure, then manipulating incentives to change behaviour and decisions, and culminating in constrictive rules that prescribe or proscribe particular actions or outcomes. Enriched information is the essential first step, for the government cannot intelligently alter or constrain behaviour if it lacks relevant data. If it were measured in terms of the volume of information produced, budget reform would be regarded as an unalloyed success. National governments now know much more about the sensitivity of budget estimates to changes in economic conditions, the medium- and long-term implications of current policies, and which programmes are effective and which are not than they did a generation ago. But the assessment would be less favourable if effectiveness were measured in terms of whether the new data have made much difference in budget results. Rigid budgets that impede reallocation from less to more effective uses and disconnect decisions on resources from information on performance call information-centred reforms into question. The coexistence of well-informed budget makers and sub-par budget outcomes should impel reformers to examine the premises on which their innovations rest.

The Great Recession did stir demand for improved fiscal and budget information, but in distressed countries much of the demand came, at least at the outset, from regional and international organisations that were sceptical about official government data. As the crisis deepened and these countries became dependent on external aid, they, too, had need for accurate budget projections and assessments. In a few cases, critical data continue to be generated by international monitors who regard country-produced data as insufficient or unreliable.

The crisis has transformed some budget-related information from useful to necessary, from data that intelligent policy makers should want into information they need to carry out essential tasks. This transformation is critical in determining the disposition of the enriched information made available through modernised budget procedures. When this transformation does not occur, it may be expedient for time-pressured budget officials to ignore data that get in the way of completing the required tasks.

At the same time that the crisis made reliable fiscal and budget information more urgent, it also made some newer types of information less credible and less useful. Medium-term frameworks have been a leading casualty of economic turmoil, as 3-5 year decisions on revenues and expenditures have been overtaken by unforeseen turmoil. In the rush to stabilise public finance, the overriding need to find politically acceptable cuts has shunted performance data and programme evaluations.

The inadequacy of information-centred reforms may explain the contemporary popularity of rules that formally constrain politicians and managers. The rapid spread of fiscal rules and medium-term frameworks that formally limit deficits or aggregate spending suggests that reformers no longer regard voluntary action as sufficient. At the end of the day, however, rules are effective only to the extent that they are respected. The troubled state of public finance in many rule-constrained countries provides strong evidence that when weakly enforced rules collide with incentives and pressure to overspend or undertax, the outcome will likely be deficit and debt levels in excess of permitted levels. The problem is that rules are needed to check these incentives, but unless policy makers are motivated to behave in a fiscally prudent manner, rules will not be adequately enforced. Most of the countries on the short list of those with good budget practices and outcomes make and enforce their own rules. They pay attention to what the rules prescribe, but also to long-term trends and issues. They sometimes tweak the rules, but never to the extent of disabling them or compromising their credibility. Whether their good behaviour is due to political culture, responsible leadership or generally favourable economic conditions, the rule-abiding countries are distinguishable from the much larger number of countries that regard rules as no more than one of the variables to be considered in producing budgets.

The key lesson is that each country must summon the will to make and live by limits, to be fiscally prudent even when it is not expedient, to pay attention to how today's decisions affect tomorrow's well-being, and to give due regard to what works in spending public money. Outsiders can guide and prod, but the most important quality is that government leaders, programme managers and citizens yearn for responsible budgets.

3.1. Will the crisis change budgeting?

For more than half a century, beginning with the post-war boom, budgeting in OECD countries was a process for allocating incremental resources to public programmes and agencies. Although there were occasional setbacks when tight budgets impelled governments to trim expenditures, the overall trend was to expand public spending apace with or in excess of the expansion of economic output. However, the severity and duration of the Great Recession appear to have reversed this long-running trend. The most stressed countries have been compelled by financial circumstances to adopt decremental budgets with deep cuts in current and future spending, while moderately impacted countries have also sought cutbacks or adopted *status quo* budgets.

A brief hiatus in the upward march of public spending would not itself spell an end to the incremental era in budgeting. After all, budgets may bounce up when national economies again bounce back, as occurred in the past, most notably during the early years of the OECD Senior Budget Officials in the 1980s and 1990s. There are, however, several reasons to expect that this time will be different, and that decremental or *status quo* budgeting will become standard procedure for some countries. One reason is the lasting damage done to the fiscal positions of impacted countries, especially the hangover of public debt that will have to be serviced in the years ahead. The elevated level of debt will burden many national budgets long after economic growth has resumed. Moreover, future budgets will be beholden to rising costs of pensions and health care, leaving little or no increments for programme enhancements. Additional constraint may come from the inability or unwillingness of national governments to generate incremental revenue by boosting already high tax rates.

The availability of incremental resources will depend on the future pace of economic expansion. Economic increments are the wellspring of budget increments. If the former do not materialise, the latter will not be available. Anaemic growth will not suffice to finance both future mandated spending increases for existing programmes and new spending for programme initiatives. The minimum growth needed to finance significant initiatives varies among countries, but is certainly above the level that many OECD countries have experienced in recent years.

But even without robust increments, there is reason to expect budgeting's future to be similar to its "normal" pre-crisis past. Normal means stable budgets that base the next year's allocations, with only marginal deviations, on the previous year's amounts and on pre-existing commitments. Budgets are not normal when they are disowned by the government and replaced by new decisions before the end of the fiscal year to which they pertain, and not when they cause the fall of government, abridge long-established social commitments, and provoke mass protests. Normal budgets pacify contentious decisions on programmes and budgets by turning them into routine questions of whether the government should spend a little more or a little less. This is how incrementalism drains of conflict by relying on procedures and decisional cues that are repeated year after year, sometimes with variation. Budgeting cannot thrive if it is an incendiary process that destabilises political life and sows deep uncertainty about the government's plans and capacity, or about the services that citizens will receive.

The political rationale for incrementalism is that, in order for the government to complete budget work, it must curtail conflict and the number of active decisions it makes each year. The fundamental need to sedate and simplify the budget pertains when the government allocates increments or decrements. Though there are obvious differences between budgets that add spending increments and those that allocate cutbacks, in both the budget work focuses on marginal changes from the previous year's decisions. Of course, the imperative to calm budgeting by simplifying the process and narrowing the scope of issues to be decided is greater when cuts are made than when expansion is the order of the day. Once economic and political conditions stabilise, decremental budgets will probably be constructed in much the same way as incremental budgets have been for decades – by looking at past spending to decide future spending.

National governments have strong incentives to stabilise future budget conditions by restructuring pension and health commitments in response to looming demographic pressures. Rather than face pressure to slice expenditures every year, many governments will opt for "big bang" changes in entitlements that significantly reduce future budget obligations and thereby enable them to revert to incremental budgets. Decremental budgets often contain selective spending increases that do not add much to spending but ease the budget's path to adoption. Even when they are compelled to deliver cutbacks, future governments will seek to make space in their budgets for fresh needs and political priorities. In other words, incrementalism will be very much a part of governments' future.

Faced with intense pressure for large corrections in budget policies, distressed countries have relied on *ad hoc* procedures to produce emergency packages that are presented to parliament for its immediate approval. Information and decisions have been tightly controlled by a small corps of policy makers at the centre of government or in the finance ministry. Bilateral negotiations between central and sectoral ministers and between the national government and regional or municipal authorities have been replaced in some countries by unilateral actions veiled from public view, with little opportunity for civil society or sectoral interests to influence the package. The concentration of information and power has reversed decades of progressive opening of the budget process through formal and informal consultations between political leaders and other stakeholders.

The current period of profound fiscal anxiety, intense conflict, concentrated policy making and political instability is not the template for budgeting's future. If it were, budgeting as it has been practised for more than a century would disintegrate into improvised actions, with rules and procedures fabricated to suit each year's circumstances. Breakdowns would be common, conflict would be elevated, and governments would have difficulty completing prescribed budget work on a fixed schedule.

Coping with less buoyant fiscal opportunities may provoke some democratic governments to alter prominent features of budgeting. Some may strive to more fully link resources to results and to get more value for money through performance-based budgets; some will organise budgeting around medium-term frameworks that genuinely constrain revenue and spending decisions; some will shift a portion of the risks and liabilities accumulated by the government back to households; a few may yield a portion of fiscal sovereignty to supranational institutions.

These would be big changes, but the routines of budgeting still will be easily recognisable to those who toiled in budgeting before crisis struck.

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Buy back PPPs: An arbitrage opportunity

by
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As Portugal is facing strong fiscal pressure, government spending on public-private partnerships (PPPs) in the road sector has become a main budgetary constraint. In this article, we show how the financial crisis has created a unique arbitrage opportunity that provides a solution to this problem. Since the private sector is in urgent need of liquidity, we suggest that the Portuguese government should use some of the bailout funds, borrowed at lower interest rates, to buy back the roads concessions, discounting future payments at the high interest rates currently charged to Portugal. For the roads already in operation, the purchase of the assets would significantly reduce future public payments and would also release money into banks and the economy. For the roads currently under construction, we propose that the government buys only the equity of these companies. That would also reduce future payments, and allow for the postponement or even cancelation of some of these projects, while granting private companies an exit from projects that they are no longer able to finance. This operation would save around half of PPP payments over the next 20 years.

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1. Introduction

Over the last decades, countries around the world have used public-private partnerships (PPPs) to build and manage a significant part of their infrastructures. However, doubts about the efficiency of this specific instrument regarding public resources have been raised by several authors (for example: Broadbent, Gill and Laughlin, 2008; Froud and Shaoul, 2001; Ng and Loosemore, 2007; Shaoul, 2002, 2005, 2009). Additionally, concerns about the affordability of these projects have also been pointed out (Grimsey and Lewis, 2002 and 2005).

These two questions on efficiency and affordability are also the key points on PPPs in Portugal. Especially in the road sector there are many doubts about the value for money (VfM) generated by the PPPs. The profitability of the concessions, the conditions of renegotiation and financial rescues, and the high level of public payments are in the base of such claims. The high level of payments has also generated concerns about affordability over the next two decades. This is relevant now that Portugal is in the midst of a financial rescue provided by what is called "the Troika" (European Union, European Central Bank and International Monetary Fund). As expected, the adjustment programme has included some measures regarding PPPs. Mainly, the Troika's memorandum of understanding requests the Portuguese government to include these contracts in the consolidation perimeter of national accounts deficits, but the bailout programme wants to see increased monitoring and solutions to renegotiate the PPPs.

As the road sector represents three-quarters of the total budget effort on PPPs, solutions to reduce the future public payments related to PPPs will necessarily have to address contracts in this sector. In this article, we suggest that the government should buy back these contracts. We are not suggesting a forced nationalisation, or even a "haircut" or any other solution that could be interpreted as some type of default. We are talking about a negotiation between the public and private sectors based on an arbitrage opportunity, which we explain here. Concerning the roads already in operation, the arbitrage opportunity allows a reduction of the interest rate implicit in these contracts: the average capital asset pricing model (CAPM) of these projects amounts to 16%, with the public debt interest rate of 6%, at a time when the private sector is desperate for liquidity. This would save around 50% of future payments, and at the same time would help the government to put money into the banks and the economy.

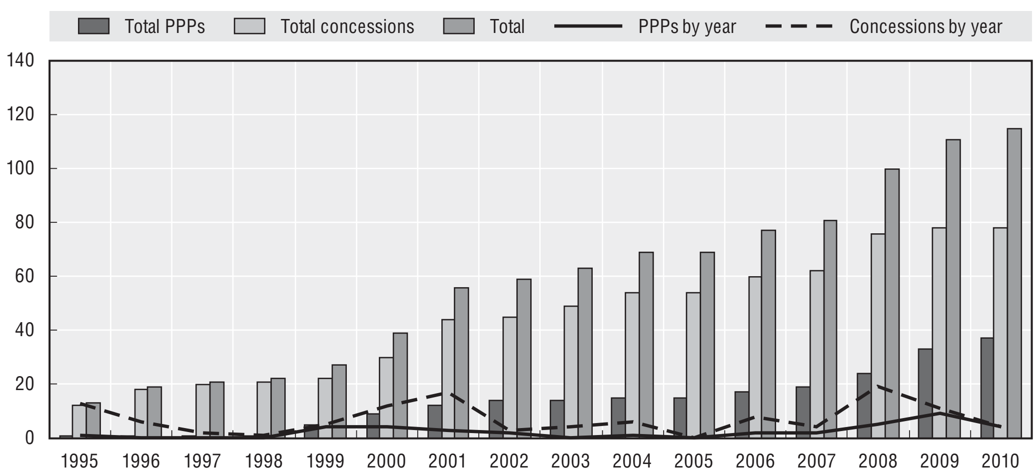
For the roads in construction, we propose that the government buy the equity of these projects. That way, payments after 2014 will be reduced, while relieving the companies of projects that they are no longer able to finance in the market. Savings are also above 50% in the first 20 years. Additionally, the government would be solving the construction companies' problem of financing these projects.

This article is organised as follow: Section 2 presents the Portuguese case of PPPs. Section 3 presents the two waves of road PPPs mentioned before. Section 4 examines the solution for the first wave, and Section 5 for the second wave. Section 6 concludes.

2. The Portuguese case of PPPs

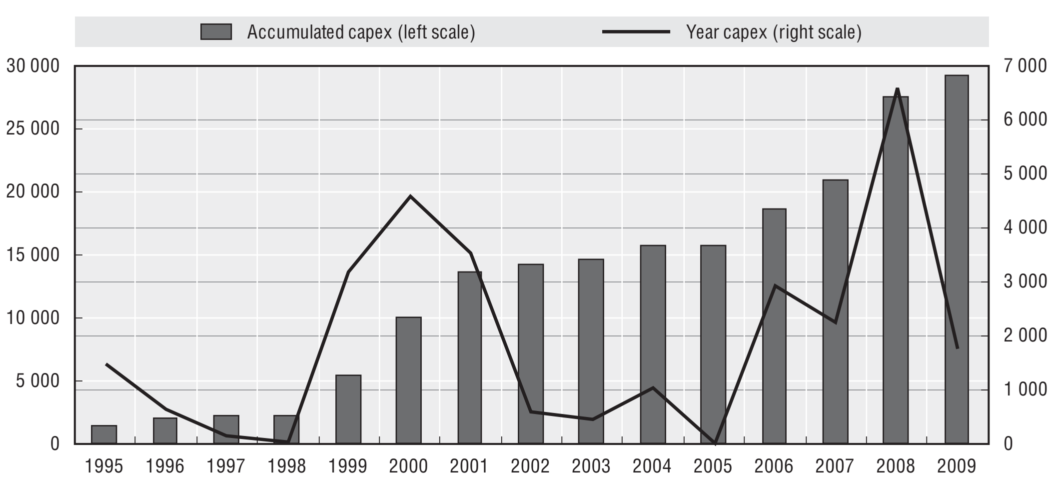
The history of public-private partnerships (PPPs) in Portugal starts in 1993 and primarily involves projects in transportation (basically roads), with a recent move to some health projects (DGTF, 2011). In the past 15 years, around 40 PPPs were contracted, and an additional 80 concessions (Figure 1). This enormous effort represented a private investment above EUR 30 billion (Figure 2), which led to some concerns regarding affordability. The future payments due by the state to honour these contracts represent an annual effort above 0.5% of GDP until almost 2030, while between 2014 and 2020 these payments will go up to 1% of GDP (see Figure 3). These payments will have to be netted of some revenues to the state, but all projections of future revenues have proved to be somewhat optimistic.

Figure 1. **Number of PPPs and concessions in Portugal**



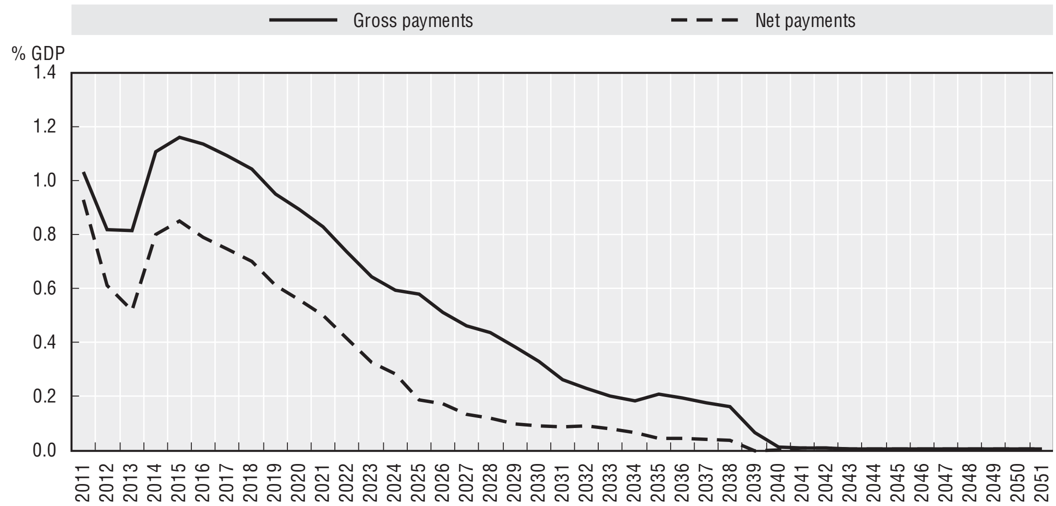
Source: DGTF (2011), *PPP: Parcerias Público-Privadas, Relatório 2011* (annual report on PPPs), Ministry of Finance, Lisbon.

Figure 2. **Total investment in PPPs and concessions in Portugal**



Note: Capex = capital expenditure.
Source: DGTF (2011), *PPP: Parcerias Público-Privadas, Relatório 2011* (annual report on PPPs), Ministry of Finance, Lisbon.

Figure 3. **PPP payments, 2012-50, in per cent of GDP**



Source: Ministry of Finance, *2012 State Budget*, Lisbon.

Some authors raise doubts about the value for money of these projects (e.g. Sarmento, 2010), as the decision to deliver public investment through PPPs is more related to an "off-budget temptation" regarding public investment than to efficient public procurement procedures. In fact, considering the high values of public payments regarding the assets and the services, governments in Portugal were more concerned about public deficits than with value for money. Hence, we conclude that PPPs were used with a single purpose: to put this public investment outside the consolidation perimeter of public accounts.

Whatever the reasoning behind these projects may be, the net present value (NPV) of their future payments already represents more than 10% of the country's current GDP (see Table 1). This intensive use of PPPs turned Portugal into one of the leading countries in this market around the world. As shown in Figure 4, a recent study on PPPs from the European Investment Bank revealed that Portugal is in the lead position, among European countries, when considering the capital expenditure (capex) as a per cent of GDP.

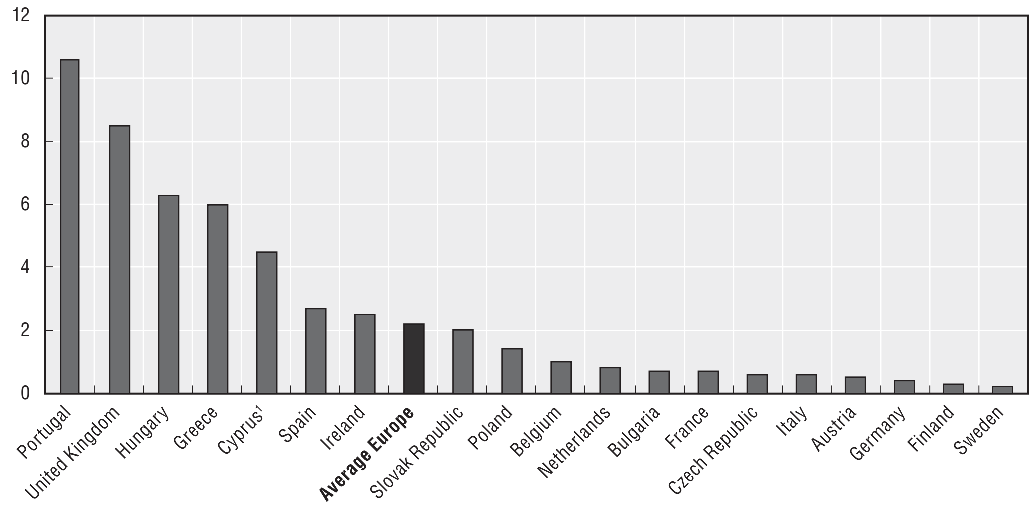
Table 1. **Net present value of PPPs**

	6% discount rate	Yield to maturity 2008 (4%)	Yield to maturity 2011 (13%)
Roads	10.0	12.1	5.8
Health	1.6	1.8	1.1
Security	0.2	0.2	0.1
Total	**11.7**	**14.1**	**7.1**

Source: Calculations by the authors based on data in Figure 3 (Ministry of Finance, *2012 State Budget*, Lisbon).

Along with the heavy value burden of PPP contracts for the public sector, one also needs to consider the extremely rapid pace with which these many contracts were set up. This was done without necessarily ensuring that the administration was capable of managing them all. The novelty of the experience, added to the fact that the governments were not prepared for the level of complexity some of these contracts introduced, led to some questionable decisions. In addition, until 2003 there was no proper legal framework, leaving the Ministry of Finance extremely passive in this area.

Figure 4. **Use of PPPs in European countries (per cent)**



1. *Note by Turkey:* The information in this document with reference to "Cyprus" relates to the southern part of the Island. There is no single authority representing both Turkish and Greek Cypriot people on the Island. Turkey recognises the Turkish Republic of Northern Cyprus (TRNC). Until a lasting and equitable solution is found within the context of the United Nations, Turkey shall preserve its position concerning the "Cyprus issue".

   Note by all the European Union member states of the OECD and the European Union: The Republic of Cyprus is recognised by all members of the United Nations with the exception of Turkey. The information in this document relates to the area under the effective control of the Government of the Republic of Cyprus.

Source: Andreas Kappeler and Mathieu Nemoz (2010), "Public-Private Partnerships in Europe – Before and during the recent financial crisis", *Economic and Financial Report 2010/04*, July, European Investment Bank.

As the original contracts started to prove extremely hard to afford, the Portuguese government embarked on a series of renegotiations to reduce and postpone some of the payments, leading to situations that increased compensations to the private sector while skewing the risk allocation towards the public sector.

Now that the financial impact of these contracts is beginning to be felt, those once "future" payments have now become a significant burden to the present fiscal consolidation, adding to the extreme fiscal crisis Portugal is experiencing. Not surprisingly, the memorandum of understanding signed by the Portuguese government when the financial rescue plan was set up by the IMF, the ECB and the EU (the Troika) mandates the need to reduce these payments.

Thus Portugal is in urgent need of a solution for these contracts: a solution that will ease the fiscal burden, mainly for the road sector. Roads represent the largest portion of anticipated payments, with the private concessionaires being entitled to very advantageous compensations without having to cover most of the risks.

Nevertheless, the solution for handling these contracts cannot be an early termination, as this would represent a partial default of the government. On the other hand, choosing to renegotiate the contracts would likely repeat the experience of previous renegotiations where the government systematically ended up worse in the long run.

As we will see, the road sector had two waves of PPPs. Both waves have an arbitrage opportunity based on the excessive profits and the current need of the private sector for liquidity. In the remainder of this article, we will analyse how this arbitrage opportunity can reduce the future payments and contribute to fiscal consolidation.

3. The two waves of PPP highways[1]

The first wave of PPPs in the road sector was composed of the so-called SCUTs[2] highways. Road contracting in the first wave was divided into seven separate procedures between 1999 and 2001. Since its inception, there have been strong discussion and controversy about this being the best contracting option for these highways and whether these public-private partnerships have, in fact, delivered value for money to the public sector. The SCUTs extend over a total of 930 kilometres of highways originally with shadow tolls, with the public budget stepping in to pay the private consortia in lieu of the users.

When setting up the SCUTs PPPs, the government conducted no public sector comparator analysis. Possibly, this was one of the major reasons for the discussion on whether these contracts created value for money or not, reinforcing the opinion that the decision to use PPPs was not based on any financial analysis, as there was no idea of how much it would cost to build and operate the roads by traditional public contracting. This opinion was also voiced in the conclusion of the 2003 audit on PPPs from the Portuguese Court of Audits (Tribunal de Contas, 2003). In fact, there was no study whatsoever on the economy, efficiency and effectiveness of these PPPs before the decision was taken.

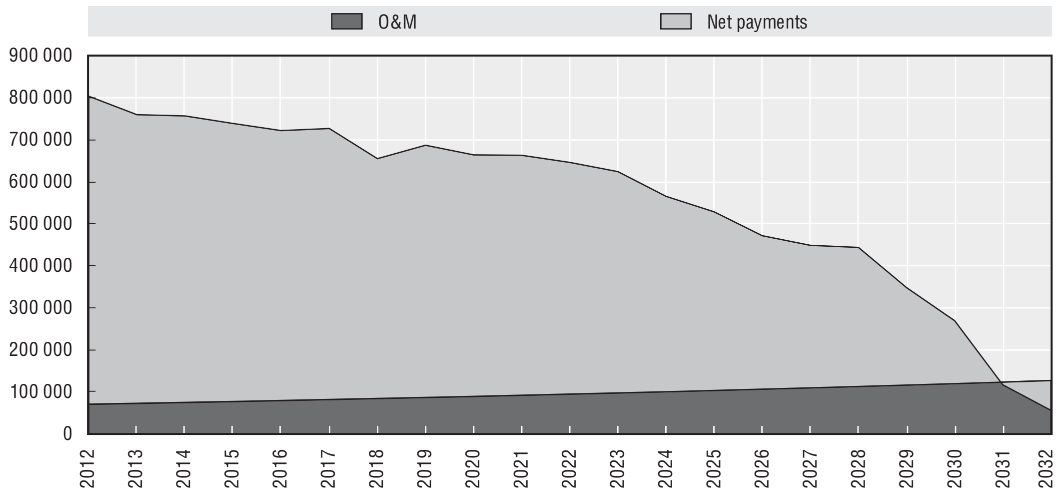
Now, after several rounds of renegotiation, the SCUTs are no longer operating with shadow tolls but with real electronic tolls, with the users paying for the use. The individual concessionaires charge the tolls, but these revenues are totally channelled to the government. In exchange, the concessionaires receive a compensation for availability. These renegotiations have reduced the level of risk to the private sector, and revenues were maintained and in some cases increased. These improvements have allowed concessionaires to maintain or even increase their rates of return despite the fact that their level of risk was reduced (Tribunal de Contas, 2012).

The second wave of road PPPs was launched between 2007 and 2008, when the Portuguese government awarded seven new highway projects to public bids, under the supervision of the national public roads concessionaire, Estradas de Portugal (EP). EP is an entirely state-owned company that became the concession grantor, which explains why these roads are usually referred to as "subconcessions". These projects are to be completed by 2014, thereafter representing an additional EUR 800 million of annual payments to the government (see Figure 5). All of the subconcession contracts are similar to the current version of the former SCUTs contracts: that is, the roads have real tolls whose revenues revert to the concession grantor (EP), while the concessionaires receive payments based on availability.[3]

These two waves represent 14 projects and – with joint annual public payments above EUR 1.4 billion from 2014 onwards – represent three-quarters of total payments on PPPs by the government. The remaining quarter involves payments mainly to PPPs related to health care and railways.

Thus any fiscal consolidation concerning the reduction of PPP payments must necessarily tackle these projects. In the next section, we explain how these projects present an excellent arbitrage opportunity for reducing the public finance burden.

Figure 5. **PPP SCUT payments and costs of operation and maintenance (O&M), 2012-32 (million euros)**



Sources: Net payments based on DGTF (2011), *PPP: Parcerias Público-Privadas, Relatório 2011* (annual report on PPPs), Ministry of Finance, Lisbon. Calculations of O&M by the authors.

4. Buy back SCUTs: The model and results

Due to the increasing and high level of the future public payments on the SCUTs projects, it is imperative to reduce them significantly. The current situation regarding the SCUTs PPPs offers an arbitrage opportunity based on two factors:

- The return of the projects is around 16% (the average CAPM of the seven projects).
- The private sector (concessionaires and sponsoring banks) is in dire need of liquidity.

Regarding the first premise, in the current version of the contracts, the public sector is obliged to an annual payment by availability (which means that the demand risk is totally allocated to the public sector). Like any other PPP, these payments are meant to cover operation and maintenance expenses (O&M), taxes, the debt service and the profits of the shareholders. This means that, once we remove the O&M expenses – which cover the operations part of the contract – we are really left with a debt payment from the public sector to private companies in exchange for the construction of the infrastructures, and indirectly to the banks and shareholders that financed the PPP. The question is: How much is this debt effectively costing the public sector? If we use the CAPM as a measure for the profitability of the asset, then we come to a 16% interest rate.

CAPM: $E(R_i) = R_f + \beta_i\,[E(R_m) - R_f]$

Where:

$R_f = 6\%$

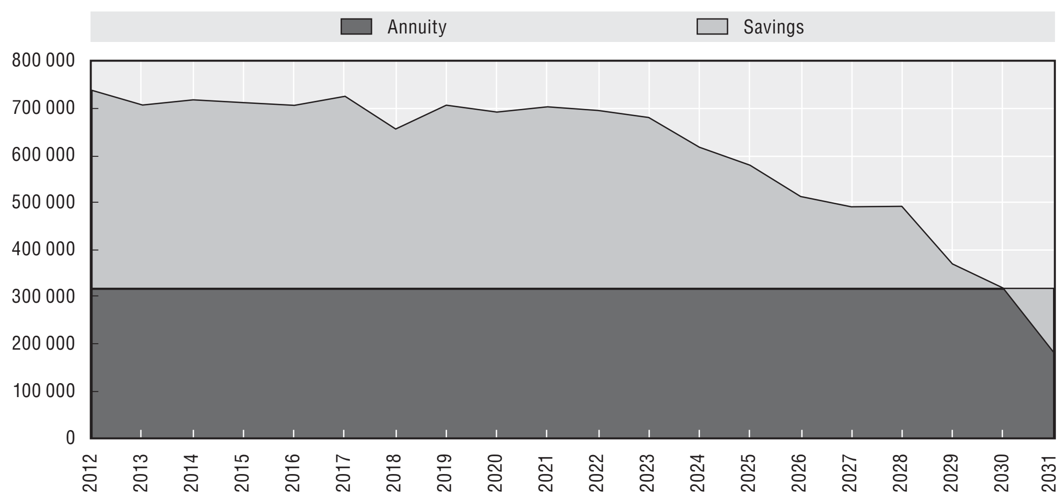
$\beta_i = 0.5 \times [1 + 8 \times (1 - 0.265)] = 3.44$ ([4])

$E(R_i) = 6\% + 3.44 \times [9\% - 6\%] = 16.3\%$

Therefore, if we use this 16% rate to discount the future payments (without the O&M expenses) stipulated in the current contracts, we come up with an NPV of EUR 3.5 billion. This value represents the current value of the debt implicit in these contracts.

This value can be financed by direct public debt at an interest rate of 5% to 6% for a 20-year maturity[5] (for the purpose of this article we have assumed a 6% interest rate). The public sector would pay to the seven private concessionaires a value of EUR 3.5 billion, entirely financed through public debt. However, with this operation, in 2012 the public budget would no longer pay EUR 700 million to the concessionaires (this value will decrease with time until 2031) and would start paying an annuity of EUR 300 million (interest plus principal) to the treasury bondholders. The values of the annuity and the savings from 2012 to 2031 are shown in Figure 6.

Figure 6. **SCUTs loan annuity and savings (million euros)**



Source: Calculations by the authors.

In summary, the arbitrage opportunity is simply an exchange of the interest rate, exchanging 16% for 6%. The savings generated by this operation are supported by this change in the interest rate of the debt.

The second main question for this solution to work remains to be discussed: are private shareholders willing to negotiate under these terms?

First of all, it is necessary to remember that, under the assumption that the discount rate is valid, receiving the NPV immediately is financially equivalent to receiving the future annual payments as contracted. This would then lead the negotiation to focus entirely on the value of the discount rate. On this matter, it is important to mention that, during the negotiations, the private sector cannot take on a discount rate much lower than the CAPM suggested here. Thinking strictly in terms of maximising the NPV, a lower discount rate would increase the value to be received by companies. But on the other hand, lowering the CAPM means that the current returns on those assets are excessive. Accepting a lower CAPM is tantamount to accepting a cut in the current payments, and the government can then simply ask for a renegotiation of the terms of payment. In the event that private companies ask for a lower discount rate (say 8%, which would double the NPV), it would become easier for the government to prove that the current 16% of gains are disproportionate and, consequently, cut payments to a CAPM of 8%.

But why would the private sector want to negotiate now, and ultimately accept a discount rate around the 16% value or any other value? The answer is the lack of liquidity and the need to deleverage, both from private shareholders and the commercial banks which finance most of the investment. This operation would allow for the anticipation of payment to banks by the concessionaires, encouraging banks to support this solution, and would also allow a substantial amount to go to the shareholders of these companies. The government is buying back the entire future payments. It is not simply buying equity; it is buying the full assets of the projects, which are equity and liabilities. The banks will certainly appreciate the immediate funding of the liabilities. The financial and liquidity difficulties, and the need of the Portuguese banks and companies to deleverage, address the second premise: the private sector needs to have cash.

In this way, the buy-back operation would be a negotiation between the public sector (the Portuguese government and the Troika) on one hand, and the private sector (companies and banks) on the other. Here there is no early termination, "nationalisation" or even a financial loss or "haircut" in private sector gains. What we have is an arbitrage opportunity that helps the government achieve two objectives: inject money into the economy and the banks, and at the same time reduce future public expenditures significantly. The NPV of the savings to the public sector is EUR 3.7 billion. However, this operation has some disadvantages, mainly to the public sector: it increases the direct public debt, by Eurostat criteria (2 percentage points), and also forces the government to negotiate first with the Troika (to assure the funds required by the operation) and afterwards with the private sector. Nevertheless, we conclude that the benefits far outweigh the costs.

Needless to say, the acquisition of all the projects would require some organisational changes in the public sector to accommodate the management of these roads. Doing this either through the Estradas de Portugal or by simply re-concessioning the roads, now under much more favourable terms, would work as solutions to this problem.

5. Buy back the new subconcessions: The model and results

The new subconcession PPPs posed a different challenge regarding the reduction of future expenditures. Unlike SCUTS, which are already constructed and in operation (and therefore contracts are already set up and future cash flows are expected by the private sector to compensate the investments made), these roads are still under construction (expected to open by 2014).

It is important to mention that construction has stopped on some of the roads, due to the fact that credit has dried up. These projects are facing several problems at the European Investment Bank (EIB) to finance their investments, caused by the fact that EIB loans have to be guaranteed by banks with a minimal rating that Portuguese banks at this moment no longer have. As a consequence, the lack of financing is creating an insurmountable hurdle for many of these companies. After all, the delay on the construction will have one of two consequences (or maybe both): an increase in costs, due to the extra works necessary to complete the road on time; and/or a contractual penalty for delaying the opening of the road.

The arbitrage opportunity in the new subconcessions is also based on the anticipated high levels of returns (the post-2014 payments) and the need for private companies to step aside from these projects, before they lead the shareholders and banks to heavy losses.

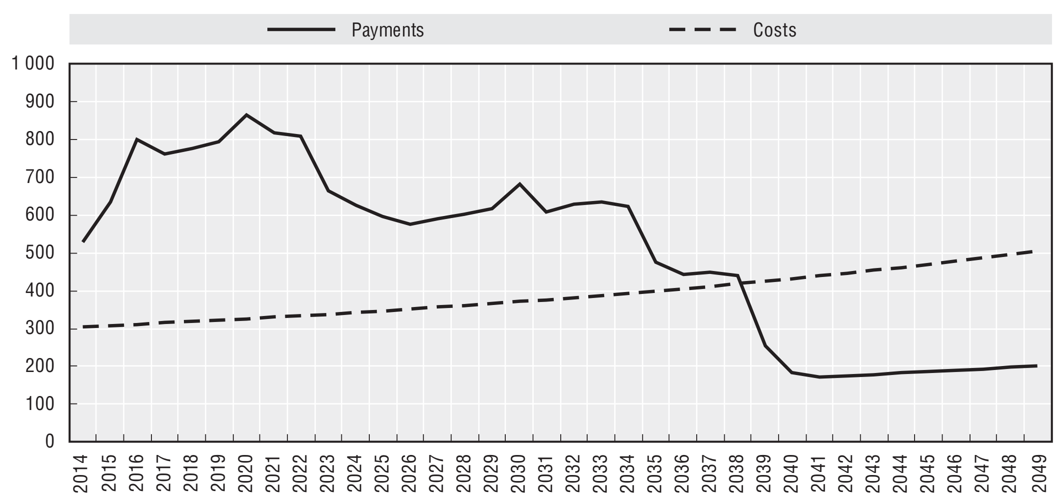
We propose a slightly different solution to these projects. Instead of paying the NPV of future cash flows, we suggest that the public sector should simply buy these companies' equity. Private companies would not have any loss to report and, as the concessionaires are construction companies, they will continue to be responsible for the construction of the road, only relinquishing the concession of the road. Banks would continue to lend money, now guaranteed by the public sector, with a lower risk. And, after 2014, the public budget would no longer have to pay the values contracted. The cost for the public sector of this operation would include the opportunity cost of the equity, the interest rate of the loans and the O&M costs (Table 2).

The result would be a significant reduction in the costs of these PPPs (see Figure 7). The savings to the public sector amount to an NPV of EUR 3.3 billion.

Table 2. **Costs of PPP versus buy-back option**

PPP option	Buy-back option	Assumptions
Payments to the private sector	Opportunity cost of equity	6%
	Interest rate on the loans	5%
	O&M costs	75 000 km/year, with a 3% annual increase

Figure 7. **New subconcession payments and costs (million euros)**



Sources: Payments based on DGTF (2011), *PPP: Parcerias Público-Privadas, Relatório 2011* (annual report on PPPs), Ministry of Finance, Lisbon. Costs calculated by the authors.

There is also the added advantage that now the government would be the owner of the concessions, able to delay the construction until a more convenient time, or even, if necessary, to stop the construction altogether if there is no money left.

6. Conclusions

As Portugal is facing fiscal challenges for the next years, PPPs have become a heavy burden for taxpayers, mainly the PPPs related to the road sector. However, the financial crisis has created an arbitrage opportunity to the public sector that a few years ago would have seemed rather difficult. The private sector (companies and banks) are in need of liquidity. This means that they are pressured to accept solutions regarding PPP future payments in exchange for cash. For this reason, the Portuguese government, for the first time in recent history, is in a favourable negotiating position.

In this article, we propose that the government buys back the contracts of the two waves of PPP highways. For the projects already in operation (SCUTs), the government would trade the rate of return of the private sector (16%) with a 6% interest rate of public debt. Reducing this rate allows savings of more than 50% of future payments. At the same time, when the private companies sell the assets, they would have to immediately repay the loans to the banks (instead of doing so over the next 15 to 20 years). Eventually even the funds paid to cover the equity to the shareholders would also find their way to the banks, as these private shareholders are mostly construction companies with stringent liquidity problems at the moment. Thus a substantial part of this money would end up in the banks, helping to solve one of Portugal's financial problems.

For the projects still under construction, we recommend that the government should simply acquire the equity. That would allow the current shareholders of these projects to step aside from projects which, under the current financial market conditions, they are not able to finance. By doing that, the government would save a significant part of the future payments of these projects after 2014.

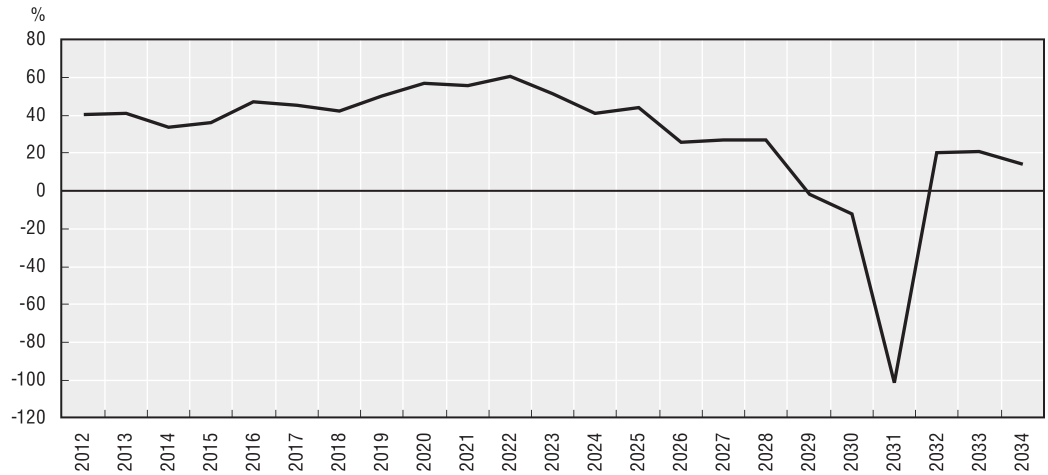
In order to better understand the implications of this solution, we outline some of its advantages and disadvantages in Table 3.

Table 3. **Public and private sector advantages and disadvantages**

	Advantages	Disadvantages
Public sector	– Strongly reduces public expenditures for the next 30 years. – Eliminates further renegotiation risk.	– Increases direct public debt by 2 percentage points. – Requires agreement from the Troika and uses up some of the bailout funds.
Private sector	– Allows financial deleveraging by banks. – Allows private companies to deleverage. – End of uncertainty for the private sector regarding these concessions (mainly in the new subconcessions). – End of country risk (relevant nowadays). – Possible gains if discount rate is lower than 16% (SCUTs only).	– Abandoning very profitable contracts.

As can be seen in Figure 8, the combination of these two proposals allows the public sector to save over 40% of the currently contracted future payments until 2025. That means an average saving of EUR 400 million until 2014 and EUR 800 million thereafter. This is a substantial value in terms of the country's public budget. When looking at the austerity measurements that Portugal has adopted, annual savings of EUR 800 million roughly represent 2 percentage points of the normal VAT rate or half of the salary cuts in the public sector. It also represents 80% of cuts in the national health services or the total cuts in pensions, or even double the cuts in the other social benefits. One of these austerity measures could be avoided or reversed.

Figure 8. **Total savings as a per cent of total cost**



Source: Calculations by the authors.

Notes

1. We are considering PPPs strictly as regulated by Portuguese law. The definition of a PPP is enshrined in Article 2 of Decree-Law No. 86 of 26 April 2003, with a new formulation stipulated by Decree-Law No. 111 of 23 May 2012 which sets the general rules applicable to the state involvement in the PPP. Many other forms of public-private associations exist in Portugal, but we are not considering those here.
2. SCUT stands for "Sem Custos para o UTilizador", which is Portuguese for "without costs to the user".
3. An important consequence of using this solution is that it ensures that EP starts collecting so-called "market revenues" and stops being funded exclusively through direct contributions from the state budget. With "market revenues", the government is allowed, under European Union public accounting rules (ESA95), to leave EP out of the consolidation perimeter of the government, which will significantly ease deficit calculations for the Portuguese government.
4. We use a tax rate of 26.5%, a debt-to-equity ratio of 8 in accordance with the average of the concessionaires and β_u = 0.5 *(Source: http://pages.stern.nyu.edu/~adamodar/*).
5. The Troika financial assistance programme has already made several bailout loans to the Portuguese Republic. One is a 15-year-maturity loan with a 4% interest rate. Although no such loan exists with a 20-year maturity and would probably need to be negotiated with the EU, ECB and IMF, a 6% interest rate seems actually rather conservative when compared to other loans in Portugal and other countries in similar circumstances in Europe.

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Illuminating budgetary risks: The role of stress testing

by
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The increased vulnerability of government finances in many countries underlines the importance of public risk management. We apply a specific risk management tool – stress testing – to public finances. After presenting a general framework for stress testing government finances, we illustrate its application for the case of the Netherlands. Our analysis indicates that high levels of contingent liabilities call for sufficient shock absorption capacity in public finances.

JEL classification: E62, H63

Keywords: Fiscal policy, public debt, stress test, risk management, budgetary sensitivity, implicit and explicit guarantees, Netherlands

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1. Introduction

The sharp deterioration of public finances in several countries caught many by surprise. During the financial crisis, increases in budget deficits and public debt went far beyond what could be expected on the basis of standard budget sensitivities. Revenue windfalls turned into shortfalls, implicit guarantees for the financial sector became explicit, and outstanding guarantees increased strongly as private risks turned into public risks. Notable examples of such budgetary risks are the European Financial Stability Facility (EFSF) in the euro area and the exposure to the housing market through government-sponsored enterprises (GSEs) in the United States and other countries.

The amplification of both on- and off-balance government liabilities implies that the fiscal space to deal with new shocks has diminished, while exposures to new shocks have increased. Overall, the sharp increase in risks on government balance sheets underlines the importance of a risk management approach to public finances.

The aim of this article is to contribute to such a risk management approach by applying a specific risk management mechanism – stress testing – to public finances. Stress testing is a standard tool in the financial sector, but its application to public finances is still in development. We provide a general framework for stress testing government debt, and then illustrate its actual application for the case of the Netherlands.

The stress test illuminates the effects of risk correlations that may occur in a severe but plausible scenario. While the limitations of the exercise should be kept in mind – a stress test is not a prediction – it can provide useful information on the vulnerability of public finances. By focusing on tail events, it complements existing information on "likely" economic and fiscal scenarios on which the annual budget is based. This facilitates decision making on crucial issues such as the acceptance of explicit risks, the management of implicit liabilities (including policies for reducing them), the pricing of guarantees, and the need for safety buffers in public debt. Moreover, such a policy-oriented stress test of public finances complements existing debt-management models.

In designing the stress test, we start from the usual response of the budget balance to economic growth. We then incorporate effects not captured by standard budgetary sensitivities. Here, the literature emphasises the impact of asset prices and the materialisation of implicit and explicit liabilities, i.e. events with low probability but very high impact. These risk drivers are likely to be correlated, especially in a tail event; hence the need for stress tests to take these correlations into account. The subsequent calculations are based on a combination of a macro model and additional input on scenarios for support to financial institutions and the materialisation of government guarantees.

The rest of this article is organised as follows. Section 2 summarises the general stress-testing framework. Section 3 illustrates the application of the general framework to the Netherlands. Section 4 concludes. Annex 1 provides detailed information on the stress test scenarios.

2. The stress-testing framework

In addition to the forecast of the most likely scenario, economic and fiscal forecasts generally contain a qualitative description of the major risks to the outlook. Sometimes, growth forecasts are presented for a pessimistic or conservative economic scenario. Fan charts can depict confidence intervals around the baseline. Debt sustainability analysis and ageing studies provide information on the long-term developments in public finances. What is missing, we believe, is an in-depth analysis of the response of public finances – and public debt in particular – to correlated exogenous shocks. This analysis has become all the more relevant due to the increase in risk on governments' balance sheets.

We therefore focus on the effects of severe but plausible shocks to public finances, in particular the gross debt of the general government. The choice for gross instead of net debt is motivated by the fact that gross debt needs to be financed. Moreover, financial assets may be illiquid or earmarked for specific purposes and therefore not be immediately available for paying off gross debt in times of stress. Still, we acknowledge the relevance of complementary approaches that would focus on risks to the net worth of the government.

The starting point is the standard equation that links the change in debt to the budget deficit and the stock flow adjustment, all measured as a percentage of GDP:

$$\Delta GrossDebt_t = BudgetDeficit_t + StockFlow_t$$

The budget deficit – i.e. total expenditure minus total revenues – represents a change in net worth of the government, and adds to the (net) debt. A full discussion of the stock flow adjustment – defined as the change in gross debt that is not explained by the budget deficit – is outside the scope of this article.[1] The main point here is that a large component consists of financial transactions which add to gross debt and represent a crucial ingredient for the stress test.

The next step is to identify the main drivers of shocks to the budget deficit and the stock flow adjustment. This, in turn, will provide insight on the effects of shocks to gross debt. Table 1 lists the main drivers: shocks to economic growth, asset prices (especially as a result of financial cycles), explicit and implicit liabilities. The second column provides examples of concrete events that trigger shocks to public debt.

Table 1. **Shocks to debt dynamics: Risk drivers and triggers**

Risk driver	Triggers	Effect on the debt dynamics through:
Economic growth	Unexpected deterioration in economic scenario.	Budget balance
Asset prices	Unexpected drop in prices of real estate, equities, gas/oil; increase in interest rates.	Budget balance
Explicit contingent liabilities	Event with low probability but high impact that triggers payments on guarantees, e.g. EFSF or housing market support.	Budget balance and/or stock flow (financial transactions)
Implicit contingent liabilities	Event with low probability but high impact that triggers payments on implicit liabilities, e.g. capital support to financial institutions.	Budget balance and/or stock flow (financial transactions)

We now discuss the risk drivers listed in Table 1. The effects of shocks to economic growth can be measured through standard budgetary sensitivities as measured by the OECD (Girouard and André, 2005). In individual years, sensitivities may diverge from their constant, average value for various reasons. The composition of demand may change, hence altering the weights of the individual revenue and spending components. Also, swings in asset prices may not be fully related to the economic cycle and hence impact the budget in unforeseen ways (e.g. Girouard and Price, 2004; Morris and Schuknecht, 2007). Therefore, we include asset prices as a separate risk driver in Table 1. Overall, there is increasing evidence that revenue windfalls and shortfalls exhibit a cyclical pattern (Morris et al., 2009). Box 1 contains a further illustration based on our own research for the Netherlands. Overall, a comprehensive analysis should take into account that budgetary sensitivities may be unusually large under a severe scenario.

Box 1. **Estimating budget volatility in the Netherlands**

The issue of budget volatility through "non-traditional" factors such as asset prices and composition effects is of particular relevance for a country like the Netherlands: an economy with pension assets of well over 100% of GDP, with natural gas reserves, with exports amounting to 70% of GDP, and with high mortgage debts. Moreover, a set of unique data allows additional research on the budget sensitivity in the Netherlands. For many years, desk officers in the Ministry of Finance have registered revenues for various taxes and social security contributions while making a distinction between policy-induced changes to the revenue stream and endogenous developments. This allows a direct estimation of the endogenous response of tax income to the economic cycle. To gain further insight into the budget volatility, we thus follow a two-step approach (Schilperoort and Wierts, 2010).

First, we estimate a standard reaction function for the budget balance in which the primary balance reacts to the output gap and the debt level. The debt level is included to address sustainability concerns. For the period 1983-2008, we find a correlation with the output gap of around 0.5. This is in line with the budget sensitivity for the Netherlands, which the OECD estimates at 0.53 (Girouard and André, 2005). For more recent years, the reaction coefficient increases to around 0.7. While the limited number of observations prevents us from drawing firm conclusions, the increased correlation may be due to the introduction of multi-annual budgeting in the 1990s, which increases the automatic stabilisation function of the budget. Since the multi-annual budget framework limits the role of discretionary policy, the results suggest an increased sensitivity of the budget to the cycle.

To investigate whether the increased volatility is endogenous or policy driven, we subsequently look into the progression factor. This is the nominal growth rate of tax revenue, corrected for the impact of discretionary policies, divided by the growth of nominal GDP. For the period since 1972, we find a value close to 1, implying that tax revenue has kept up with GDP growth in the long run. At the same time, we find that the ten-year rolling average is declining, reaching 0.58 in 2011. While this decline may help to explain low tax revenue in downturns, it is not consistent with windfall revenues in good times. Such a cyclical pattern would instead suggest that the progression factor itself fluctuates. To test this hypothesis, we run a regression, relating the progression factor to output and share prices. Again, we find an increased cyclicality for more recent periods: the bigger the output gap, the higher the progression factor.

Explicit contingent liabilities are liabilities for which the materialisation of payments depends on particular events.[2] Prime examples include government guarantees and government insurance schemes. Contingent liabilities are not included in the general government debt, since their realisation is uncertain. The "OECD Best Practices for Budget Transparency" (OECD, 2002) and the IMF "Code of Good Practices on Fiscal Transparency"

(IMF, 2007) recommend that significant non-debt liabilities be disclosed. From our stress-testing perspective, the relevant point is that contingent liabilities represent low-probability, high-impact events. A pre-condition for carrying out a stress test is the existence of an integral overview of all contingent liabilities, in line with the OECD and IMF guidelines. The stress test then requires going further by carefully considering the type of events that may trigger the realisation of the obligations.

Implicit contingent liabilities do not have a legal basis. They arise as a result of expectations or pressures for government intervention. Examples include bailouts of the financial sector, disaster relief, and repair of environmental damage. A decision therefore is required on the type of stress test that is carried out. Should the stress test consider primarily economic and financial shocks, or should natural disasters and/or other types of events also be included? A stress test requires policy makers to think about the kind of severe events that could trigger the realisation of liabilities. The financial crisis has demonstrated the difficulties in identifying up front the possible impact of implicit liabilities on public finances. The importance of this channel – with some countries being forced to seek international financial support when contingent liabilities materialised during the crisis – nevertheless demands that, to the extent possible, implicit liabilities be included in a comprehensive risk management framework.

The consideration of economic and financial scenarios, in combination with triggers for implicit and explicit liabilities, provides the starting point for designing the stress simulations. During "normal" times, correlations between these risk drivers will be small. However, during severe stress, all these drivers tend to be correlated. For example, a severe shock to economic growth may very well coincide with a negative sentiment on financial markets, a call on guarantees (e.g. for the EFSF) and financial transactions such as capital support for financial institutions. Similarly, a large natural disaster will not only trigger implicit or explicit liabilities, but can also have strong effects on the economy. This underlines the need for an integrated approach to stress testing.

Once the scenarios have been constructed, the next step is to calculate their impact in an integrated manner. This may require input from different agencies, e.g. from the forecasting agency on the economic scenario, from the supervisors/central bank on hypothetical recapitalisations, and from government departments on the realisation of guarantees. On the basis of these inputs, the economic and financial scenario can be re-run in the macro model, taking into account second-round effects and – to the extent possible – non-linearity, including changes in behavioural relationships in a tail event. For example: a fall in house prices may lead to lower tax revenues for the government directly, but also indirectly through lower consumption and economic growth. In some countries, a severe housing shock may trigger additional fiscal losses on guarantees and government-sponsored enterprises. Moreover, commercial banks are likely to incur losses, possibly necessitating recapitalisations and further slowing the economy by credit constraints. In short, correlation between risks, negative feedback loops, and fat tails in statistical distributions should be considered to the extent possible.

Overall, such an exercise will probably underline limits to the available models for calculating multi-faceted scenarios. Macro models that calculate fiscal effects after taking into account second-round effects may need to be supplemented with satellite models that calculate specific parts of the scenario, especially with respect to the financial sector.

3. Application to the Netherlands

With these considerations and against the background of increases in public debt and risks, a stress test for public finances has been developed in the Netherlands. This section describes the general approach and the main results of the exercise. Further details and background information can be found in the report "The Government Finances Shock Proof: A Risk Analysis of Dutch Public Finances" (Ministry of Finance, 2011a).

The objective of the stress test is to provide insight on the development of Dutch public finances if new setbacks were to materialise. Added value to existing analysis stems from: *i)* bringing together different organisations, and thereby different perspectives and expertise; *ii)* considering relatively large shocks; *iii)* taking on board the implicit and explicit liabilities; and *iv)* incorporating the correlation between different types of risk. We decided to limit our scope to economic and financial shocks. Previous exercises by the Ministry of the Interior have quantified the possible impact of other types of shocks, such as a natural disaster or a terrorist attack.

3.1. Risk drivers

The exercise starts with the risk drivers defined in Section 2. Regarding economic growth and the impact of asset prices, important contributions were delivered by the independent Netherlands Bureau for Economic Policy Analysis (CPB) which produces all economic forecasts for the Dutch government. The CPB uses its macro model for the Dutch economy to assess the impact of simultaneous shocks on economic growth and public finances. This is a difficult exercise, since standard correlations in macro models may not apply in extreme conditions. Non-linearity has been accounted for to the extent possible.

Estimating the effect of explicit contingent liabilities starts with an overview of the exposures to individual government guarantees, insurance schemes and obligations to public companies. Table 2 provides an overview of the largest schemes in the Netherlands. For the purposes of the stress test, possible triggering events were added. The Ministry of Finance has taken the lead on the estimation of possible losses on government guarantees. For some guarantees, outside analysis has been brought in. For example, in the case of the National Mortgage Guarantee Scheme, the auditors have performed stress tests.

Regarding implicit contingent liabilities, the crisis has underlined the possible impact of interventions in the financial sector. The central bank and banking supervisor De Nederlandsche Bank (DNB) has looked specifically into potential financial sector losses in the simulations, which do include the impact of substantial losses on sovereign bonds. We also make the assumption that the government will step in to support the banking sector in case of capital shortfalls (instead of letting banks fail), hence putting further upward pressure on the government debt level.

3.2. Stress scenarios

Having defined the risk drivers, the next step is to include correlations between them. In crisis situations, correlations between events may emerge that were not foreseen in advance. The failure of risk models in the banking sector during this crisis illustrates the limits of a model-based approach using a small set of historic data. The stress test is therefore based on reasonable, albeit uncertain assumptions regarding the relationship between the most important risks. By way of illustration, Table 3 presents a schematic overview of the causal links between a number of different possible negative shocks.

Table 2. **Overview of risk insurance schemes exceeding EUR 10 billion**[1]

Risk	Commitment undertaken (maximum in billions)	Possible shock (trigger)
Financial market risks:		
Inter-bank loans guarantee facility	33.2	Financial crisis
European risks:		
European Financial Stability Facility (EFSF/ESM)[2]	97.8	European debt crisis
World-wide risks:		
Guarantees for international financial institutions	60.9	Global or regional economic crisis
Export credit insurance	14.5	
Other/Dutch risks through foundations:[3]		
National Mortgage Guarantee Scheme (NHG)	136.2	Dutch housing market, recession
Social Housing Guarantee Fund (WSW)	86.3	Dutch housing market

1. This concerns the implemented risk, end of 2011.
2. The EFSF is a temporary emergency mechanism which will be systematically replaced by the European Stability Mechanism (ESM) from mid-2013. The EFSF involves a surplus guarantee to ensure that its lending capacity can be effectively implemented. The total guarantee on the principal and the interest on the principal amount to approximately EUR 44 billion. The surplus guarantee on the principal and the interest on the principal amount to approximately EUR 54 billion. The surplus guarantee is in fact a secondary guarantee to ensure the AAA rating of the EFSF.
3. The state is only indirectly exposed to risks because the commitments are not made by the state but by a foundation that holds a financial buffer to absorb future losses. The state will only be held accountable if the foundation fails to meet its commitments. Amounts indicated give the theoretical maximum exposure

Source: Ministry of Finance (2011), "The Government Finances Shock Proof: A Risk Analysis of Dutch Public Finances", Dutch State Treasury Agency, The Hague.

Table 3. **Indication of causal links between risks, from left to right**

Shock	Consequence					
	Dutch housing market	Stock market crash	Higher oil prices	Financial crisis	European debt crisis	Global economic crisis
Dutch housing market	Not applicable	Undetermined/Indirect effect	Undetermined/Indirect effect	Major effect	Undetermined/Indirect effect	Undetermined/Indirect effect
Stock market crash	Undetermined/Indirect effect	Not applicable	Undetermined/Indirect effect	Minor effect	Minor effect	Minor effect
Higher oil prices	Undetermined/Indirect effect	Undetermined/Indirect effect	Not applicable	Undetermined/Indirect effect	Undetermined/Indirect effect	Minor effect
Financial crisis	Undetermined/Indirect effect	Minor effect	Undetermined/Indirect effect	Not applicable	Major effect	Undetermined/Indirect effect
European debt crisis	Minor effect	Minor effect	Undetermined/Indirect effect	Major effect	Not applicable	Undetermined/Indirect effect
Global economic crisis	Minor effect	Minor effect	Undetermined/Indirect effect	Minor effect	Minor effect	Not applicable

Major effect
Minor effect
Undetermined/Indirect effect
Not applicable

Source: Ministry of Finance (2011), "The Government Finances Shock Proof: A Risk Analysis of Dutch Public Finances", Dutch State Treasury Agency, The Hague.

Combining the different risk drivers, and taking into account their interdependence, we build three simulations capturing a variety of risks, as summarised in Table 4 and explained in detail in Annex 1. The scenarios incorporate wide-ranging but often correlated shocks to variables such as world trade, the euro, house prices, asset markets, interest rates, consumer confidence, and unemployment. We assume that the shocks are large, sometimes larger than witnessed historically. To a certain extent, it has been more art than science to comprise these different, correlated shocks together in consistent simulations. The exercise benefited from discussions between participants from the different organisations. History and the correlations in the economic models provided guidance, while basic economic reasoning clearly played a role.

Table 4. **Summary of simulations for the Netherlands**

1. Financial crisis	2. European debt crisis	3. Global economic crisis
This variant assumes that the problems seen in the banking sector in 2008 and 2009 will return.	This variant assumes that the problems in several euro-area countries will continue. Private parties will find that they have to take write-downs on government bonds, while governments will have to extend the term of loans and adjust interest rates.	Global imbalances have been significant for many years. This variant assumes that uncertainty about United States debts causes the value of the dollar to fall, resulting in world-wide uncertainty.
● Global trade drops by 15%, followed by a slight recovery. ● Import prices fall by 5%, including energy (in euros) by 20%. ● Share prices drop by 40%, housing prices by 10%, the number of housing transactions by 25%. ● Nominal, long-term interest rates fall, but risk premiums (with respect to that interest rate) increase by 1 percentage point. ● Negative stimulus from consumer confidence.	● The volume of global trade falls sharply. ● The value of the euro falls by 20% but import prices increase negligibly due to the reduced volume of global trade. ● Share prices fall by 40%, housing prices by 20%, the number of housing transactions by 40%. ● Nominal long-term interest rates hardly change, although the risk spread is 1 percentage point higher. ● Negative stimulus from consumer confidence.	● The volume of global trade contracts by 15%. ● The value of the dollar falls by 30% compared to the euro. Import prices in euros fall by 10-15%. ● Share prices drop 50%. ● Nominal long-term interest is down by some 2 percentage points, risk spread is up by 1 percentage point. ● Negative stimulus from consumer confidence and loss of assets because of the fall in the price of the dollar.
Results (year 5): ● GDP: -5.4% ● Budget balance: -3.4% GDP ● Government debt: +24.5% GDP	Results (year 5): ● GDP: -5.4% ● Budget balance: -2.6% GDP ● Government debt: +18.9% GDP	Results (year 5): ● GDP: -7.8% ● Budget balance: -4.4% GDP ● Government debt: +29.3% GDP

Source: Ministry of Finance (2011), "The Government Finances Shock Proof: A Risk Analysis of Dutch Public Finances", Dutch State Treasury Agency, The Hague.

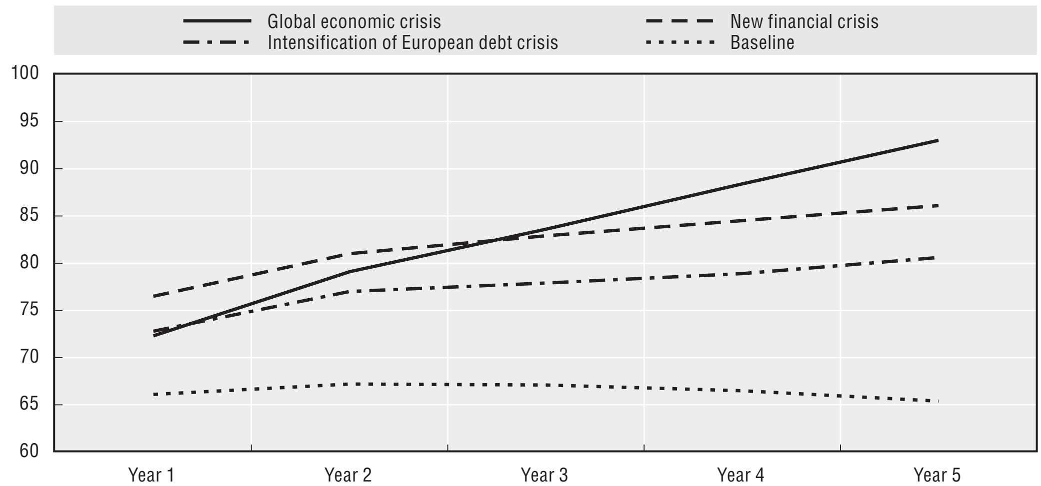
While the simulations are to some extent inspired by recent developments, we stress their purely hypothetical character. Also, it should be noted that new shocks could be of a completely different nature and could hit the economy in currently unforeseeable ways. The approach nevertheless seems natural for the Netherlands: a very open economy, with a large financial sector and part of an integrated currency area.

3.3. Results

In the three simulations, economic growth and public finances are hit hard. Asset prices and world trade plunge, and economic growth turns negative. In the simulations, the debt level immediately jumps up substantially, much more than would be expected on the basis of the shocks in GDP and the budget balance. This is due to interventions in the financial sector and the triggering of government guarantees. In later years, the debt ratio remains on an increasing path. At the same time, the debt ratio remains below that of most other advanced economies due to the favourable starting position of the Netherlands, with a debt ratio well below the OECD average. Note that this international average is also likely to increase further in the case of these adverse shocks. Figure 1 presents the outcome of the simulations on the gross debt ratio. Annex 1 provides a more elaborate summary of the inputs and results of the exercise.

The results of the exercise should be interpreted with caution. New shocks can hit in ways which can currently not be foreseen, and when shocks hit, correlations may be different than assumed in economic models. As the stress tests in the financial sector have shown, it would be wrong to derive a sense of security from the results. Also, unlike the stress tests in the banking sector, it is not easy to determine when the test has actually been passed or failed. A specific level of debt may or may not lead to insolvency, depending on many factors including the strength of the economy and the dependency on the financial markets. At the same time, the exercise does provide a useful insight on

Figure 1. **Development of the debt ratio (% of GDP)**



Source: Ministry of Finance (2011), "The Government Finances Shock Proof: A Risk Analysis of Dutch Public Finances", Dutch State Treasury Agency, The Hague.

vulnerabilities and correlations (e.g. in the case of the Netherlands, it showed that large shocks in world trade have a relatively powerful negative impact on the economy and public finances). The unique collaboration between the CPB, the central bank, and the Ministry of Finance proved very useful in bringing together the feed-back loops between the real economy, the financial markets, and public finances.

Furthermore, it is important to note that – apart from the assumption that the government will intervene to safeguard financial stability – the stress test is based on an assumption of no policy change. In reality, however, governments are likely to respond to severe shocks, thereby limiting or increasing the impact on government finances (e.g. consolidation or stimulus measures). For instance, the Dutch budgetary rules oblige the government to take compensatory measures in case of expenditure overruns. The no-policy-change assumption is nevertheless useful for providing insight into the possible endogenous reaction of government finances. This facilitates an *ex ante* judgment on whether the government has the capacity to carry the risk, and provides a framework for evaluating the effects of different policy actions.

A final note regards communication. Stress testing government debt is a new approach, and policy makers, politicians, and the public at large may not be used to being confronted with scenarios that are highly undesirable in real life. Careful communication is required to ensure that the stress test serves risk management purposes and is not interpreted as a forecast of future events. At the same time, highlighting the effects of stress scenarios may support informed decision making on the acceptance of risks, managing them, and increasing resilience for withstanding them. In the Netherlands, it was decided to postpone the decision on publication until after the exercise had been completed. This allowed the exercise to be done by the technical experts, without constraints being placed on either the inputs or the output of the exercise. In the end, the results were presented in full to Parliament.[3] Both Parliament and the Court of Audit welcomed this transparency and requested periodic updates of the exercise.

3.4. Policy implications

The unpredictability of crises underlines the importance of a strong initial fiscal position and good risk management in order to ensure the capacity to absorb future shocks, whatever they may be. This is one of the reasons why the Netherlands decided to embark on a fiscal consolidation path and to pursue structural reforms. The importance of structural reforms has been highlighted during this crisis, when countries with relatively sound public finances proved vulnerable to external shocks as a consequence of imbalances in their economy. The shock absorption capacity of the Dutch economy and public finances was a main topic of the "Budget Memorandum 2013" and the fiscal policy advice to the incoming government.[4]

In addition to the restoration of sufficient fiscal space, the stress test shows the importance of managing contingent liabilities. Regarding the explicit liabilities, the Netherlands decided to tighten its policy for issuing guarantees. Guarantees may only be issued if the added value and necessity have been demonstrated. In addition, the new budget rules require that the government requests a premium for its guarantees to cover the risks. All outstanding guarantees will be evaluated. The risk management of the National Mortgage Guarantee Scheme has been strengthened through a tightened eligibility for the scheme, an increase in the premium, and a stronger institutional setting.

Managing implicit liabilities is not easy, given that exposures may be hard to identify until shocks actually hit. Moreover, managing the risks stemming from the financial sector and the euro area is complicated by the fact that decisions are often taken at the multilateral level. Nevertheless, progress has been made. Regarding the financial sector, implicit liabilities are being addressed through recovery and resolution plans for systemically important financial institutions. Moreover, these institutions will in the Netherlands be subject to additional capital surcharges.

3.5. Complementary analysis

Since new shocks can hit in unforeseen ways, cost-at-risk models by debt managers provide an important complementary approach. Traditional cost-at-risk models aim to minimise the financing costs for a prudent level of risk. While in our analysis the impact on public finances is the output of severe economic and financial shocks, the Ministry of Finance has also simulated severe shocks to public finances – regardless of their origin – as an input for debt management. Indeed, a prudent approach requires that debt management policies should as a minimum be able to deal with the shocks modelled in the stress test. Complementarity also stems from the fact that cost-at-risk analysis simulates large shocks in the interest rate, while in macro models such interest rate increases are not easy to square with an environment of low growth and low inflation. Developments in some European countries have shown the importance of the interest rate channel, when increases in interest rates driven by doubts on the financial markets about the sustainability of public finances threaten to create a self-fulfilling prophecy.

The IMF has highlighted the importance of augmenting traditional cost-at-risk analysis with an appropriately designed stress test (IMF, 2011). According to the IMF, the exercise should converge to a joint stress test of the sovereign balance sheet and financial sector, while enhanced collaboration among debt managers and other policy makers will be essential for identifying, monitoring and mitigating risk on the sovereign balance sheet. While we did not take traditional cost-at-risk analysis as a starting point, the Dutch stress test does indeed build on a range of different analyses: the work done – by the OECD, among others – on the sensitivity of the budget, the fiscal impact of severe stress in the banking sector, the cost-at-risk analysis, and risk analyses of government guarantees and public sector companies.

We also note that substantial research has been done on the volatility of the budget balance, including its sensitivity to the cycle and appropriate safety margins with regard to national or supra-national limits. Much less work in this regard has to our knowledge been done on the debt level. This seems a promising avenue for further research, especially since debt levels have shot up significantly since the crisis, while many countries have set debt ceilings or targets (OECD, 2011). Moreover, the crisis has made clear that debt levels can move up quickly as a percentage of GDP due to interventions in the financial sector and due to the denominator effects of negative growth. Stress testing of public finances can be a useful tool to gain insight into the sensitivity of public debt to new shocks.

4. Concluding remarks

During the crisis, economic growth plummeted in many countries, while asset prices collapsed, explicit liabilities were triggered, and implicit liabilities materialised. As a result, government debt increased markedly and countries took on new liabilities. This means that the fiscal space to deal with new shocks has diminished. The increased vulnerability enhances the importance of risk analysis and management. Stress tests provide a tool to gain insight into the remaining shock absorption capacity. While stress testing has received renewed attention in the financial sector over the past years, applying it to public finances is still in the developing stage.

In our exercise, we worked with different organisations to assess the impact of the risk drivers on public debt – the economy, asset prices, explicit liabilities, and implicit liabilities – taking into account the feedback loops between them. We identified different individual shocks and tried to bundle them in consistent simulations. In a way, our exercise can be seen as a rudimentary step towards a holistic approach to stress testing public finances. Further work may build on current efforts to better incorporate the financial markets in macroeconomic models, and could seek to further integrate macro stress tests and debt management models.

Results for the Netherlands confirm that the debt level may soar in the case of further negative shocks. While the results should be interpreted with caution, our experience is that conducting a stress test on public finances can be instrumental in focusing the mind on risks. Determining the potential impact of implicit and explicit liabilities generates essential information for decisions on the acceptance, pricing and management of risks, and on the size of buffers needed for shockproof public finances. This can help to raise public awareness about the need to maintain or restore a sound fiscal position.

Notes

1. The three principal components of the stock flow adjustment are: *i)* differences between the cash and accrual recording bases of transactions (since debt is measured on a cash basis while the deficit is measured on an accrual basis); *ii)* valuation effects and other statistical adjustments (since the debt is a stock while the deficit is a flow); and *iii)* differences between the net and gross recording of financial transactions. See also Buti et al. (2007) or Hagen and Wolff (2006) for further elaboration. Furthermore, note that – in principle – creative accounting could also be added as a risk driver to Table 1, since it could lead to sudden revisions to the debt and the budget balance later on.

2. See European Commission (2004, pp. 94-105) for an excellent overview of the different types of government liabilities.
3. This is in line with OECD and IMF principles on fiscal transparency which state that the public should be provided with comprehensive information regarding major fiscal risks (OECD, 2002; IMF, 2007).
4. In the Netherlands, before each election, a committee of high-level representatives from ministries, the central bank and the Netherlands Bureau for Economic Policy Analysis provides non-political advice to incoming governments on the budgetary targets and policies during their term.

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Annex 1: Stress test simulations

Simulation 1: Financial crisis

By way of illustration, this variant assumes that the problems seen in the banking sector in 2008 and 2009 have returned:

- Global trade drops by 15%, followed by a slight recovery.
- Import prices fall by 5%, including energy (in euros) by 20%.
- Share prices drop by 40%, housing prices by 10%, the number of housing transactions by 25%.
- Nominal, long-term interest rates fall, but risk premiums (with respect to that interest rate) increase by 1 percentage point.
- Negative stimulus from consumer confidence.

Table A.1. **Consequences of Simulation 1: Financial crisis (changes compared to the baseline)**

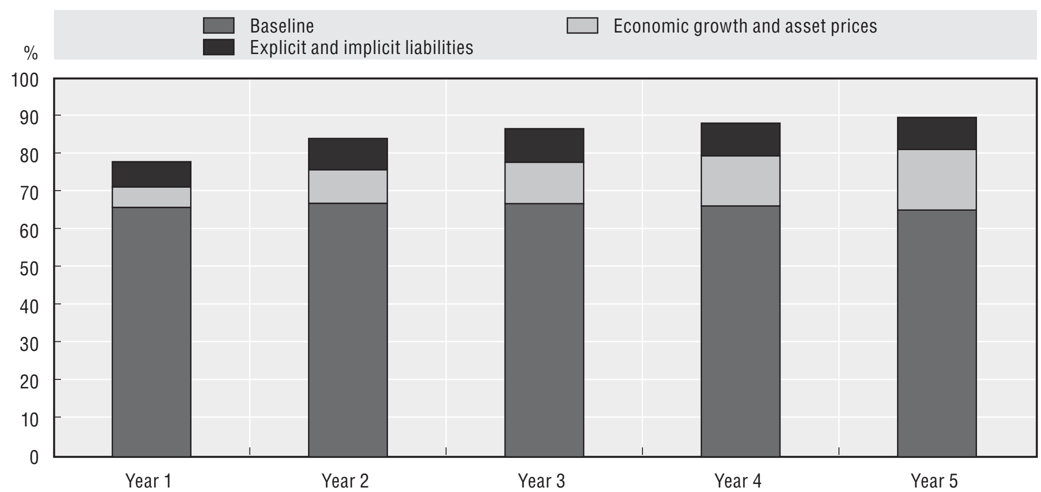
	Year 1	Year 2	Year 3	Year 4	Year 5
Relevant global volume of trade[1]	-14.7	-10.6	-10.6	-10.6	-10.6
Long-term interest rate[2]	-0.8	-1.2	-0.8	-0.4	-0.4
GDP[1]	-4.4	-4.4	-4.5	-5.0	-5.4
Private consumption[1]	-2.4	-3.5	-4.5	-5.8	-6.7
Export of goods, excluding energy[1]	-12.7	-10.0	-10.4	-10.6	-10.8
GDP deflator[1]	-1.1	-2.2	-1.7	-1.3	-1.4
Unemployment (% of workforce)[2]	1.5	2.8	2.6	2.4	2.5
EMU balance (% of GDP)[2]	-1.8	-3.0	-3.2	-3.1	-3.4
EMU debt (% of GDP)[2]	12.1	17.2	19.9	22.0	24.5

1. Cumulative deviation compared to the baseline level as a percentage.
2. Absolute cumulative deviation compared to the baseline level (deviation expressed in percentage points. A detailed explanation of how to read the table can be found in CPB (2011).

1. The crisis will further reduce confidence in the economy and on financial markets. The reduced level of confidence, the deteriorated financial position of households and lower pensions are causing growth in household consumption to contract. Similar effects can be seen in other countries, resulting in a drop in the relevant global volume of trade. In consequence, the demand for oil is decreasing, with lower oil prices as a result. In addition, the reduced level of confidence has a direct impact on the stock market. The higher risk premiums in the financial markets mean that businesses have to pay higher interest rates.[1] The partial effect of the real channel results in a worsening of the debt ratio by some 16% of GDP in year 5.

2. Financial stability comes under pressure and the government intervenes to help systemically important institutions. Based on the experience gained during the credit crisis, an intervention in the amount of approximately EUR 30 billion is assumed. The partial debt-increasing effect through the interventions channel amounts to more than 4% of GDP in year 5.
3. The problems in the financial sector in various countries will rebound on public finances and exert pressure on growth. This simulation assumes that the capacity of the EFSF will be fully used up, that the maturity will be extended and that the interest on the EFSF loans will be reduced to the cost of funding the EFSF. This further increases the debt for the Netherlands by a nominal EUR 25 billion from year 3 onwards (more than 4% of GDP).[2] The partial debt-increasing effect through the guarantees amounts to almost 4% of GDP in year 5.

Figure A.1. **Consequences of Simulation 1 for EMU debt (% of GDP)**



Source: Authors' calculations.

Simulation 2: European debt crisis

This variant assumes that the problems in several euro-area countries will continue. Private parties will find that they have to take write-downs on government bonds, while governments will have to extend the term of loans and adjust interest rates.

- The volume of global trade falls sharply.
- The value of the euro falls by 20%, but import prices increase negligibly due to the reduced volume of global trade.
- Share prices fall by 40%, housing prices by 20%, the number of housing transactions by 40%.
- Nominal long-term interest rates hardly change, although the risk spread is 1 percentage point higher.
- Negative stimulus from consumer confidence.

Table A.2. **Consequences of Simulation 2: European debt crisis (changes compared to the baseline)**

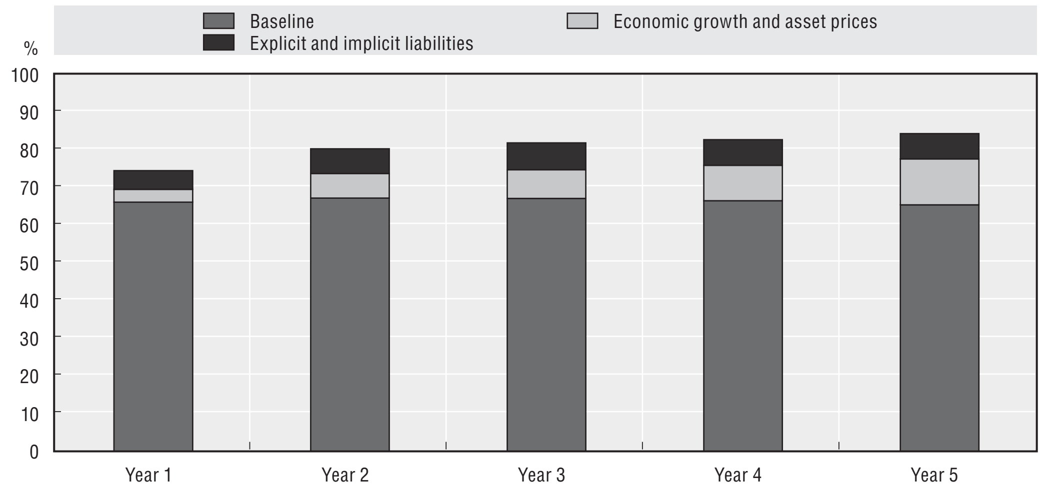
	Year 1	Year 2	Year 3	Year 4	Year 5
Relevant global volume of trade[1]	-7.4	-8.7	-5.8	-5.7	-6.4
Long-term interest rate[2]	-0.1	-0.1	0.0	0.0	0.0
GDP[1]	-2.9	-4.2	-4.2	-4.7	-5.4
Private consumption[1]	-3.6	-5.0	-6.3	-8.1	-9.1
Export of goods, excluding energy[1]	-5.8	-7.7	-5.7	-5.9	-6.8
GDP deflator[1]	-0.3	-0.2	1.3	2.8	3.2
Unemployment (% of workforce)[2]	0.9	2.3	2.3	2.1	2.2
EMU balance (% of GDP)[2]	-1.3	-2.3	-2.4	-2.4	-2.6
EMU debt (% of GDP)[2]	8.4	13.1	14.7	16.2	18.9

1. Cumulative deviation compared to the baseline level as a percentage.
2. Absolute cumulative deviation compared to the baseline level (deviation expressed in percentage points). A detailed explanation of how to read the table can be found in CPB (2011).

1. The ongoing European debt crisis will dent confidence. Reduced confidence can then cause a contraction in the growth of household consumption and an increase in risk-averse behaviour in the financial markets. This is once again an international scenario, so the same effect will also occur in other countries. The model therefore includes a drop in the relevant volume of global trade. Unemployment also increases once again. The partial debt-increasing effect of the real channel amounts to some 12% of GDP in year 5.
2. The debt problems can spread to the financial sector. Many financial institutions own government paper and are exposed to private parties in those countries. Furthermore, the credit rating of banks is partly determined by the rating of the country in which their head office is located. The model assumes that the Dutch government will invest EUR 20 billion in the Dutch financial sector. It also assumes that the guarantee scheme will be re-opened and will guarantee EUR 10 billion in year 1. This amount will be gradually reduced year-on-year. In this simulation, the European Central Bank suffers losses on debt instruments that are passed on to the Dutch central bank (DNB). As a result, De Nederlandsche Bank's profit transfer to the state evaporates completely. The partial debt-increasing effect through the interventions amounts to 3% of GDP.
3. The drop in housing prices combined with increasing unemployment results in losses under the National Mortgage Guarantee Scheme (NHG). These losses can initially be absorbed in the capital base. In year 5, however, although the capital base is still positive, it drops below the threshold triggering an interest-free government loan of EUR 100 million.

This simulation has consequences for the guarantees issued under the EFSF. It is assumed that all of the effective capacity of the EFSF will be used up, that the maturity of the facility will be extended and that the interest on the loans from the EFSF will be reduced to the cost of funding the EFSF. One of the effects is to increase the debt by EUR 25 billion starting in year 3. The partial debt-increasing effect through the guarantee channels amounts to almost 4% of GDP in year 5.

Figure A.2. **Consequences of Simulation 2 for EMU debt (% of GDP)**



Source: Authors' calculations.

Simulation 3: Global economic crisis

The deficits in both the balance of payments and the budget in the United States have been significant for many years. This variant assumes that uncertainty about United States debts causes the value of the dollar to fall, resulting in world-wide uncertainty.

- The volume of global trade contracts by 15%.
- The value of the dollar falls by 30% compared to the euro. Import prices in euros fall – partly due to the volume economy – by 10-15%, including a drop in the cost of importing energy by more than 35%.
- Share prices drop 50%.
- Nominal long-term interest is down by some 2 percentage points, risk spread (with respect to that interest rate) is up by 1 percentage point.
- Negative stimulus from consumer confidence and loss of assets because of the fall in the price of the dollar (in this regard, the simulation clearly deviates from an exchange rate scenario).

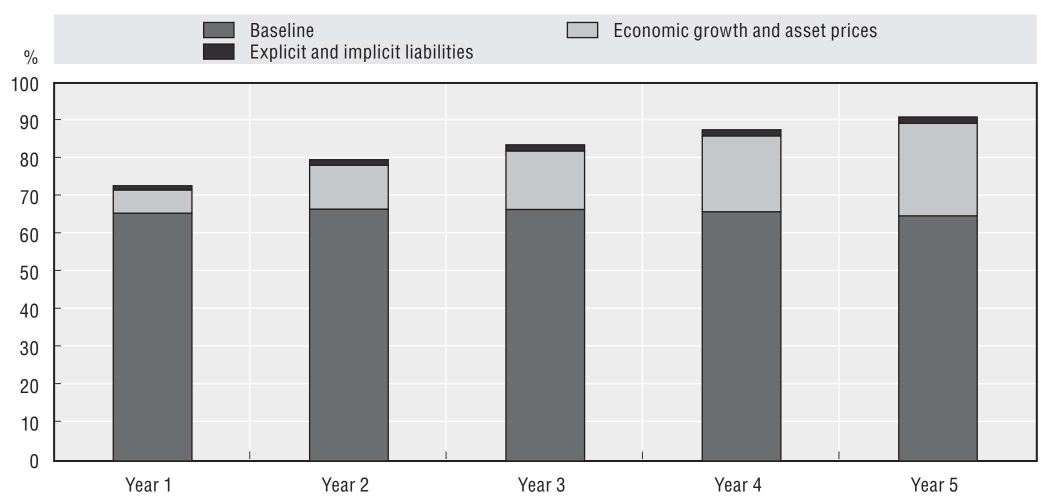
Table A.3. **Consequences of Simulation 3: Global economic crisis (changes compared to the baseline)**

	Year 1	Year 2	Year 3	Year 4	Year 5
Relevant global volume of trade[1]	-15.0	-15.0	-15.0	-15.0	-15.0
Long-term interest rate[2]	-1.3	-1.4	-1.8	-2.1	-2.4
GDP[1]	-4.6	-6.1	-7.1	-7.8	-7.8
Private consumption[1]	-1.6	-1.6	-2.3	-3.8	-5.1
Export of goods, excluding energy[1]	-13.2	-13.8	-14.7	-15.2	-15.0
GDP deflator[1]	-1.9	-4.1	-4.3	-5.8	-8.7
Unemployment (% of workforce)[2]	1.6	3.8	4.8	5.2	5.0
EMU balance (% of GDP)[2]	-1.7	-3.3	-4.3	-4.7	-4.4
EMU debt (%of GDP)[2]	7.3	13.4	18.2	23.6	29.3

1. Cumulative deviation compared to the baseline level as a percentage.
2. Absolute cumulative deviation compared to the baseline level (deviation expressed in percentage points). A detailed explanation of how to read the table can be found in CPB (2011).

1. A fall in the value of the dollar directly impacts the purchasing power of United States households, which in turn negatively impacts the relevant global volume of trade. This international shock also causes the price of oil to drop (in dollars), resulting in reduced revenue for the Dutch budget because of lower gas prices. Pension funds have to repair their coverage ratio because of the lower share prices and lower interest rates, which in turn results in lower pensions and consequently reduced consumption. The partial debt-raising effect through the real economic channel is more than 27% of GDP in year 5.
2. As expected, the banking sector has sufficient buffers in place to absorb these simulated circumstances without government support. This channel is not expected to increase the debt.
3. Dutch exporting companies can be affected in the event of a sharp drop in the relevant global volume of trade and an increased degree of economic uncertainty. The Dutch government insures a very small portion of these export transactions through the export credit insurance facility (EKV). Based on assumptions regarding the increased chance of damage and correlations between different countries, this variant forecasts an increase in the expected losses under the EKV facility of EUR 50 million per year compared to normal circumstances. In addition, the problems in the United States may have consequences for Dutch public finances through the ING Alt-A portfolio. In this scenario, a loss is incurred because of a reduction in the cash flow from the portfolio, but in the initial years this loss does not yet affect the balance and the debt because the portfolio contains a buffer to absorb losses. Finally, it is assumed that part of the capacity of the EFSF is used up. The partial debt-increasing effect of the guarantees amounts to almost 2% of GDP in year 5.

Figure A.3. **Consequences of Simulation 3 for EMU debt (% of GDP)**



Source: Authors' calculations.

Notes

1. The interest rates stated in Table 1 are risk-free. Professionals pay more – including a risk premium – in addition to these amounts.
2. Loans from the EFSF increase the debt ratios of EU member states.

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Introducing accountable budgeting: Lessons from a decade of performance-based budgeting in the Netherlands

by
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This article assesses the experience of the Netherlands with performance budgeting since full programme and performance budgeting was introduced in 1999-2002. The lessons learned so far resulted in 2012 in a reform called "Accountable Budgeting" involving a major overhaul of the performance budgeting structure in order to enable more detailed parliamentary oversight as well as to enhance internal control by the Ministry of Finance and line ministries. The article examines international experience with PBB reform and its use in the context of the Netherlands national government, focusing on the lessons learned concerning the use of performance information in the budgetary process. The "Accountable Budgeting" reform is explained, and the concluding section assesses which PBB assumptions were challenged, abandoned or retained in these reforms and discusses possible future developments in budget presentation.

JEL classification: H610

Keywords: Accountable budgeting, Verantwoord Begroten, performance-based budgeting, PBB, parliamentary oversight, budget reform, performance information, budgetary process, budget reform, budget presentation, Netherlands

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Summary

The implementation of performance-based and programme budgeting reforms in the Netherlands more than a decade ago has, not unlike the experience in other countries, only partly lived up to its expectations. On the one hand, there has not been much evidence that supports major reallocation of spending as a result of these reforms. In addition, the information value of the budgets and the administrative burden for line ministries have been continuous sources of debate. On the other hand, the concept of linking funding to results has proven its usefulness in agency management and helps the Ministry of Finance in its role to differentiate between a powerful claim and a powerful claimant. There is also no tendency to give up the benefits of increased transparency and enhanced managerial flexibility that resulted from introducing a programme budget. Following a decade of mixed results, some lessons were learned and gave way to a major overhaul of the budget presentation and programme structure called "Accountable Budgeting" (*Verantwoord Begroten*). The first of these lessons was that a political process like budget allocation by parliament will not be rationalised by changing the budget structure. Second, it had to be acknowledged that a programme budget can never live up to the expectation of being a super comprehensive policy document that contains all the information considered useful by every stakeholder. Third, there is a need for more detailed financial information in the budget documentation, although none of the stakeholders involved would support a return to a classical line-item budget.

This "Accountable Budgeting" reform was introduced in the 2013 budget documents and targeted some of the more persistent problems encountered with regard to performance-based programme budgeting in the Netherlands. These problems included the limited usefulness of budgets and annual reports for financial analysis and unclear results accountability, especially with regard to policy outcomes. The changes introduced were intended to enable more detailed parliamentary oversight of spending as well as to enhance internal control by the Ministry of Finance and line ministries. To achieve this, more detailed financial information was presented following a uniform classification of financial policy instruments and categories of organisational expenses. In addition, the use of policy information (performance indicators and policy texts explaining policy objectives) was curtailed and had to meet stricter conditions concerning the precise role and responsibility of government. As a result, about 50% of all performance indicators disappeared from the budget documents. The reason for this shift was that performance information in the old budgets had become more aimed at legitimising funding and compliance than in providing useful insights for oversight or to learn and improve. The use of performance information for the latter purposes does not necessarily happen in a cyclical, annual way and is more likely to occur following multi-year *ex post* evaluation. For this reason, the lessons from evaluation gained a more prominent place in budget documents.

Another consideration was the fact that an increasing amount of information on policy effectiveness is becoming available from a diversity of sources within and outside government. The concept of a budget document as a portal that electronically discloses the various sources of financial and policy information may better serve the information needs of today's citizen and parliamentarian than reliance on a limited set of indicators that is susceptible to selective presentation and framing. "Accountable Budgeting" can be seen as a first building block towards a more modern budget presentation that meets the demands of the information age. In any case, with this reform, the Netherlands has taken an important step to meeting more realistic expectations concerning programme budgeting.

Introduction

Winston Churchill allegedly said that success is the ability to go from failure to failure without losing enthusiasm. Measured by this standard, performance budgeting reform should be credited with quite a successful history. The promise of more efficient allocation of public spending and cutting wasteful ineffective spending led governments worldwide to structurally integrate their budgets with performance planning and reporting. However, not unlike the experience in other OECD countries, there has not been much evidence in the Netherlands that supports major reallocation of spending as a result of performance-based budgeting reforms (PBB). It can be easily argued that a political process like budget allocation by parliament will not be rationalised by changing the budget structure. For a finance ministry, however, performance data can be vital for differentiating between a powerful claim and a powerful claimant. In this article, we will assess the experience of the Netherlands with performance budgeting since full programme and performance budgeting was introduced in 1999-2002. The lessons learned so far resulted in 2012 in a reform called "Accountable Budgeting" (*Verantwoord Begroten*). This reform comprehends a major overhaul of the performance budgeting structure in order to enable more detailed parliamentary oversight as well as to enhance internal control by the Ministry of Finance and line ministries. Before going into these reforms in more detail, the international experience with PBB reform and its use in the context of the Netherlands national government will be addressed in Sections 1 and 2. In Section 3, we will focus on what lessons were learned concerning the use of performance information in the budgetary process. In Section 4, the "Accountable Budgeting" reform itself will be explained. We will end in Section 5 with an epilogue in which we assess which PBB assumptions were challenged, abandoned or retained in these reforms, followed by an outlook on possible future developments in budget presentation.

1. Performance-based budgeting and its rationale

1.1. Defining PBB and "New Public Management" reforms

Although the roots of performance-based budgeting (PBB) can be traced back as far as the early 20th century, PBB gained international popularity in the 1970s and 1980s. Inspired by the United States "Planning, Programming and Budgeting System" (PPBS) in this period, the Netherlands started introducing some policy information in its budgets and pioneered with systematic policy analysis. Although this helped familiarisation with result-oriented budgeting systems, these efforts did not lead to institutionalisation of PBB in the Dutch budgeting process. PBB gained worldwide popularity in the 1990s and early 2000s as part of the "New Public Management" agenda. NPM introduced a set of recipes that were meant to transform the public sector towards more result orientation and efficiency. New Public

Management generally refers to a set of reforms that intend to improve efficiency and effectiveness of the public sector by introducing different sorts of market-style incentives. These include (Kraan, 2011a):

- separation of policy execution from policy development;
- stimulating competition among service providers, by allowing private suppliers to provide collectively funded services and through demand financing (consumer subsidies and vouchers);
- loosening of standards of operational management both in policy development and policy execution ("let managers manage");
- steering and control of executive agencies on the basis of output targets;
- budgeting on the basis of output targets (performance budgeting);
- outsourcing of intermediate production for both core ministries and executive agencies to the market.

It is not yet clear what the post NPM era will look like exactly, but it seems that the heyday of New Public Management is well behind us. In the meantime, many traces of these reforms still dominate today's public sector landscape. In the Netherlands, PBB was one of the important reforms inspired by NPM.

There are several ways of categorising performance budgeting systems. A common way is to do so according to the degree to which performance information is linked to funding. Allen Schick distinguishes between two polar versions of performance budgeting, a broad and a strict definition:

> Broadly defined, a performance budget is any budget that presents information on what agencies have done or expect to do with the money provided to them. Strictly defined, a performance budget is only a budget that explicitly links each increment in resources to an increment in outputs or other results. The broad concept views budgeting in presentational terms, the strict version views it in terms of allocations. Many governments satisfy the broad definition, few satisfy the strict definition. (Schick, 2003:101)

Teresa Curristine used a three-fold typology to describe performance budgets in OECD countries (OECD, 2007). In some cases, a direct link between performance, resource allocation and accountability is in place (direct/formula performance budgeting). More often, the link is indirect, and planned performance targets and results are used for planning and accountability purposes only (performance-informed budgeting, or PIB). Finally, there are performance budgeting systems that have no link between performance and funding and that use performance information for accountability only (presentational performance budgeting). Although it can be argued that, in the Netherlands, all three of these forms are present in the budget document, the emphasis seems to lie mainly on the PIB form.

Notwithstanding the multitude of conflicting and overlapping definitions of PBB, using a PBB system is commonly associated with the following activities:

- setting measurable objectives and performance indicators for government programmes;
- presenting expected results alongside spending levels in budget documents;
- measuring and reporting results during or after programme execution;
- evaluating results and using this information for strategic planning and budgeting.

The introduction of a PBB system is often accompanied by initiatives to change the budget structure from a line-item budget into a programme budget. A traditional line-item budget is structured along the lines of organisational units and spending categories. As a result, parliament approves a long list of proposed spending separately as input items (e.g. labour costs, retirement expenses, grants to an agent, etc.). The programme budget is shaped by government programmes that each have (a set of) associated policy goals and activities and that may span several organisational units. The Netherlands did switch to a programme and performance budget in 2002. The appealing logic in simultaneously introducing a programme and a performance-based budget lies in the notion that for a principal (e.g. parliament, the finance ministry, a line ministry), the loss of control as a result of reduced input controls will be compensated by increased accountability over actions and results. Clearly inspired by NPM, the Dutch PBB reforms saw a radical reduction of the number of line items in the budget (see Section 2.1). Arguably, many OECD countries chose to implement programme budgeting in an ideologically less extreme form than the Netherlands did. For example, the United States Congress repeatedly chose not to give up line-item controls. As a result, budgeting, performance planning and cost accounting largely remain separate silos, although often presented jointly in a variety of cyclical documents. Still other countries (e.g. Poland) see the co-existence of the classical line-item structure and a programme structure as a temporary step toward programme budgeting.

1.2. Objectives of PBB reform

A multitude of promises and expectations were communicated by performance-based budgeting reformers at the start of reforms. These can be generally classified into two broad aims:

- The increase of transparency of government spending and associated results in order to give voters and the legislative branch better opportunities for accountability and oversight. This involves integrating performance data into budget documents and requires measuring and reporting of performance information.
- The increase of effective allocation and management of resources. This not only requires measuring and reporting of performance information but also actually using this information to inform decisions made in the budgetary process.

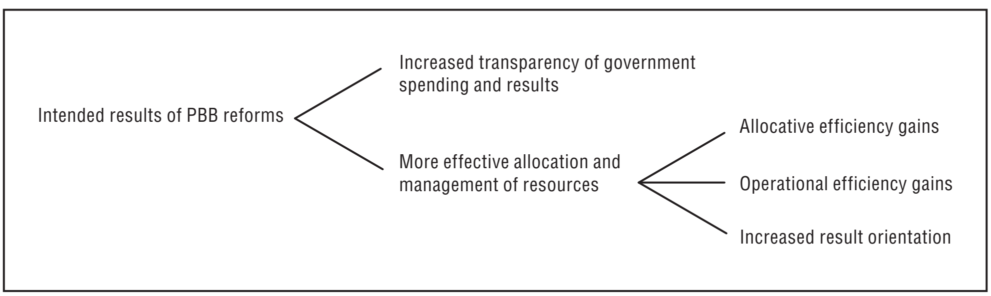
The aims of transparency and (re)allocation are both expected to contribute, in their own way, to solving the puzzle of allocating public funds. A transparent budget proposal is seen as a necessary precondition for making better-informed choices. The use of performance data in the debate about different allocation options is expected to result in decisions to fund programmes and policy instruments that have shown adequate results while improving or saving on less-effective ones. The savings generated by PBB implementation may be of two types:

- Allocative: Savings generated by reducing the funding level of particular programmes while retaining or increasing spending on performing programmes are referred to as improvements in allocative efficiency. This happens during budget preparation and approval of the budget by parliament.
- Operational: Savings generated by changes in funding levels within a programme are referred to as improvements in operational efficiency. Operational efficiency improvement as a result of PBB happens at the agency level in the budget preparation

and execution phases and is therefore less visible than changes within authorised programmes.

Although not explicitly envisioned by many PBB reformers, another recurring claim to its success is an increase in result orientation within government organisations. Such a result orientation involves providing a greater emphasis on tangible results by government (including setting objectives, monitoring performance, and planning), and improved transparency of planning and reporting documents for users (GAO, 2004; IOFEZ, 2004; OECD, 2007). This type of success is hard to identify and substantiate for non-organisation members or distant stakeholders. Although often more of a "by-catch" than a stated intention of PBB reforms, the increased result orientation of public sector organisations and their members can be counted as a separate type of result. The potential contributions resulting from PBB reforms are shown in Figure 1 (note that they are interrelated to some degree).

Figure 1. **Potential contributions of PBB reforms**



The reasons given for turning to a PBB style of budget in the Netherlands mainly referred to the first of the two broad aims (transparency), whereas the efficiency arguments were communicated less clearly and seemed to be added later. This can largely be explained by the fact that the reform was initiated by parliament using transparency and accountability arguments, while the efficiency arguments were mainly part of the finance ministry's internal agenda and were not expressed that clearly in the official documents. Nonetheless, the new budget structure was also meant to support a more efficient and effective government by making a more distinct relationship between policy, performance and resources, and to increase the coherence both between budget and accounting documents and within budget and accounting documents (Minister van Financiën, 1999).

2. A decade of mixed results in the Netherlands

2.1. The Dutch approach to PBB

The Netherlands turned to performance-based programme budgeting at the turn of the 21st century. Under the acronym VBTB, translated as "Policy Budgets and Policy Accountability", the traditional structure of the budget was extensively revised into a performance-based budget. This reform included moving from a traditional line-item budget to a programme budget where funds were authorised according to general policy objectives. As a result of the performance budgeting operation, the number of line items to be authorised in the budget went down from about 800 to 160. In the new budget document, the content of each policy article was designed to answer three basic questions that were mirrored in the annual report (see Table 1).

Table 1. **Central VBTB questions to be answered for each programme**

Budget	Annual report
What do we want to achieve?	Did we achieve what we intended?
What will we do to achieve it?	Did we do what we meant to do?
What will be the costs of our actions?	Did it cost what we expected?

In 1999, the Minister of Finance sent a plan to parliament launching VBTB. This initiative was preceded by a number of initiatives by parliament to investigate the possibilities for performance-based policy accountability. As part of the preparation, a "dummy budget" was produced, and selected ministries presented their 2001 budget in both the new and the old format. The Ministry of Finance oversaw the implementation process, investing heavily in training civil servants, issuing new regulations, and monitoring progress. All ministries had complied with the new budget structure in September 2001 when they presented their 2002 budgets.

2.1.1. Budgetary process

Designing and implementing the budget in the Netherlands, like in most countries, involves different actors in different phases of the budget process. Choices in the programme structure, policy objectives and indicators are made by the line ministries in their part of the budget preparation phase but are subject to approval by the Ministry of Finance during its part of the budget preparation phase. Final approval takes place when the draft budgets are approved by the Council of Ministers and finally parliament. In terms of allocation, a coalition government works with a detailed government agreement in which multi-year expenditure ceilings for every year of the Cabinet period are laid down, as well as the fiscal rules. The annual budget law is subdivided into chapters, and each chapter is subdivided into policy articles which constitute the line-item level of authorisation. The yearly allocation takes place to a large extent in the second quarter, by means of budget letters from the Minister of Finance to all ministers.

Under the Dutch system of ministerial responsibility, each minister is responsible for his or her own budget authorisation, execution and evaluation. This includes defending a budget proposal to parliament and informing parliament about the degree of success of the ministry's own policy design and programme execution. So, due to the decentralised nature of budget preparation and performance planning, the Ministry of Finance in practice does not interfere actively in the performance planning of line ministries unless it feels there is a financial need to do so. With regard to the performance budgeting structure, the ministry's formal role is usually limited to organising the budgetary and accountability process and overseeing compliance with budgetary guidelines. Although the role of the Minister of Finance may appear modest in a formal sense, the organisation of the budget process ensures that the Minister of Finance plays a powerful role with regard to all public spending, including allocation proposals. The Government Accounts Act grants the minister significant authority and influence, as the draft budgets in all their aspects have to be approved by the minister at the end of the budget preparation process. The performance information used in budget documents and policy evaluation has proven to be useful at times as leverage in the budgetary dialogue with line ministries, especially to amplify other budgetary arguments. On average, however, the majority of the performance information in the budget documents was not considered very useful with regard to assessing policy effectiveness. For this purpose, multi-year policy evaluation proved to be a better tool.

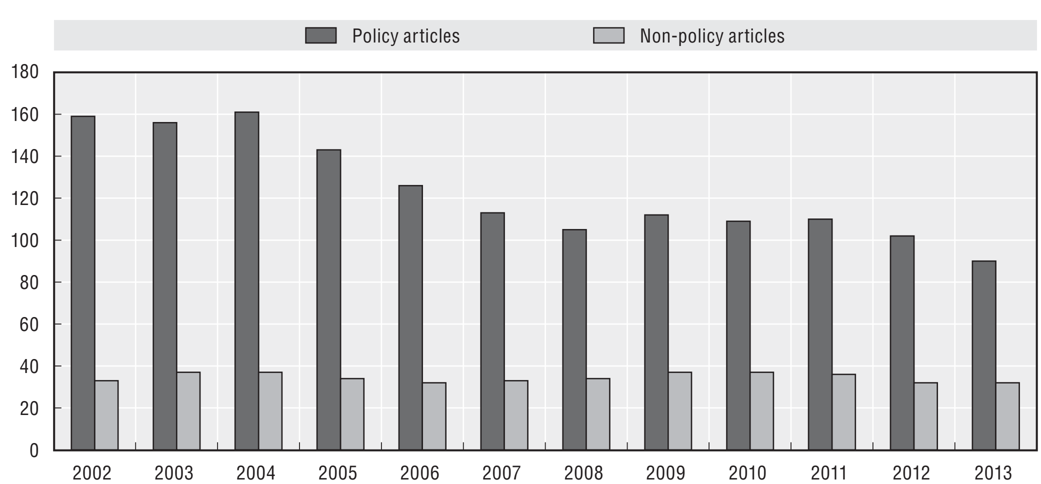
The VBTB reform also saw the introduction of a new milestone in the Netherlands budget calendar: the yearly "Accountability Day" in May. On this day, the Minister of Finance presents the central government annual financial report and the ministries' annual reports to parliament. This event mirrors the presentation of the central government budget and the *Budget Memorandum* on the third Tuesday in September (Budget Day), and intends to stimulate a dialogue between the government and parliament about the effectiveness and efficiency of public spending.

2.1.2. Budget structure and content

The budget's policy programmes are referred to as budget articles in the Dutch budget system and are the dominant unit for budget planning and reporting. The budget articles integrate planned expenditure, performance planning and cost accounting. They are the unit for budget authorisation by parliament, as well the unit of analysis for financial compliance audits by the Netherlands central Court of Audit and for policy evaluation by line departments, notably policy reviews (see Schoch and Broeder, 2013).

The budget in the Netherlands has contained around 100 to 160 budget articles depending on the specific year, each subdivided into three to four sub-articles on average (Figure 2). Each budget article had one general objective. Under the VBTB system (up until 2012), each general objective was supported by several operational goals at the sub-programme level called "sub-articles". Usually, though not always, the article's general objective supported outcome indicators, while the underlying operational goals were monitored by output indicators. Objectives, instruments and measurable data on performance were required to be presented for each operational objective; this applied to all budget articles except some that were labeled non-policy articles. The latter were in place for more technical reasons, such as dividing residual overhead costs or to cover unforeseen costs.

Figure 2. **Development of number of programmes (articles) in the budget of the Netherlands**



It is important to note that parliament in 2000 agreed to significantly reduce its line-item input control of the budget in exchange for more information on outputs and outcomes. The loss of control on a line-item level was reinforced by the fact that less-detailed financial information was provided within programmes. Under VBTB, the budget article did not specify expenditures at the level of detail of an appropriation account. Most of the time, it only distinguished between direct costs and overhead costs spent for each sub-article. In terms of budget authorisation, this meant that parliament no longer controlled the allocation of funds between types of expenditures (personnel, goods and services, capital) or organisations. To illustrate what the content of a VBTB budget article looks like, a sub-article of the Ministry of Transport is presented in Figures 3 and 4.

Figure 3. **Example of VBTB structure, Ministry of Transport (2011)**

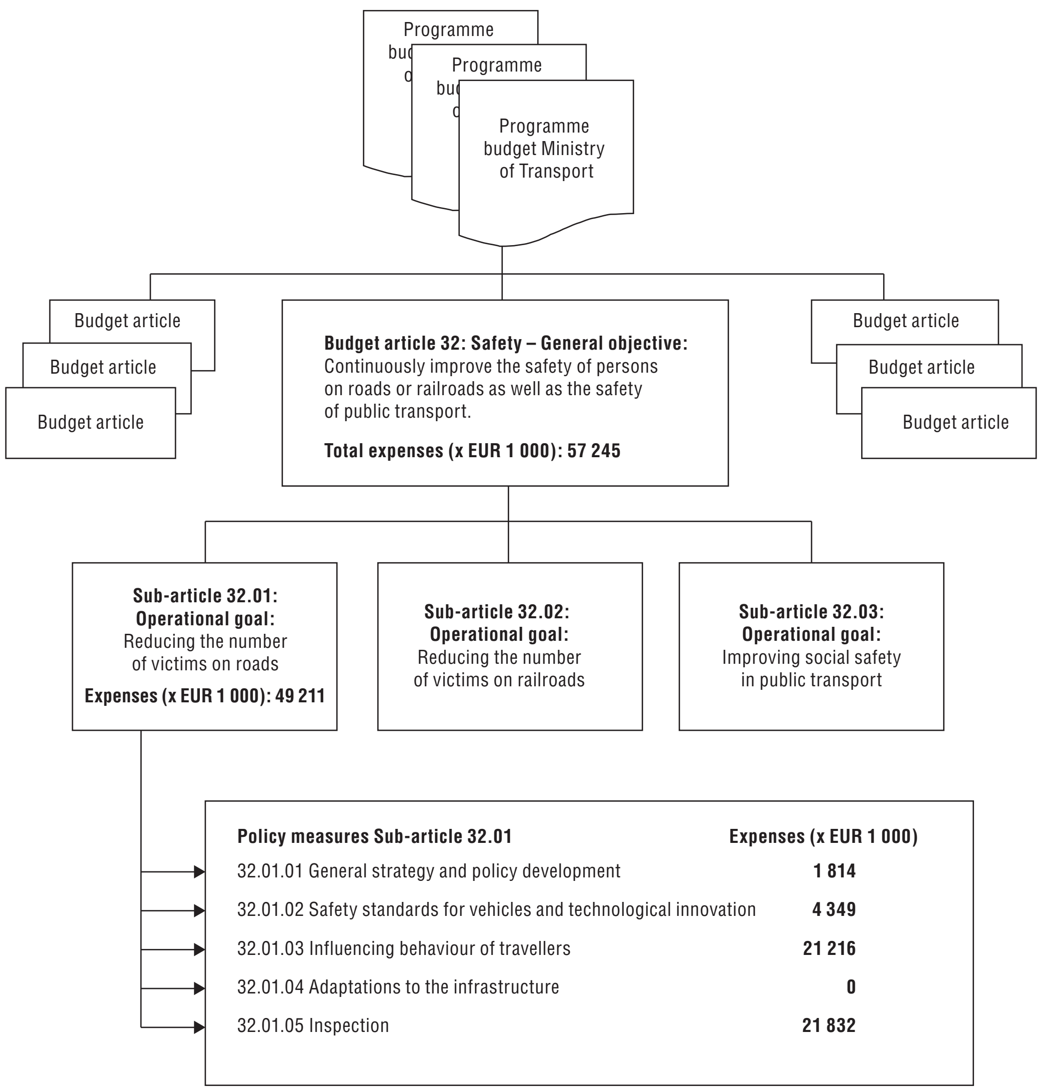
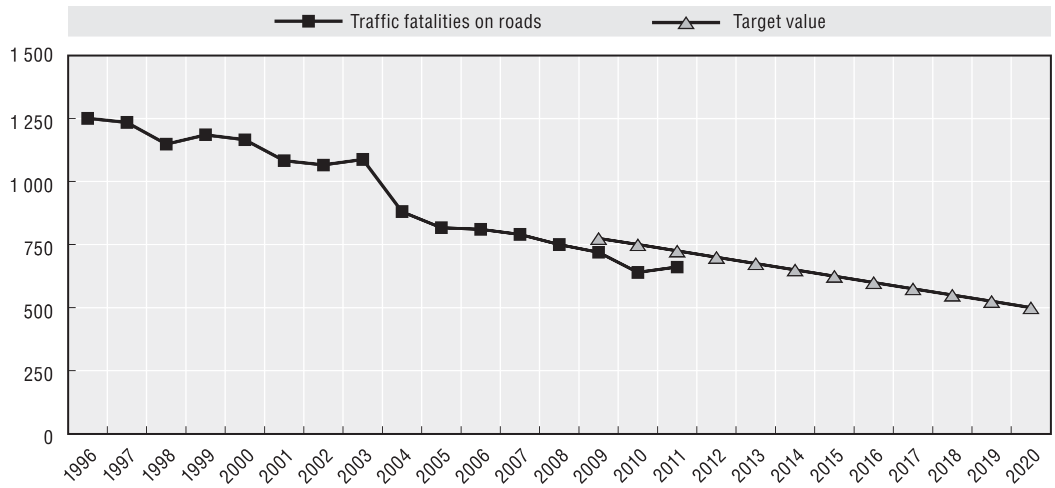


Figure 4. **Example of performance indicator, Ministry of Transport (2011)**

Performance indicator for Sub-article 32.01 (reducing the number of victims on roads)



Source: 2011 Budget, Ministry of Transport, Netherlands.

Looking back to the launch of VBTB, one can conclude that the initial aim was to enhance budget transparency and accessibility. Soon the scope was broadened to include all the intended results commonly attributed to the PBB reform (see Figure 1). The three simple questions had an appealing logic and were internalised in the dialogue about finance and policy on all levels of central government. That does not mean, however, that the apparent simplicity of the VBTB format was easy to comply with nor that the reform brought all of its intended benefits.

2.2. Results, challenges and reforms (2002-12)

When the Netherlands performance budgeting system VBTB was evaluated three years after its introduction, the main conclusion was that using the budget as an instrument to achieve both greater transparency and greater efficiency was considered to be no longer feasible. The reason was that the performance information included in the budget in order to assess efficiency was often too elaborate, detailed and technically specific, and stood in the way of the aim of improving accessibility and transparency of budget documents (IOFEZ, 2004). The most important improvements in the field of transparency were the new structure and the inclusion of objectives in budgets and annual reports. However, the information about the contribution of government programmes to policy objectives was often "fuzzy". Objectives were formulated in such abstract terms that it is impossible to determine (in retrospect) whether they have been achieved. There was a natural tendency of officials and administrators to hedge their bets and give veiled answers (Debets, 2007). In addition, it was noted that making effects measurable may imply quantifying policy that can better be assessed in qualitative terms. This leads to the risk that performance measurement is counterproductive and in reality exists only on paper. There is also the risk that policy is poured into a mould without giving any thought to its actual content. As a result, the efficiency of policy suffers because pouring policy into a mould does entail costs, mostly administrative. At the same time, it was concluded that the introduction of PBB did have a positive effect on result orientation within government and therefore potentially on operational allocation (IOFEZ, 2004). To illustrate the findings of this evaluation in this respect, a number of relevant conclusions from the evaluation report are given in Box 1.

Box 1. **Selected conclusions from the VBTB evaluation (2004) regarding result orientation and operational efficiency**

In the field of efficiency, respondents indicated that VBTB had stimulated people to give more thought to the intended results of policy. This is an incentive to greater efficiency.

The role of policy objectives in internal management has increased. The budgetary cycle is more closely attuned to the cycle of planning and control, and the policy objectives have become broader than merely funding and operations.

The interviews held in the context of the evaluation show that VBTB has helped ministries and implementing organisations adopt a more result-oriented manner of working.

The process of drawing up annual plans and discussing them with the ministry to obtain approval has led to debates on the objectives presented and on their effective implementation.

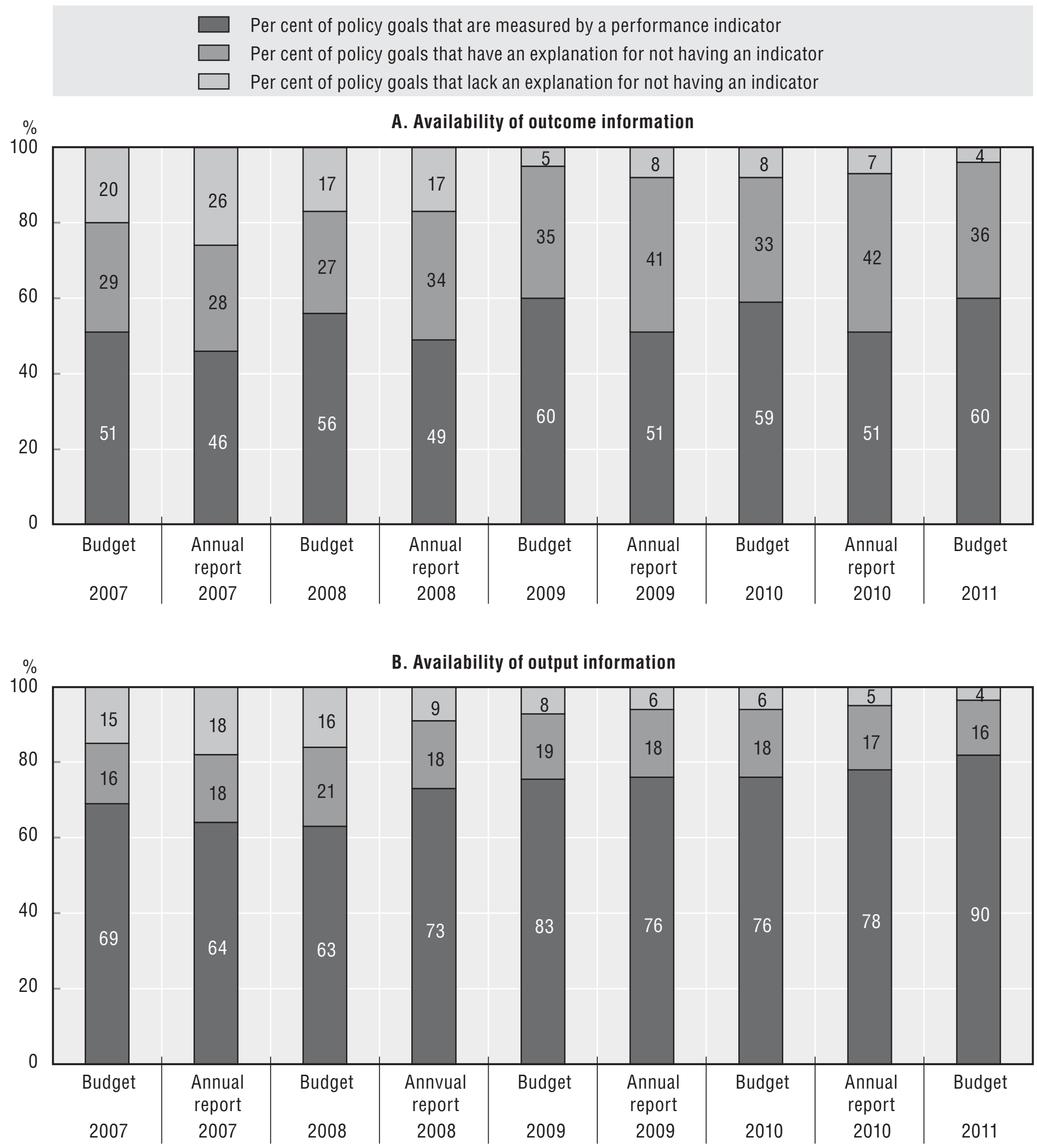
Source: Minister van Financiën (2004), *Evaluatie VBTB*, Tweede Kamer der Staten generaal (TK Vergaderjaar 2004-2005, 29 949, No. 1), Ministry of Finance, The Hague.

The 2004 evaluation of VBTB concluded that the objectives of improving transparency as well as allocative efficiency could not both be reached by using the single instrument of the budget structure. Instead, VBTB would be aimed foremost at budget transparency in order to strengthen parliamentary authorisation and oversight. The improvement of effectiveness and efficiency would have to come from improving policy plans and policy evaluation (Minister van Financiën, 2004).

To ease concerns about reliability and auditability of performance data, an obligation was introduced to state the source of performance data in the budget documents. In addition, a more flexible set of PBB guidelines for budget documents was issued in 2006. An important adaptation included the provision that performance indicators should only be added "when useful and relevant". In addition, output and outcome reporting were to be continued on a "comply or explain" basis. The percentage of programmes making use of the "explain" clause for not having an indicator is given in Figure 5 for the 2007-11 budget documents.

Throughout the years, there was also growing discontent with a lack of parliamentary attention for policy results in the budget and annual report as well as with the perceived administrative burden of performance measurement and reporting.[1] The Accountability Day did not live up to its expectations, as the number and seniority of MPs participating in the debate was usually low and the impact in terms of votes was small. This discontent by both parliament and the government was described well by the finance minister at the time, Wouter Bos, during his first Accountability Day in 2007 (see Box 2).

Figure 5. **Availability of performance indicators in the budget documents**



Source: Algemene Rekenkamer (2011), "Staat van de Rijksverantwoording 2010" (TK Vergaderjaar 2010-2011, 32 710, No. 2), Netherlands Court of Audit, 18 May, The Hague.

In response to this critique, a three-year experimental reform was started in 2007 to:

- increase the political relevance of annual reports and budget documents;
- lower the administrative burden for line departments in producing the budget documents.

The first goal was pursued by reporting elaborately on the coalition government's policy priorities, including lessons learned concerning policy execution or policy design. At the same time, lengthy and detailed policy texts and performance indicators on non-priority subjects were omitted altogether from a selection of annual reports (though these remained in the budget). A new instrument introduced in 2008 was the accountability letter in which the Prime Minister reported to parliament on progress on the Cabinet's main priorities. This letter is presented simultaneously to parliament with the

Box 2. **Address by the Minister of Finance Wouter Bos on Accountability Day, 22 May 2007**

"I was and still remain a strong supporter of the VBTB philosophy and I do feel it is necessary to give account afterwards over policy results, however:

- The documents are too comprehensive and clarity can be greatly improved.
- Many seem to subscribe to the notion that if policy goals and results are measurable, they must also be good. That, of course, is not the case. VBTB should not turn into a form of numerical fetishism.
- Managing those aspects that happen to be easily measurable should never become a goal in itself.
- Account should be given on policy goals whether they are achieved or not. What can be attributed to successful policy and what can be improved?"

annual reports of the ministries. To attain maximum focus in the accountability letter and the debate, parliament selects about five policy themes six months before Accountability Day. This new priority-driven approach was partly inspired by the United Kingdom experience with the Prime Minister's Delivery Unit during the second term of Prime Minister Tony Blair (see Box 3).

Box 3. **Short explanation of the Prime Minister's Delivery Unit of the United Kingdom**

Established in 2001, the Prime Minister's Delivery Unit oversaw the realisation of a number of the second and third Blair administration's top priorities concerning education, health, crime, transport, and internal affairs. In its approach, the PMDU employed a combination of:

- performance management;
- tailored support for specific problems;
- high-frequency reporting (or even real-time data);
- prompt action.

In so-called stock takes, held every 2-3 months, the Prime Minister held the responsible minister to account about the progress toward projected targets. In this way, significant progress was made towards realising the key objectives. For example, the percentage of hospital emergency departments that met the four-hour target (the time in which a patient must be seen, treated, admitted or discharged) rose from nearly 80% in 2001/02 to over 95% in 2004/05.

Source: Sir Michael Barber (former head of the PMDU) (2007), Presentation at the Netherlands Ministry of Finance on 29 October 2007, The Hague.

Initially attempted as a form of internal performance management in the United Kingdom, the Dutch version of the British delivery approach was also intended as a tool of external accountability. Budget documents featured extensive information on funding and results of these priorities, while the coverage of "going concern" tasks was diminished. In the Dutch case, the number of selected priority goals amounted to all 84 objectives in the government's coalition agreement, somewhat hampering the idea of selectivity. In addition, some of the priority goals were vague and politically formulated, and lacked a clear implementation strategy and chain of accountability.[2] Some of the practical lessons learned from the adoption of a Dutch version of the "delivery approach" were:

- During the first year of government, it is usually too early for reporting exciting policy results. Instead, aim for realistic mid-term (two years) and end results (four years).
- For some high-profile political goals, the central government's role may turn out to be a rather passive one because of a strong dependency on other stakeholders and external factors.
- It may not always be feasible to use the intentionally stable structure of the budget for political priorities that are unstable by nature.
- Since every line ministry wants to be included in the government's top priorities, some priority goals may just reflect "going concerns". Ambitious cross-cutting goals may help commit several ministries at once.
- When working with cross-cutting goals, agree on a clear accountability structure between line ministries to prevent stovepiping and unclear ownership.
- In order to limit the risk of overpromising policy results, be aware of the dependency on other parties and external effects that cannot be influenced.
- Involve line ministries early in the process when formulating SMART quantitative goals (specific, measurable, agreed, realistic, time-bound) in order to establish realistic and measurable goals. This process should not be left to political leaders alone.

The evaluation of this experiment in the Netherlands in 2010 revealed that the political debate on performance accountability did indeed shift more towards political priorities. Parliament's attention to policy results did increase, albeit relatively modestly. Surprisingly to some, parliamentarians referred to the performance indicators omitted from the annual reports in only 4-10% of all their questions and remarks, when debating budget accountability.

After the experimental approach ended in 2010, the accountability letter of the Prime Minister was retained (at least for now). Also, line ministries were encouraged by the Ministry of Finance to develop critical self-reflection in performance reporting by formulating policy lessons in their documents.

2.3. The Dutch experience in the international context

The experience with PBB in the Netherlands seems to be largely representative of international PBB experience. The attempts to link government spending to public sector performance seem to have increased the transparency of budget documents to a certain extent (Curristine, 2008; GAO, 2004; Nispen and Posseth, 2006). Less visible and harder to substantiate are claims that PBB increased the result orientation within government organisations and was beneficial for operational efficiency. The evidence here is mostly anecdotal and inconclusive but is reported elsewhere as well (GAO, 2004; IOFEZ, 2004; OECD, 2007).

On the downside, experience in the Netherlands and other OECD countries demonstrates that the effects of PBB on budgetary deliberations by parliaments have been nearly absent (Frisco and Stalebrink, 2008; OECD, 2007; Wanna et al., 2010). The question of PBB impact on budgetary allocation is obviously a broader one, as the finance ministry can have a significant impact on a draft budget before it is sent to parliament. But also in this respect, some findings suggest a fairly limited impact. One of the interesting findings from the 2011 OECD Performance Budgeting Survey which was carried out among finance ministries is that the most frequent answer to the question "What happens when performance targets are not met?" was that there were no consequences at all, followed by the answer that the results were made public. Incidentally, the same went for the question "What happens when performance targets are met?" – in the case of not meeting targets, budget decreases occurred occasionally to never, just slightly more often than budget increases.

As part of the OECD "Value for Money" study,[3] Dirk-Jan Kraan comes to some rather harsh conclusions regarding PBB implementation (Kraan, 2011a). First, the shift from input to output controls has led to cost increases in cases where input controls and standards of operational management were almost completely abandoned. Although no reliable comprehensive data are known for the Netherlands, this may refer to the system in the Netherlands which is characterised by a high level of decentralisation and managerial flexibility. In addition, the abolishment of input controls for parliament was relatively radical in the Netherlands compared to other OECD countries.

Second, it is claimed that output financing of government agencies has led to a loss of service quality and an increase of bureaucracy. This refers to the (necessarily) sub-optimal output and outcome formulations as a result of changing preferences and political compromises. An obsession with indicators by managers and inspectors can result in bureaucracy at the expense of service delivery. The bureaucratic burden of PBB has also been noted in the Dutch public sector, especially in cases where the utilisation of the data themselves remained unclear.

Finally, Kraan concludes that budget authorisation on the basis of output targets (instead of financial inputs) has led to loss of control by parliament and unreadable budget documentation. Indeed, the Dutch parliament increasingly perceived the almost complete lack of input information as an accountability gap. Incidentally, similar findings emerged from several recent studies on the Dutch local government which introduced a similar system of performance-based programme budgets from 2003 (Bordewijk and Klaassen, 2011 and 2012; Elzinga, 2012; Bogt et al., 2012).

Anecdotal evidence from practitioners as well as authors on public administration offers plenty of explanations why the predicted benefits of PBB doctrine did not materialise or did so only partially. To agency managers, who are usually busy battling unexpected crises that can only be cured by resources rather than by strategic thinking, performance management is little more than a distraction (Moynihan, 2008). Neither should it be surprising that the political environment in which budget allocation takes place far from guarantees a predictable use of the performance information that is generated. One can even argue that it would take a totalitarian regime to fully embrace a normative theory of budgeting, for this would imply the end of politics (Wildavsky, 1992). The view that performance measurement is too simple an approach for the diversity and complexity in the public sector was expressed by Beryl Radin as she confronted reality with six assumptions that constituted what she called the "unreal and naïve approach" of the performance movement (Radin, 2006):

1. Information is already available.
2. Information is neutral.
3. We know what we are measuring.

4. We can define cause-effect relationships in programmes.
5. Baseline information is available.
6. Almost all activities can be measured and quantified.

Although one can have serious doubts about the attempts to "rationalise" budgetary decision making using PBB, some claim that performance management reforms can change managerial behaviour and that performance information does get used, be it at a different place and time. According to several authors, benefits of PBB reforms in terms of efficiency mostly occur at the agency level and in the budget preparation and budget execution phase, and not in the budget approval and evaluation phases (Joyce, 2003; Moynihan, 2008; Posner, 2009; Verhoest et al., 2011). So the budgetary impact of PBB may lie mainly in its ability to improve technical efficiency within government programmes, illustrated by Table 2.

Table 2. **Utilisation of performance information to enhance efficiency**

Level of dialogue	Budget phase			
	Budget preparation	Budget approval	Budget execution	Budget evaluation
Council of Ministers – parliament				
Ministry of Finance – line ministries	Yes		Yes	
Line ministries – agencies	Yes		Yes	
Within agencies	Yes		Yes	

The 2011 OECD Performance Budgeting Survey confirms that performance information gets used more commonly for management and accountability than for programme allocation.

Although performance information has proven especially useful in *ex post* evaluation in the Netherlands (see Schoch and Broeder, 2013), the column under "budget evaluation" for the Council of Ministers – parliament in Table 2 does not have a "yes". The reason is that the evaluations do not take place as part of the annual budgetary cycle. Instead, budget evaluations tend to follow diverse multi-annual policy cycles that may be triggered by unpredictable events including changing political preferences. Moreover, attempts in 2008-10 to align the policy evaluation reports with the annual reports have been unsuccessful.

3. The value of performance information to the budgetary process

3.1. Using performance information to learn and improve

The actual use of performance information by a public sector bureau and its principal(s) to inform management decisions is a vital link to PBB. Although the use of performance information by government agencies has been reported for a myriad of purposes, not all of these purposes may be seen as a successful adoption of the underlying PBB goal of more effective allocation of resources. Use of performance information can be classified in five broad categories (Lancer Julnes, 2008):

- Reassurance: Government shows it is doing what it is supposed to do with the taxpayers' money.
- Compliance: Agencies demonstrate that they comply with performance measurement regulations.

- Programme learning: Learning from results may lead to programme changes or maybe just to a better informed dialogue.
- Enlightenment: Externally, enlightenment can lead to mobilisation and put an issue on the political agenda. Internally, enlightenment can lead to more informed decisions and better-educated stakeholders; this can generate new insights and challenge previously held perceptions.
- Legitimisation: Performance information can be used to rationalise, justify or validate current, past and future courses of actions and decisions (including funding levels).

Among these different uses of performance information, using it for reassurance seems to match the PBB purpose of increasing transparency and accountability. The use of performance information for the purposes of programme learning and enlightenment seems to be particularly relevant for both operational efficiency and internal result orientation, thus indirectly contributing to the aim of more effective allocation of resources in the public sector.

Concerning compliance, Allan Schick once noted that “compliance is usually the enemy of performance” (Schick, 2003:86). When looking at the experience in the Netherlands, it seems fair to say that performance information has been used by line ministries extensively for compliance and legitimisation whereas the added value for reassurance, enlightenment and programme learning has often been debated and was the source of various reforms. As mentioned earlier, the Dutch Court of Audit oversaw compliance with the PBB regulations, and in doing so focused mainly on the availability of performance indicators in the documents. Due to the powerful role of the Court of Audit in the budget evaluation phase, line departments had a strong incentive to fill their entire budget with performance indicators, arguably ignoring the aspects of quality and relevance.

Regarding legitimisation, by looking at the budget documents in the Netherlands, it becomes apparent that policy units used the PBB structure extensively to highlight the importance of their programmes and political priorities. It can be argued that the focus on political priorities in the period 2008-10 reinforced the politicising of the budgets. The 2011 OECD Performance Budgeting Survey shows that line ministries most commonly use performance information to increase spending in their negotiations with central budget authorities; this points to the ability of line ministries to effectively use PBB for legitimisation purposes.

3.2. In search of realistic expectations

Given the way policies are reshaped, conducted and adjusted in a political environment, it may appear unrealistic to expect an abundant use of performance information for programme learning or enlightenment. Or, as Allen Schick noted: “Successful organisations learn and adapt, changing what they do and how they work in response to both internal and external signals. But performance is only one of the drivers of change, and not always the most important one” (Schick, 2003:88). This may indicate that traditional PBB theory is flawed to a degree, or at least does not take into account knowledge about learning behaviour in public sector organisations, a point made earlier by Donald Moynihan (Moynihan, 2005).

The problems encountered with the use of performance information by public sector organisations are summed up well by Donald Moynihan in his “interactive dialogue model of performance information use" (Moynihan, 2008). This model, or rather set of assumptions, challenges some often unarticulated notions behind PBB theory. The model's central assumptions are:

- Performance information is not comprehensive.
- Performance information is ambiguous.
- Performance information is subjective.
- Production of performance information does not guarantee use.
- Institutional affiliation and individual beliefs will affect selection, perception, and presentation of performance information.
- The context of dialogue will affect the ability to use performance information to develop solutions.

The first three assumptions reflect the idea that performance information usually consists of one or more indicators of actual performance and, as such, never represents a whole universal truth about performance. These assumptions partly mirror the "misassumptions" of PBB as noted by Beryl Radin (Radin, 2006). The importance of these notions lies in the fact that once you accept that performance information is incomprehensive, ambiguous and subjective, a number of underlying key assumptions of PBB theory ought to be reconsidered as well – most notably the reliance on a comprehensive, yet SMART policy goal and a limited set of key indicators as the basis for a performance-informed dialogue between actors in the budget process.

The fourth assumption deals with problems regarding the use of performance data. Moynihan also notes that when performance information is used, it is not always used in the way PBB reforms envisioned it to be used (Moynihan, 2008). So, not only does the production of performance information not guarantee use, the use itself may or may not contribute to efficiency depending on the purpose of use.

The consequences of institutional affiliation and individual beliefs for selection, perception and presentation of performance information touch upon the transparency and accountability goals of PBB reforms. Although a bias may not occur deliberately, it can nonetheless erode trust in a relationship between the Council of Ministers and parliament, between the central budget authority and line ministries, or in any other accountability relationship. In addition, there is a fine line here with the issue of deliberately spinning and framing results. This is likely to occur when the incentive to report good results proves stronger than the incentive to actually achieve these results. This risk is especially apparent in direct/formula performance budgeting, and examples of this have been reported in the Netherlands as in other OECD countries.

Finally, the way the dialogue is conducted between those who measure and interpret performance and those who account for performance can prove to be an obstacle to applying the lessons to be learned. It can be argued that some characteristics of the budget process – like loyalty and confidentiality – may even undermine a learning culture (Posner and Mahler, 2012). A dialogue that involves only a few parties that maintain a close relationship offers the best guarantee for efficient exchange of information because much information can remain implicit (Moynihan, 2008; Wierdsma, 1999). A drawback of such a dialogue is that only acceptable and predictable positions are taken and no truly new insights emerge. PBB can be viewed as an attempt to break open the policy dialogue to be able to involve other parties (e.g. the financial department, parliament). This is attempted by making many implicit assumptions explicit (e.g. policy objectives, goals, expected outcomes, criteria for success). However, if a perceived outsider is forcing his/her insights into a policy dialogue, defensive routines are likely to occur on the part of the public sector bureau. This can result in a ritual dialogue in which referral is made primarily to formal positions and documents rather than to actual policy content (Argyris and Schön, 1996; Knaap, 1997). Many of the problems encountered in policy evaluation refer to this dilemma (see Schoch and Broeder, 2013).

4. A new approach based on lessons learned

4.1. Introducing "Accountable Budgeting"

After the initial euphoria over the VBTB reform in the Netherlands, discontent grew among different stakeholders for different reasons. Parliament was not content with the kind of information in the budget, especially the absence of a clear relation between annual performance planning and accountability afterwards, the total lack of input information, and the failure to link the budget to the use of evaluations. The Court of Audit was critical of the increased use of the "comply or explain" clause that allowed ministries to refrain from reporting performance indicators if they could explain why no relevant one was available. Line ministries perceived the budgeting process as a heavy administrative burden. This was not only caused by the number of indicators (some programmes had over 50) and the apparent lack of political interest for this information, but also because of the time-consuming internal debates about the elaborate policy texts in the budget. These proved to be a continuous threat to transparent and accessible budget documents. The Ministry of Finance felt that the old VBTB structure was an impediment to effectively deal with this problem. Moreover, it had become more and more apparent that the budget documents had lost most of their relevance in helping the Ministry of Finance to monitor and control the spending of line ministries. This was illustrated by the fact that during the 2009/10 round of comprehensive spending reviews (see Schoch and Broeder, 2013), the budget documents were seldom used because they contained too little relevant financial information. As a result of all these continuous problems, an agreement was reached in 2011 to make some significant changes in the framework of the budget.

Before going into the details of these changes, it should be emphasised that none of the stakeholders mentioned above supported abandoning programme budgeting or a return to input budgeting. Nor was it the opinion of the Ministry of Finance that ministries or agencies should stop using explicit policy goals and performance information in their policy processes. The changes made only refer to information to be included in budget documents. The idea was not that the fundamentals of performance-based budgeting were not working anymore. Instead, it was concluded that the framework of performance-based budgeting had created an overload of policy information in a non-focused direction. More and more indicators were used to legitimate the policy of the minister and were not about the role and direct responsibility of the minister. Often, indicators were used to illustrate social problems in a broader perspective. Indicators often did not explain the effectiveness of policy measures as initiated by the minister. Instead they served to help make the case for government intervention through a particular measure or programme, or they clearly resulted from pressure (often from the Court of Audit or a single member of parliament) to include more indicators. The Ministry of Finance realised that, in most cases, it is impossible to give an overview of the effectiveness of an entire policy field by only presenting indicators and a policy description in the budget document. To really investigate policy effectiveness requires organising a thorough and useful evaluation survey that takes into account all the interrelated complexities of a policy field. That is the only way to help provide real answers to the questions that matter, like: does the policy work out in the right and expected direction, and what other factors are playing an important role?

As a consequence of this conviction, the framework of VBTB had to be adapted to become more factual and less political. In terms of performance and policy information, this meant, on the one hand, a more focused way of presenting indicators and policy information (or more modest, if you will). On the other hand, a more dominant role for policy evaluation was envisaged. Without going into the aspects of policy evaluation (see Schoch and Broeder, 2013), the results of these evaluations in terms of lessons, policy changes and associated budgetary consequences should have an explicit place in the budget documentation. This enables parliament to critically assess and debate the government's own assessment of a policy's effectiveness and efficiency at the moment when it has to authorise spending. A more detailed presentation of financial instruments was found to not only increase the relevance of the documents for parliament, it also supported the aim of more factual presentation of *de facto* policy theory. This also included a clearer separation between programme expenses and organisational expenses.

In essence, after years of attempts to reduce the complexity of public policy in budget documents, the Ministry of Finance was faced with the challenge of finding new ways to deal with this complexity in its programme budget. This led the Ministry of Finance to explore the lessons learned from VBTB and resulted in a new framework called *Verantwoord Begroten* (VB, or "Accountable Budgeting").

4.2. Characteristics of the new budget structure

The accountable budget focuses on a programme's general objective, to be achieved by a minister according to his/her responsibility within a policy field, and the instruments applied. To determine which information is to be presented in the budget, budget officers use the revised questions shown in Table 3.

Table 3. **Questions for a programme to be answered in the new budget structure compared to the old one**

VBTB (old budget structure)	Accountable Budgeting (new budget structure)
What do we want to achieve?	What does the minister intend to achieve?
What will we do to achieve it?	Which financial instruments is the minister going to use?
What will be the costs of our actions?	What are the costs of these instruments?

Although virtually identical at first view, these questions do mark an elaboration of the earlier rules of performance-based budgeting in the Netherlands to make them more specific to the actual role and responsibility of the minister. This renewed focus stems from the idea and belief that the budget has to be about budgetary matters first and can never offer a complete and comprehensive policy description. Other policy documents sent to parliament have to fulfil that role. Although it can certainly be useful to refer to other policy documentation in the budget, the budget itself cannot fulfil the role of a super-comprehensive policy document and at the same time be helpful for parliament's budgetary decision making. So, in essence the budget is a financial document and not a policy note. When comparing the "Accountable Budgeting" structure with the old VBTB structure, there are important transformations regarding financial and policy information, set out below.

4.2.1. Policy expenditures are presented in more detail following centrally defined financial instruments

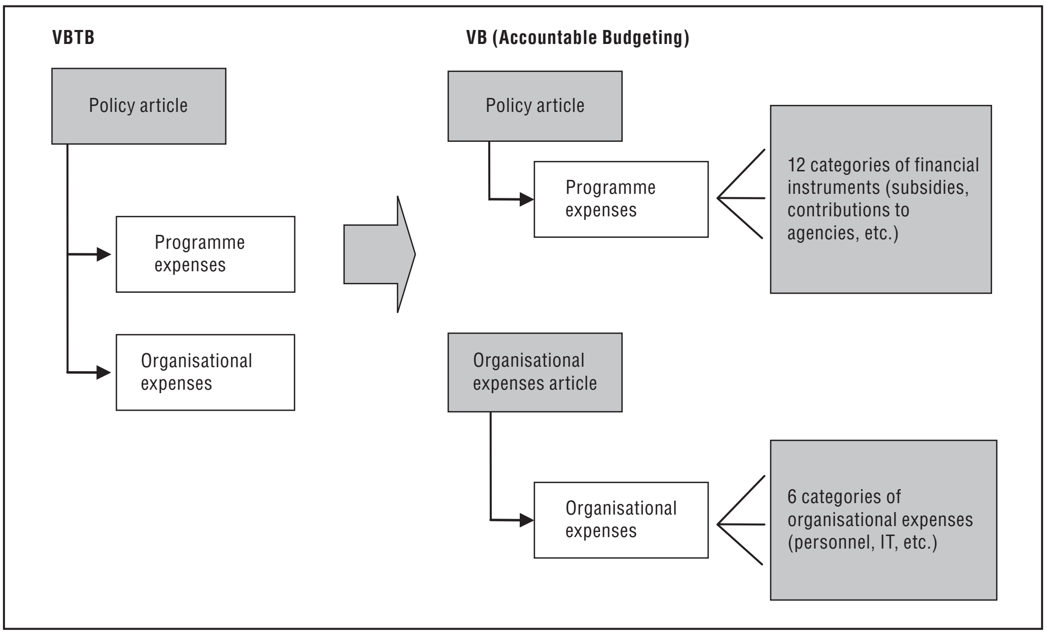
Because parliament has to approve the budget document with all the financial resources, members of parliament obviously need to know exactly what will be spent on different budget goals. They also have to be provided with additional information that reveals what kind of organisations receive the funds and what each particular organisation is expected to contribute to each goal. As explained earlier, the introduction of programme budgeting in the Netherlands at the turn of the 21st century saw a radical decrease in the number of line items combined with financial information being presented only at quite a highly aggregated level. Therefore it is not surprising that parliament, especially in fiscally tough times, experiences a lack of control. The information regarding financial instruments (subsidies, purchasing from the private sector, contributions to agencies or decentral government, etc.) may appear as a return to the old-style input budgeting, but in fact provides a vital link for displaying the *de facto* relationship between policy goals and accountability for results. For example, a very ambitious policy goal that in reality only requires a small amount of programme expenditure consisting of unearmarked or lump-sum transfers is now presented at face value, limiting the opportunities for framing and using performance information for legitimisation purposes.

With Accountable Budgeting, the budgetary table has been redesigned. In this table, all the budgetary instruments like subsidies, charges and contributions to agencies, etc., are presented, including the larger individual expenses (from EUR 1 million) within each category of financial instruments. There is thus complete visibility of the major sums paid to specific organisations, agencies and institutions to fulfil specified policy goals and, in a broader context, the role and responsibility of the minister for that policy field. The enumeration of financial instruments is restrictive. Instruments have been clearly defined so that line ministries can present the table in the same way, leading to consistency in the budget documents and therefore to a better insight for parliament. In explanations that accompany the table, parliament can find more information about the individual instruments and the most important changes in the policy fields related to changes in the budgetary level of the instrument, or an explanation of price × quantity ($p \times q$).

4.2.2. Organisational expenses (expenditures for personnel and material) are presented in a single non-policy programme, separated from the policy expenditures

According to some, this shift is totally against the logic of a programme budget because any programme is supposed to include all the costs associated with the delivery of the programme's output or outcome. In reality, however, the consequences of this shift in terms of management and organisation are quite limited. The reason is because the large majority of the Dutch central government's organisational expenses are incurred by government agencies and remain presented as programme expenses in the policy programmes. Only the apparatus of each central line ministry in The Hague – only a small part of total organisational expenses – is no longer divided between policy programmes. These expenses are authorised through a single non-policy article per ministry. In addition, this non-policy article also contains a table with all the organisational expenses of external agencies (that are authorised as programme expenses elsewhere in the budget). In this way, all organisational expenses for policy making as well as policy execution of a single ministry are displayed. An additional reason for no longer attributing the costs of central line ministries to policy programmes was to prevent the budget from being used as a tool to preserve stovepipes, as stovepiping would obstruct flexibility between policy directorates. Figure 6 displays the changes in the presentation of programme and organisational expenses.

Figure 6. **Changes in the presentation of financial information in the budget**

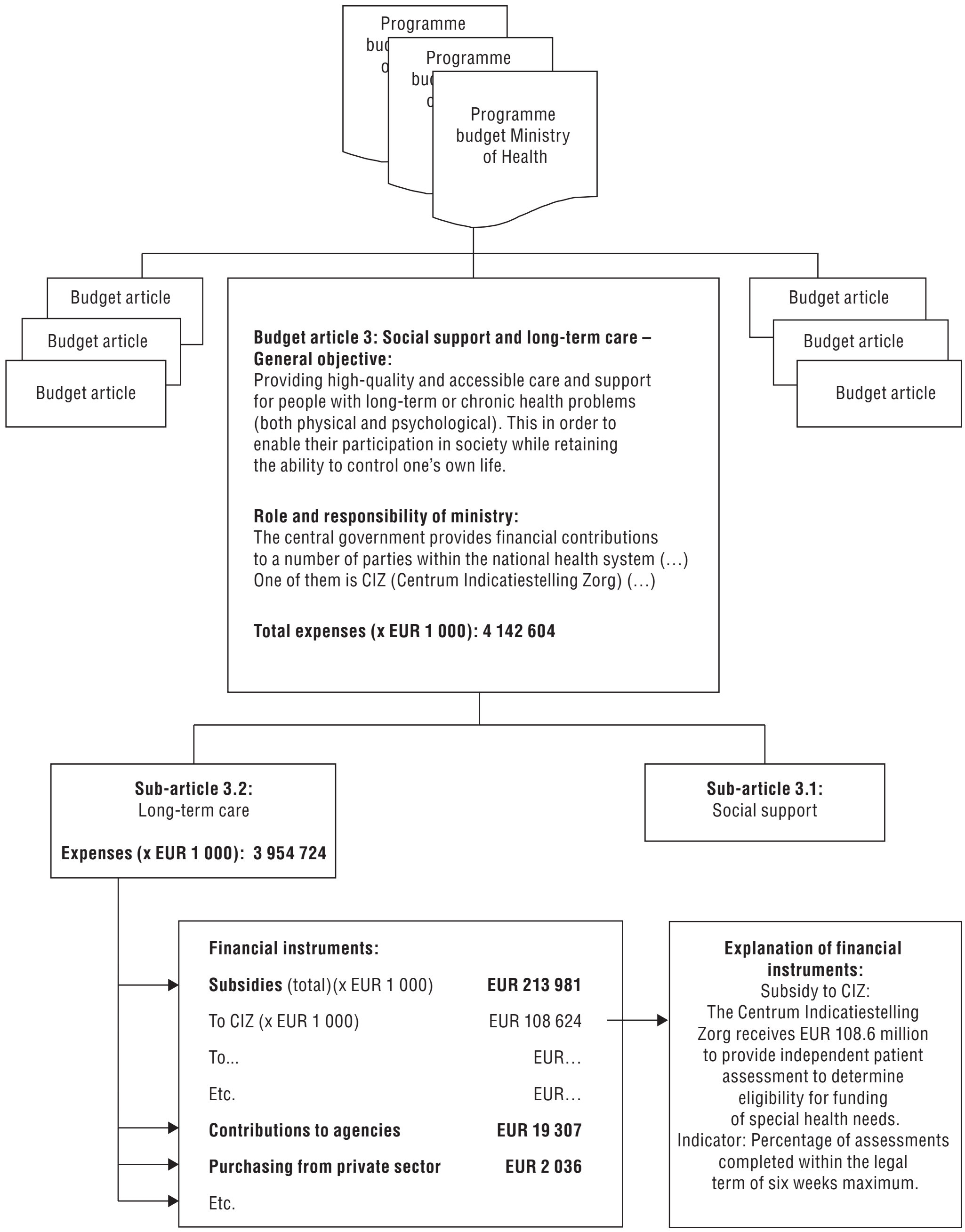


4.2.3. Policy information is limited to the information directly related to a minister's sphere of influence and the financial instruments used. Performance targets can only be included in the budget when certain conditions are met

The policy information omitted from the VBTB budget will not disappear but will be presented in a more focused way to purify the process of budgetary decision making. If there is no direct relation to the ministerial responsibility and the expenditure proposals, the information should not be presented in a budget document as an indicator for performance, but should be used in other policy documents as an illustration of a situation rather than as a result of public intervention. Very often this type of information has been sent to parliament at earlier moments. If there is a direct and significant relation between results, outputs or outcome and the way a ministry fulfils its responsibility, performance indicators and target values still have a place in the budget documents (as shown in the examples in Figures 7 and 8). If not, contextual policy information can have a place in the budget if it refers directly to the broader problems targeted by the programme or if it provides insight into the level of funding. Many of the indicators from the previous VBTB budgets did not meet these criteria. Some examples are presented in Table 4.

For reasons of clarity and comparability, four types of role by a ministry are distinguished: to stimulate, finance, facilitate or actually execute policy. Performance indicators can be combined to match these types of roles. If the presented outcome is more due to other influences or developments and not directly related to the effort of the

Figure 7. **Example of Accountable Budgeting structure of the Ministry of Health (2013)**

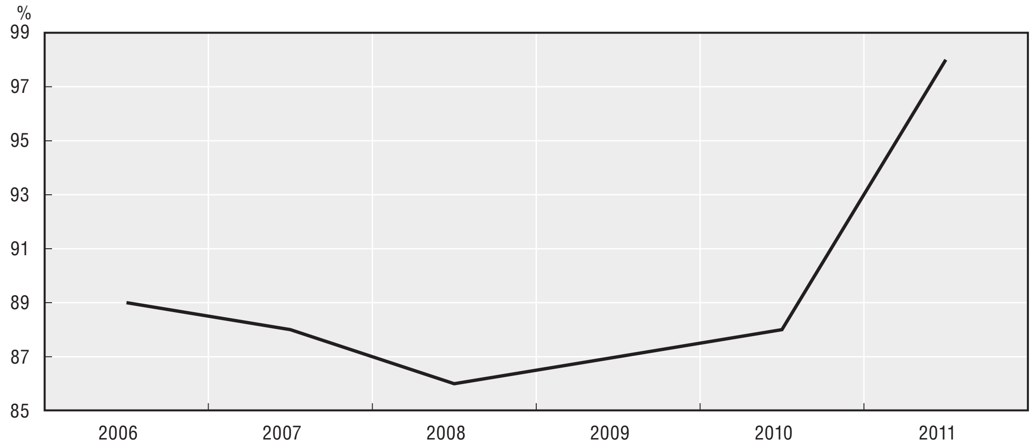


minister, it is better to place the indicator or information in the policy notes instead of in the budget. In the Accountable Budgeting framework, quantitative performance targets can only be included in the budget when a minister can credibly be held accountable for the results afterwards. This is the case when:

- a clear outcome for society can be identified regarding the policy field (e.g. this can be difficult in the case of defence or diplomacy);

Figure 8. **Example of a performance indicator, Ministry of Health**

Percentage of requests for health treatment processed within six weeks



Source: Centrum Indicatiestelling Zorg (Care Assessment Centre), Netherlands.

Table 4. **Examples of indicators from VBTB budgets with weak causality and/or low relevance**

Indicator	Policy goal	Programme	Ministry
Number of medals won by the Netherlands in the Summer Olympics	46.3: Sports in the Netherlands symbolises ambition, is a source of recreation, and contributes to our national image at home and abroad.	46: Sports	Health
Percentage of students who can be considered "motivated"	Students receive higher education, and scientific staff conducts high-quality research.	6: Higher education	Education
Study intensity: weekly number of hours students spend on study-related activities (perception of the student)	Students receive higher education, and scientific staff conducts high-quality research.	6: Higher education	Education
Position in Failed State Index for eight selected countries	2.5: Regional stability by effective crisis prevention, crisis response, crisis resolution and post-crisis build-up efforts.	2: Peace and stability, effective humanitarian aid and good governance	Foreign Affairs

- the central government plays a dominant role in achieving this outcome (e.g. if a large role is played by international parties or the private sector, this may not be the case);
- the central government has an active role within this policy field (e.g. if it only provides unmarked funding or funds entitlements, this may not be the case).

Clearly applying these criteria is far from an absolute science. However, the criteria have proved to be helpful in the discussion with line ministries on results accountability and on the usefulness of performance indicators. In cases where these criteria are not met, policy information in the budget (or preferably referral to it) can still be useful. It has to be clear, however, that in those cases the causality between money and results is too weak to promise specific results to society in exchange for allocating funding. It is important to note that this is not necessarily a shortcoming on the part of a ministry. For many policy areas, the choice is made deliberately, and with good reasons, to leave allocation decisions to, for example, decentralised government or school boards.

4.2.4. Focus on learning and referral to evaluation

Two changes reflect the greater emphasis on policy evaluation. First, a mandatory multi-annual table in each ministry's budget shows when each programme was or will be reviewed. This clearly reveals when a programme evaluation is postponed repeatedly. It also makes clear if recent evaluation results were obtained in the previous budget year or can be expected in the next one. Having this information presented more prominently in the budget is expected to help encourage parliament's involvement in the evaluation planning. Second, in the programme format of the budget, a separate section is reserved for a brief reflection on policy adaptations and changes due to evaluation, either by the ministry itself or by an external party. In the annual report, this section is mirrored by lessons learned from evaluation. In this way, ministries are challenged to critically self-assess the results of their evaluation efforts within the budgetary perspective.

4.2.5. Improved presentation of the flexible part of a programme's budget

Always an important topic for parliament during authorisation is the question of how much of the budget is still flexible to (re)allocate in the next fiscal year. Although there were rules for presenting this information in the previous structure, ministries now provide better and more uniform information, increasing the insight into what is referred to as the budget flexibility within a programme. A uniform definition of committed expenses[4] is now used by the ministries, resulting in a percentage of financial commitments in the fiscal year. The budgetary table of a programme shows this percentage. For the percentage of the programme's budget that is still flexible, line ministries can explain which steps need to be taken to make the budget available for alternative allocation.

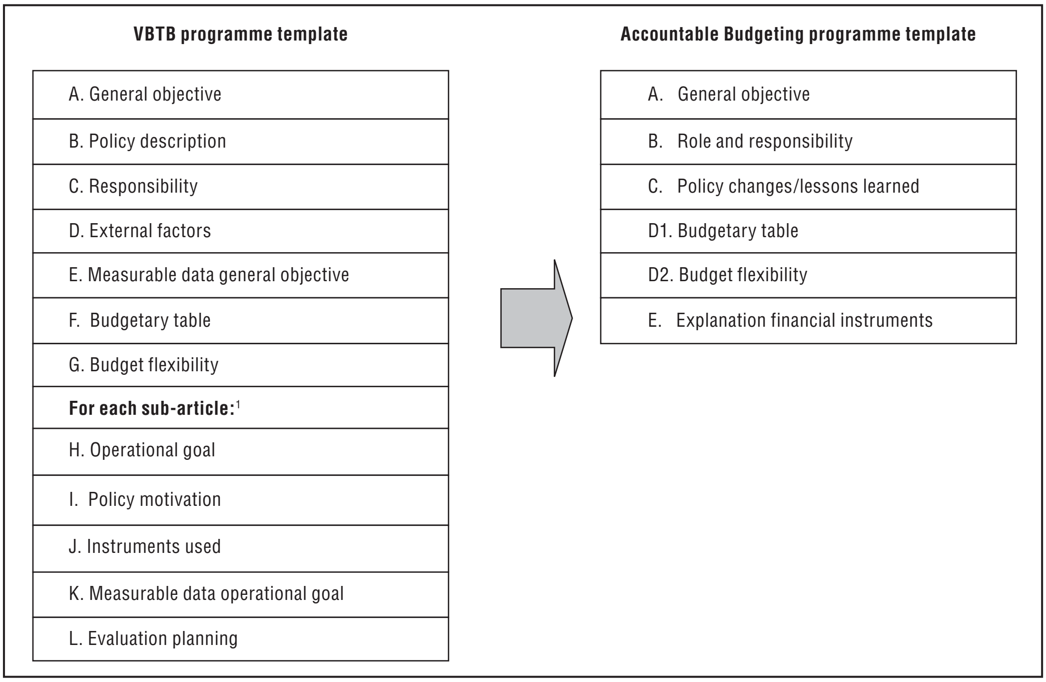
All these changes were worked out in a revised budgetary template for policy programmes as shown in Figure 9. The new template meant a simplification of the VBTB template, and achieved a shift from explaining policy goals to explaining financial instruments.

One of the goals behind this reform is to limit the extensive possibilities that the previous PBB structure offered of using PBB for the purpose of policy legitimisation by line departments. As a by-catch, the administrative burden to line departments can be reduced significantly using the new template, especially in preparing the annual report. If done right, the only things that have to be explained in the annual report – other than explaining major differences between planned and realised spending – are the Sections C and D1 and tables with performance information if these occur in Sections B or E.

4.3. Process and evolution of the model

After partial implementation of the new format in the 2012 budget documents and evaluation of the results, all budget documents for the 2013 budget year were converted to the new concept of Accountable Budgeting. Based on the knowledge that introducing a new concept will involve a lot of effort from the line ministries, the Ministry of Finance chose a phased introduction of Accountable Budgeting. First, all the ministries had to divide the programme expenses and the organisational expenses (i.e. personnel/material expenditures) and present a single non-policy article for organisational expenses. This also meant the end of a few small programmes that contained nothing but organisational expenses by the line ministry. The Ministry of Defence, the Tax Service and parts of the

Figure 9. **Programme template in the old and new budget**



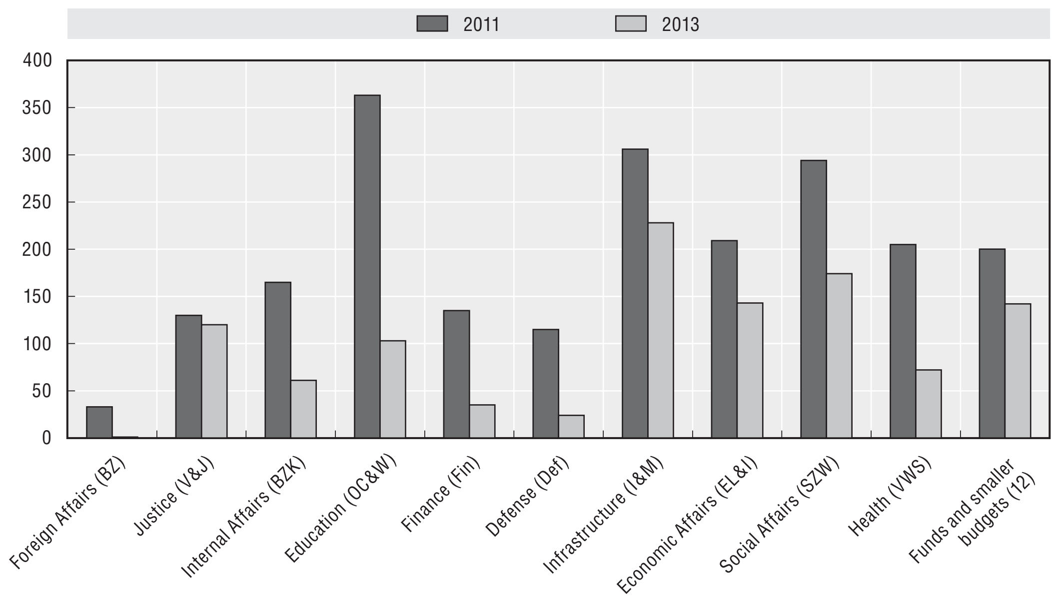
1. Rows H-K were repeated for each sub-article.

Ministry of Justice were granted an exception from centralising all their organisational expenses in a single non-policy article. The reason is that these three government bodies form the only part of the Dutch central government where policy execution does not take place by decentralised agencies but by the line ministry itself. The centralisation of organisational expenses within a line ministry's budget was done in the budget documents for 2012. The next step was achieved in 2013 by splitting these expenses into the categories agreed with parliament, such as the expenditures for personnel, external hiring, ICT, and payments to shared service centres within the governmental organisation.

In 2012, two pilot ministries already transformed all of their policy articles into the new presentation format. Some other ministries chose a more cautious approach by selecting one or two pilot programmes to convert. The forerunners were able to define issues which had not yet worked out. The Ministry of Finance used these lessons to improve the framework and rules. By the 2013 budget, all the ministries transformed their entire budget document to Accountable Budgeting.

As expected, the use of performance indicators in the 2013 budget – when compared to the last budget that had used the VBTB structure (2011) – was significantly reduced, as illustrated in Figure 10. The overall decline represents a reduction of almost 50% and can be expected to diminish even further to over 60% in 2014. Again, the non-included information is generally not expected to have disappeared altogether but is still available for internal management, separate monitoring reports and letters sent to parliament, and occasionally in answers to questions by parliamentarians. If a performance indicator was only used for external reporting and is not missed by parliament, the loss is accepted, as it was probably in the budget for compliance or legitimisation purposes only.

Figure 10. **Number of performance indicators per ministry in Accountable Budgeting (2013) compared to VBTB (2011)**



Another result of the more factual style of budget presentation was a significant reduction in the length of budget documents of up to 50% in some cases. This was largely the result of abandoning lengthy policy texts associated with each general objective and operational goal.

Not unlike other major reforms, a number of risks and critical remarks from stakeholders also apply to this one. From the start, the Dutch Court of Audit and parliament have been cautiously supportive of Accountable Budgeting but also voice some concerns. One concern is the possible loss of information in the budget documents about the effectiveness of policy. Although the Ministry of Finance is aware of the impact of introducing Accountable Budgeting, a burden nevertheless falls on ministries to present fact-based information about the real policy commitment of their minister. The extent to which information should be included in the budget and the extent to which the budget documents refer to other sources (e.g. through an Internet link) can obviously be debated. It will remain necessary to invest in explaining the new concept to parliament and to accept that such a transformation may not be adopted immediately. So far, parliament has been supportive of these changes and rapidly started to use some of the extra financial information provided to fulfil its role of oversight and authorisation. After an entire cycle from the 2013 budget to accountability in 2014 has been completed, there will be additional understanding of what works and what needs to be perfected. Taking into account the opinion of parliament – the main "customer" of the budget documents – the model will be further developed and perfected.

Nonetheless, some lessons were already learned early in this reform process.

First of all, clarity about rules and definitions is paramount. Establishing these rules and definitions needed to be done in co-operation with the line ministries involving financial directors and policy directorates all the way down to the administrative staff. For example, applying the definition of organisational expenses proved to be one of the issues where sometimes arbitrary choices had to be debated and the final agreement had to be clearly documented in case of future disagreement.

Second, during the transformation process, the Ministry of Finance had to organise enough guidance and help. Apart from providing opportunities to explain the new ideas, this help increased the finance ministry's understanding of why things are sometimes not working in specific situations (for example, policy fields) and demanded flexibility to adapt the concept to critical issues.

Third, a large investment in communication about the transformation had to be made – not only with the line ministries themselves, who have to make the transformation work, but also with key actors in parliament to help them understand what is new and also show them what they can do with the extra budget information. The Court of Audit needed to be included because it is in close contact with the line ministries and parliament and needs to adopt and incorporate the framework in its standards.

Finally, there can be fierce opposition from some quarters against changing the status quo. For some persons who work in line ministries, it is understandably difficult to accept that after years of vigorous attempts by them to perfect the old framework, the Ministry of Finance has come up with something new. Especially policy directorates sometimes mourn the loss of their "space" in the budget documents and apply pressure on financial departments to bend the new rules.

5. Epilogue

5.1. What Accountable Budgeting changed and did not change

Now that this new approach to performance budgeting in the Netherlands has been introduced, it is time to reflect on how these changes really affect the Dutch VBTB legacy and its underlying assumptions. Some notions that have not changed and remain unchallenged:

- A programme structure for the budget is the best way to inform members of parliament and taxpayers about a government programme's purpose and perceived contribution to society, as well as ensure managerial flexibility within government.
- It remains the responsibility of the Ministry of Finance to make sure that the effectiveness and efficiency of programme spending is assessed regularly. Regarding allocative efficiency, there is a shift here from the annual budget cycle to policy evaluation.
- Reliance on performance information in the budgetary dialogue was and remains valuable to the budget process at all levels within government (between the Ministry of Finance and each line ministry and within line ministries and their agencies). The largest contribution of such a performance-informed dialogue can be expected in operational rather than allocative efficiency.

However, there are also some assumptions that have clearly been abandoned with this reform:

- The relevance of performance information for (financial) accountability purposes is not served by a detailed one-size-fits-all programme template. Instead, this requires differentiation depending on the role of government and the nature of the instruments used. A dialogue between policy specialists, budget staff and relatively uninformed outsiders is indispensable for deciding on what information is relevant.

- Not all performance information that is considered relevant to all stakeholders can be accommodated in a single budget document. This is not a matter of simply trying harder to find the perfect and objective indicator. Referral to other documents is necessary.
- A top-down, supply-driven effort to produce performance information in the budget does not mean that this information will find its way into political debates about allocation. Use of performance information does not occur on demand in a cyclical, annual way and is more likely to be used to learn and improve following multi-year *ex post* evaluation.

Finally, some questions remain that cannot be answered yet as they require more experience with the new budget structure. One of the concerns voiced during this reform is that it will enable departments to use the new structure to underrate their responsibility for results (especially outcomes) in an attempt to escape responsibility and accountability. On the other hand, there are those who fear that parliament and ministers will not accept their limited influence as presented in to the new budget documents. A result could be that the central government may be pushed in the direction of centralising policy execution and demanding more bureaucratic accountability documentation from decentral government and agencies. More fundamental is the question of whether line ministries can do without guidance from the budgetary process and the Ministry of Finance and will have enough incentive to be clear about their policy goals, measure their results, and use them to learn and improve. Intertwined with this question is the larger question of whether PBB did indeed make a lasting contribution in this respect in the first place. Some early evaluations suggest that it did, while recent international studies increasingly assert this view (Moynihan and Lavertu, 2012; Posner and Mahler, 2012). Another factor that also touches upon transparency has been the role of external pressure demanding public accountability. This article concludes with a short reflection on some of these developments and their relevance to budget preparation.

5.2. The road ahead

The developments as described above are a first step, but certainly not the final situation. As already mentioned, the system of Accountable Budgeting will be evaluated in the near future. For a proper evaluation, a full budgetary cycle is needed: budget preparation (2012), budget approval (2012), budget execution (2013) and budget evaluation (2014).

In the meantime, the Ministry of Finance will give special attention to further improving the model (each budget year provides a new opportunity to introduce some enhancements) together with parliament, the Court of Audit and the line ministries. A number of foreseen (technical) enhancements can be explored:

- increase the linkages to other relevant policy documents in the budget documents;
- better and more information on external agencies;
- more overview reports for cross-cutting policy areas where two or more ministries or agencies are involved.

It is important to understand that a one-size-fits-all approach will probably not work: different challenges and therefore different approaches to policy fields will prove to be the main elements of a successful implementation of Accountable Budgeting.

Besides these technical aspects, there is also a cultural change involved. It took eight years to internalise the concept of VBTB in the line ministries and in parliament. Maybe an additional 3-4 years are needed before the concepts of Accountable Budgeting are internalised. Accountable Budgeting provides the financial directorate of a ministry with some additional tools in order to get a "grip" on the spending of policy makers. To use these tools with sense and sensibility requires both wisdom and scrutiny. The policy directorates themselves, as well as political leaders, sometimes need time to get used to the new requirements for realistic reporting on their contribution to policy outcomes. If, for instance, the role of a minister in a policy area can be characterised as stimulating (see the four possible roles described in Section 4.2.3) and there is no real steering influence, it takes courage to write this down in the budget.

The budget will stay as the main document for the purpose of budget allocation and accountability. However, there will be an increasing demand to link to additional information that can be relevant in the process of budgetary decision making. The cyclical, annual character of the budget process in providing policy information is expected to lose some of its relevance as more information becomes available at varying time intervals. Strategic choices concerning, e.g., Cabinet priorities and austerity packages will still be taken in the budget process; but decisions regarding a policy revision, for example, can take place outside the budget process. Medium and long-term sectoral planning documents (and their annual updates) provide a better basis to hold line ministers to account for outputs and outcomes than the annual budget.

The links to additional data outside the budget documents can be classified as follows:

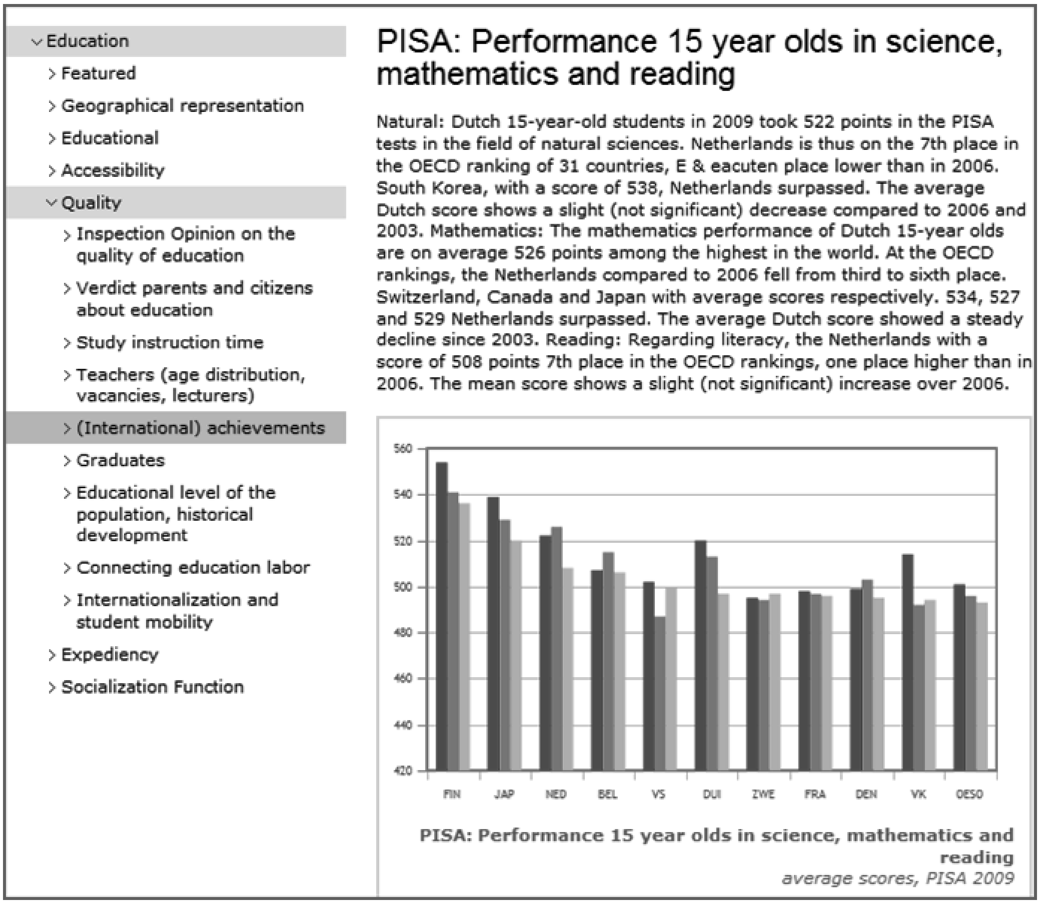
- Cabinet priorities and the monitoring of these priorities;
- more and more financial data, including the expenditures of the ministries (in line with open data initiatives);
- operational data and performance reports;
- performance evaluations;
- spending reviews;
- independent performance information;
- historical and statistical information (from government and international organisations).

There are already some promising results for this mechanism of linking to relevant data. The budget of the Ministry of Education, Culture and Science[5] refers to a wealth of input data – such as the number of pupils in the education system – and performance data (e.g. the quality of education) by linking to these datasets[6] that are produced outside the budgetary cycle context. These data are also presented on a regional and international level[7] (Figure 11).

For the medium term (i.e. 2020), we foresee a chain of events driven by an increasing demand for public transparency and tight budget controls. This chain of events involves the following three main factors in the presentation of the budget information:

1. An accelerated shift from New Public Management to what the OECD calls "basic government" (Kraan, 2011b), notably on the following points:
   - strengthening of standards of operational management, including a need for standardisation of information;

Figure 11. **Example of a clickable source of performance data in the budget document**[1]



1. In this case, one of six datasets linked to the secondary education programme of the Ministry of Education (note the ability to drill down geographically on the upper left).

Source: www.trendsinbeeld.minocw.nl/grafieken/3_1_2_23.php.

- concentration of standard setting in one or a few ministries (in the Dutch situation, the Ministry of Finance and the Ministry of Internal Affairs);
- further reduction of output and outcome information in the budget documentation.

2. A shift of focus from allocation to reallocation due to reduced budgets and the need for better insights on how these budgets are built up. Budget estimates and multi-annual estimates should be well explained, preferably in terms of outputs, historic data and statistical data and, if possible, cost per unit: "$p \times q$" explanations in those situations where the minister plays an active role in the policy field. Due to modern ICT systems, the q part (e.g. the number of applicants for a social security benefit or the number of inspections on food safety) can increasingly be provided on a daily basis, thereby shifting the accountability process to a daily basis.
3. An increasing demand from the public, journalists, etc., who want to reconstruct by themselves the "truth" about government performance and spending. As performance data are open to selective presentation and interpretation (see the "interactive dialogue model of performance information use" – Moynihan, 2008), the data provided should support a performance dialogue based more on research and advocacy. This means that

the budget should provide access to (rather than include) various sources of information instead of relying on just a few selected indicators. The same goes for the ability to follow spending all the way to the last penny.

The ultimate goal is to gradually present the budget documents in a more digital way and with an open format, making it possible for actors, organisations, etc., who are not traditionally included in the budgetary process to analyse and present these data in different ways, thereby initiating a real dialogue on value for money.

Notes

1. It should be noted that the perception of the administrative burden of performance reporting and the political attention for these results are somewhat correlated: the less attention one's work receives, the more it is seen as redundant by those working on it.
2. Examples of less concrete priority goals were: "bringing closer a solution for the conflicts in the Middle East" and "taking measures to promote respectfulness and decency in society."
3. This multi-annual, cross-country study compares several OECD countries in terms of new reforms and reform trends in public administration.
4. Committed expenses are defined by a limited number of categories of agreements that are considered legally binding (e.g. international treaty, law, private sector procurement).
5. *http://goo.gl/CSkOC*.
6. *http://goo.gl/aiHIc*.
7. *http://goo.gl/MEYJc*.

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Linking information on policy effectiveness and efficiency to budget decisions in the Netherlands

by
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This article analyses the Dutch policy evaluation system from a budgetary perspective. It addresses the context and scope of the evaluation system, explains the need for such a system from the perspective of budget decision makers, describes the legislative framework for evaluation, analyses the evaluation instruments and their impact on budgetary decision making in practice, and draws lessons for finance ministries in other countries based on the strengths and weaknesses of the Dutch evaluation system.

JEL classification: H500, H610, H830

Keywords: Netherlands, policy evaluation, effectiveness and efficiency of government programmes, budget process, budgetary decision making, evaluation instruments

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Executive summary

This article analyses the Dutch policy evaluation system from a budgetary perspective:

- How to design and maintain an evaluation system that provides budgetary decision makers with information on the relevance, effectiveness and efficiency of (future) policies for the purpose of expenditure prioritisation?
- What lessons can be drawn from the Dutch evaluation system?

It addresses the context and scope of the Dutch evaluation system (Section 1), explains the need for an evaluation system from the perspective of budget decision makers (Section 2), describes the legislative framework for the Dutch evaluation system (Section 3), analyses the organisation of the evaluation instruments and their impact on budgetary decision making in practice (Section 4), and draws lessons that might hold value for finance ministries in other countries, based on the strengths and weaknesses of the Dutch evaluation system (Section 5).

This article demonstrates that, from the perspective of the Dutch Ministry of Finance, the evaluation system needs to be tailored to the budgeting system to ensure impact on policy and budget decision making. Key elements for the Ministry of Finance are: *i)* flexibility in and choice of instruments; *ii)* adequate timing of the evaluation reports; and *iii)* selectivity (focusing on those policy areas for which there is a significant amount of political attention and the budgetary impact is substantial).

There are four key lessons from the experience in the Netherlands:

1. The Ministry of Finance must initiate its own evaluation instruments, in addition to government-wide evaluation frameworks, to tailor information to the budgeting process (timely and focused). To ensure impact, a high-level principal at the political level (the Cabinet) is necessary.
2. Basic rules with respect to quality and quality control enhance the integrity of evaluations for budgetary decision making. For the credibility of the evaluation reports, it is important to draw a clear distinction between the technical evaluation phase (independent from current political preferences) and political decision-making processes.
3. Increasing the amount of formal regulations and rules is not the answer to overcoming the inherent information asymmetry between the Ministry of Finance and line ministries. In the Netherlands, evaluation instruments with the highest impact are initiated by the Ministry of Finance – instead of being part of a government-wide evaluation framework that all ministries must adhere to – and are guided by well-understood informal practices. This fact is in addition to the general principle that the Minister of Finance may object to spending proposals as stipulated in the Government Accounts Act.
4. Each spending ministry has a disincentive to share with the Ministry of Finance more than the strictly necessary information on true budgetary needs, on the effectiveness

and efficiency of spending, and on progress with policy implementation. Line ministries fear that divulging this type of information may result in budget reductions. This information asymmetry could perhaps be overcome by the involvement of independent experts in evaluations in which independent experts, line ministries and the Ministry of Finance work together.

But in the end, it is the politicians themselves who decide which spending to cut or to increase. The aim of the evaluation system is to provide structured and objective input.

1. Context and scope of the Dutch evaluation system[1]

Governments in the Netherlands are multi-party coalitions. Negotiations on the national budget are an integral part of the formulation of a "Coalition Agreement" at the start of a four-year government term (Cabinet period). The rather elaborate budgetary paragraph of the Coalition Agreement contains quite detailed points on programmes and expenditure sectors. The annual budget process within the four-year term is subsequently about more specific matters within the parameters of the Coalition Agreement and addresses implementation issues, overspending and underspending, and other unexpected events each year. It is uncommon that entirely new policies are introduced (or eliminated) that were not already agreed at the start of the Cabinet period.

The Coalition Agreement is built on three essential ingredients:

- an agreed deficit target from which the medium-term budgetary framework is derived;
- budget discipline rules to deal with unexpected events;
- information on policy programmes (information on the relevance, effectiveness, efficiency and cost of government programmes) for the purpose of expenditure prioritisation.

There is a well-established process for agreeing on the first two ingredients, namely the medium-term budgetary framework and the budget rules. Since 1971, the Advisory Group on Fiscal Policy has annually drafted an advisory report on the subject of fiscal principles and targets. This report is written one year prior to the next term of government. The new government is free to follow the advice or not, but in practice the recommendations of the Advisory Group[2] have proven to be very influential. Key inputs for this report are the medium and long-term estimates on the economy and public finance by the independent Netherlands Bureau for Economic Policy Analysis (CPB). The Advisory Group on Fiscal Policy might also recommend (changes to) the budget discipline rules. These rules are subsequently (re)affirmed during the first Cabinet meeting of the new government.

This article discusses the third ingredient, which is perhaps the most difficult to organise: information on the relevance, effectiveness, efficiency and cost of (future) government programmes for the purpose of expenditure prioritisation. This type of information is provided by the Dutch evaluation system.

It should be noted that the evaluation system may make use of performance indicators, but that evaluations are especially needed to assess the effectiveness and efficiency of existing or future policies (see Box 1 for a discussion).

Box 1. **From performance indicators to performance evaluations**

During the past two decades, the Netherlands has modernised its budget, changing the basis on inputs to a basis on outputs and results. An important element was the "Policy Budgets and Policy Accountability" reform (VBTB) introduced in 1999. The underlying rationale was that there is (or should be) a logical relation between the goals, the budget, the policy instruments, the outputs and the social impact.

The budget structure was changed to a programme structure to reflect policy objectives and to relate expenditures to policy objectives. The aim was to increase the transparency of the budget documents to address three questions: What do we want to achieve? What will we do to achieve it? What will be the costs of our actions?

The annual financial report was consequently reorganised to answer three parallel questions: Did we achieve what we intended? Did we do what we meant to do? Did it cost what we expected? The budget documents were changed to contain a large number of indicators and detailed descriptions of policy plans.

While VBTB reforms led to significant improvements in the presentation of the budget, accountability and the quality of budgetary decision making did not increase as much as anticipated. An important part of the explanation can be found in the reliance on indicators to measure performance. While a large amount of time was devoted to discussions with respect to measurability, the "scores" on performance indicators had little impact on budgetary decision making.

- There is a problem with attribution: a target may be reached, but it is unclear how much a specific policy contributed to it. Therefore, a good score on an indicator does not imply that a given policy choice was the most appropriate or effective.
- The score on an indicator does not provide relevant information on true budgetary needs. Performance indicators tend to be used by spending departments to justify the necessity of a specific programme (if indicators show an improving situation) or request additional funds (if the desired target has not yet been reached).
- Performance indicators do not provide information on whether an ineffective programme can be fixed through policy or management changes.

While the rationale of the reforms was never in doubt, the experience did result in some key insights. The important insight was that performance indicators by themselves are insufficient to assess whether a specific policy is effective. This conclusion was clearly highlighted in the evaluation of the VBTB reforms sent to parliament: "the budget structure should only be used to increase transparency while improvement of the effectiveness and efficiency of studies would have to come from evaluations" (Minister van Financiën, 2004).

2. Evaluations from a budgetary perspective

The need for fiscal consolidation due to the costs of an ageing population and the economic and financial crisis have made it increasingly imperative for the Dutch government to improve expenditure prioritisation and promote efficiency. This means that, first, the government should allocate resources to those programmes which seek to achieve outcomes that citizens value ("relevance"). For example, primary education is generally deemed to be of higher value to citizens than the promotion of Dutch language and culture abroad. Judgment on the relevance of a programme can be based on economic analysis (Are there any market failures? What is the role of the government?) and furthermore tends to be normative and thus political in nature. Second, the government needs to ensure that policies achieve intended outcomes ("effectiveness") and that the social benefits of these policies outweigh social costs. And third, government services are to be delivered at the lowest possible costs ("efficiency"), given an acceptable level of quality.

Experience in the Netherlands has shown that the Ministry of Finance has to take an active role in order to ensure that this type of information is available at the right time and in the right format for budgetary decision making. The main reasons are different interests and information asymmetry. The Ministry of Finance and line ministries have conflicting priorities in the budget preparation process: line ministries tend to view financial resources as a means to an end – delivery of more and higher-quality services – and the Ministry of Finance has to reconcile sectoral spending with the need to control aggregate expenditure. The Ministry of Finance typically lacks detailed information about actual costs, about the effectiveness of government programmes, and about the budgetary needs of line ministries.

The subsequent challenge is that line ministries and the Ministry of Finance need different types of evaluations: line ministries generally use evaluations to improve the management and efficiency of their programmes for better and higher-quality service delivery, whereas the Ministry of Finance relies on evaluations for identifying savings and reducing the risks of budget overruns. Therefore, the Ministry of Finance cannot rely only on information from evaluations done by line departments.

Thus the Ministry of Finance needs to design the budget preparation process in such a way that information from evaluations is available at the right time in the right format, in order to assess new proposals and ongoing programmes. Without that information and a well-designed expenditure prioritisation process, ineffective, inefficient or low-priority programmes may continue to drain resources for years. The (ongoing) quest of the Ministry of Finance in the Netherlands is to establish a good evaluation system that not only provides information for spending ministries on how to improve the performance of their policies, but is also tailored to the needs of the political and budget decision makers at several key moments:

- Just before elections and the subsequent start of a new four-year government term in the Netherlands, the evaluation system needs to provide the political parties which are drafting election platforms and the politicians who are negotiating the Coalition Agreement with options for substantial policy and programme reforms.[3] At this moment, politicians require well-substantiated ideas to reduce spending in order to meet the agreed deficit target.
- At the start of the annual budget preparation process for the upcoming year's budget, evaluations ideally provide information on: *i)* the performance of ongoing programmes; *ii)* the costs and benefits of new spending proposals; and *iii)* ways to address budget overruns.

3. Legislative framework for the Dutch evaluation system

The Ministry of Finance is responsible for the overall institutional design of the evaluation system and, through legislation, assigns roles and responsibilities for its component parts. This arrangement was an explicit choice; other countries have chosen to design and institutionalise government-wide performance frameworks in, for example, the Ministry of the Interior or the Prime Minister's Office, or have set up an independent organisation.

3.1. Legislation governing roles and responsibilities

The main roles and responsibilities with respect to the effectiveness and efficiency of policies are set out in the Government Accounts Act (2001).[4] Each minister is accountable for how well his or her budget is spent. This accountability not only includes the confirmation that the funds were spent on what was intended, but also whether the policies for which the funds were allocated were effective and efficient. The act reflects the distinct roles and responsibilities of central budget makers and policy makers with respect to the formulation and implementation of the national budget and government policies.

The Government Accounts Act furthermore sets out how the roles and responsibilities are to be carried out. Each minister is required to conduct periodic reviews to assess policy effectiveness and efficiency, and must inform the independent Court of Audit of the findings of these reviews. The departmental annual financial reports require, for each budget section, information on the effectiveness and efficiency of the policies and programmes the section includes.

The legislative framework further highlights the role of the independent Court of Audit. This court is tasked with investigating whether central government revenues are received and money was spent correctly and whether policies are implemented as planned. The Court thus also assesses the effectiveness and efficiency of policies. If the Court of Audit finds that government policies fall short of intended results, it attempts to explain why.[5] The government can ask the Court of Audit to investigate certain policy areas, but more frequently the Court initiates its own studies.

It is important to highlight that the Government Accounts Act states that the Minister of Finance has the power to object to spending proposals because of the general budgetary situation, or on the grounds that a spending proposal is expected to deliver insufficient "value for money". As a result, decisions with budgetary consequences cannot be presented to the Cabinet or parliament before the Minister of Finance has given his or her opinion. In case of disagreement between the line department and the Ministry of Finance, decision making takes places in the Cabinet (Articles 12 and 16 of the Government Accounts Act, 2001). The act enables the Minister of Finance to substantially influence the spending of line ministries and to request information about the relevance, effectiveness and efficiency of (future) policies.

3.2. Legislation and regulations for evaluations

In secondary legislation, the Minister of Finance may further lay down specific rules and regulations to strengthen the system for evaluation. In general, these regulations are more specific for *ex post* evaluations than for *ex ante* ones. A reason is that *ex post* evaluations are an important instrument through which the accountability function of the budget is expressed.

3.2.1. Ex ante *evaluations*

Following the development of national guidelines[6] for cost-benefit analysis, the Cabinet set out rules for the use of such analyses. In a letter to parliament, the Cabinet stipulated that cost-benefit analyses should be done for national infrastructural investments, for projects of national importance (as deemed by the Cabinet), and for large regional infrastructure projects, if local authorities apply for national government funding (Tweede Kamer, 2000; and Ministry of Infrastructure and the Environment, 2012). The letter also explicitly stated that these national guidelines for cost-benefit analyses should be adhered to.

3.2.2. Ex post *evaluations*

There are three pieces of secondary legislation directly relevant to *ex post* evaluations. The "Regulation on Periodic Evaluation" (RPE) establishes a set of instruments and prescribes quality criteria to which *ex post* evaluations must adhere (Staatscourant, 2012). The Minister of Finance is responsible for the RPE. The RPE states that each line ministry is required to conduct a review of its policies every four to seven years for every budget article and to send the findings to parliament[7] (see policy review in Table 1). To guide ministries in reviewing their policies, the RPE provides a list of questions that must be addressed (see Box 2). In addition, the RPE stipulates that an independent expert or organisation must be involved in the review and must provide an opinion on the findings and methodology. This opinion is normally sent to parliament as an appendix to the review.

Table 1. **Evaluation system in the Netherlands**

Instrument	Description	Primary accountability (report/study "owned" by)
***Ex ante* evaluations**		
Social cost-benefit analyses	These types of studies analyse whether the net present social value of a particular public intervention exceeds its discounted social cost. This provides information to policy makers in order to determine whether policies are worthwhile and therefore justify public financing. Social cost-benefit analyses also provide information on which alternative is most effective and efficient. These studies answer questions such as: What are the costs and benefits to society? To whom do the benefits accrue and who bears the costs? Benefits and costs are as much as possible expressed in monetary terms.	Relevant ministry (most frequently the Ministry of Infrastructure and the Environment)
Other types of *ex ante* studies	Cost-effectiveness studies are not used to provide information on whether a policy is worthwhile. Instead, a goal or desired outcome is defined, and alternative interventions are appraised and ranked on the basis of costs. Business cases for investments in operational management in government agencies. For example, assessment of whether additional resources to the Tax and Custom Administration would result in additional revenues. Multi-criteria analyses to present the effects of alternative public interventions in a qualitative way.	Relevant ministry
***Ex post* evaluations**		
Policy review	Periodic evaluation (every 4-7 years) of policy areas (per policy article) to assess the effectiveness and efficiency of all current policies per budget article. A policy review provides an entry for findings of effect evaluations that have been carried out by the ministry or by external organisations. In this way, the policy reviews aim to give an overview of all pertinent information on the relevance, effectiveness and efficiency of current programmes.	Relevant ministry
Effect evaluations	Effect evaluations assess to what extent changes in policies can be attributed to a particular intervention. An effect evaluation is structured to answer the question: how would outcomes of well-being have changed if the intervention had not been undertaken? This involves counterfactual analysis.	Relevant ministry
Evaluations to identify savings and reform options		
Spending review	Review of selected policy areas, with the explicit task of identifying policy options for future savings and/or for more value for money. Terms of reference may contain compulsory savings option. Review contains *ex ante* and *ex post* evaluation elements.	Ministry of Finance
Comprehensive spending review	Multiple spending reviews carried out simultaneously. As a rule, each report must contain at least one option that reduces spending (by for example 20%) for a selected policy area. Used when the need for fiscal consolidation is urgent.	Cabinet (initiated by the Ministry of Finance)

Box 2. Regulation on Periodic Evaluation (RPE): Guidance questions for policy reviews

1. Which (part of the) policy article and corresponding expenditures does the policy review assess?
2. If applicable, when will other parts of the policy article be assessed?
3. What was the reason for the policy intervention? Is the reason still valid?
4. What is the responsibility of the central government?
5. What is the nature and coherence of the instruments used?
6. What are the expenditures for the policy, including related costs in other policy areas and programmes?
7. How are these expenditures substantiated? Can these be related to volume/use of services and prices and tariffs?
8. Which evaluations of policy have been carried out? How have these evaluations been carried out?
9. Which part of the policies has not been evaluated? And if so, please indicate reasons why certain policies cannot be evaluated.
10. To what extent does the available research allow for judgment on the effectiveness and efficiency of the policy under review?
11. Which impact and effects did the policy have? Were there any positive or negative unintended consequences?
12. How effective was the policy?
13. How efficient was the policy?

The second piece of supporting legislation, the "Budget Regulations" (RBV – see Ministry of Finance, 2012), prescribes how information and planning of periodic evaluations are to be reflected in the official budget reports with the purpose of enhancing transparency. Each ministry must publish a table in its annual budget report that shows the five-year planning of when each policy article will be reviewed. The RBV further stipulates that departments show in their annual budget other evaluations that are being conducted, including evaluations of subsidies.

The third piece of supporting legislation is the General Administrative Law (Article 4:24). Line ministries must evaluate subsidies at least once every five years. This information can be used by the government to decide whether to continue or to stop a particular subsidy. The method of evaluation is not prescribed in this law, but the basic quality criteria of the RPE apply.

4. The impact of evaluation instruments in practice

This section argues that information on policy effectiveness and efficiency as mandated by legislation and budget regulations can indeed be very useful for parliament and line ministries, but that for budget-type decisions additional instruments are needed. These instruments are not embedded in the formal legislative framework; nonetheless, they are widely used in practice.

4.1. *Overview of evaluation instruments in the Netherlands*

The current performance evaluation system consists of both *ex ante* evaluations (to underpin choices for the future) and *ex post* evaluations (for learning and accountability) and other instruments which consist of a combination of *ex ante* and *ex post* elements. Table 1 provides a description of each of the main types of evaluations, organised by the national government. The institution with primary responsibility for the report or study is also noted. Some of these evaluations can also be contracted out, for example to research institutions.

4.2. *Organisation of the evaluation instruments*

The commonality between all the different types of evaluations is that they have some linkage to the national budget, although the strength of this link varies. The identity of the "account holder" of the study is important, as it determines to a significant extent how the resulting information is packaged and its appropriateness and timeliness for the budget process.

Table 2 shows "when and how" the different policy evaluations are to be carried out (according to regulations set by the Ministry of Finance). Additionally, the principal for the

Table 2. **Institutionalisation of the policy evaluation system: "When and how"**

Instrument	Legislation governing the instrument ("when")	Procedures and rules ("how")	Principal for study	Specific role of the Ministry of Finance in the evaluation process
***Ex ante* evaluations**				
Social cost-benefit analyses	Compulsory for national infrastructural investments, for projects of national importance (as decided by the Cabinet) and for large regional infrastructural projects that apply for national funding.	Scientific handbook on methodology of (social) cost-benefit analysis. Cabinet determines the discount rate that studies must adhere to.	Ministry of Infrastructure and the Environment (or other line ministry, depending on the topic).	Budget Office chairs interdepartmental working group on methodology development. Director-General of the Budget chairs the committee to specify the discount rate.
Other types of *ex ante* studies	No	None	Relevant ministry.	None
***Ex post* evaluations**				
Policy review	Evaluations need to be carried out periodically (Government Accounts Act). Each policy field needs to be reviewed every 4-7 years (Regulation on Periodic Evaluation).	Regulation on Periodic Evaluation specifies content, specifies that independent experts need to be involved, and provides guidance to help the review team.	Relevant ministry.	Monitors programming of reviews. Budget Office chairs interdepartmental working group on methodology development and to share best practices.
Effect evaluations	Evaluations need to be carried out periodically (Government Accounts Act).	Some basic quality requirements in Regulation on Periodic Evaluation.	Relevant ministry.	None
Savings and reform options				
Spending review	No	Yes, informal procedural guidelines.	Cabinet	Initiates topics and draws up procedural guidelines. Civil servants of the Ministry of Finance and the Cabinet Office are members of all working groups.
Comprehensive spending review	No	Yes, informal procedural guidelines.	Cabinet (main responsibility lies with the Prime Minister and deputy Prime Ministers).	Idem

study and the specific role of the Ministry of Finance in the evaluation process is shown. In general, for those elements embedded within legislation, the Ministry of Finance's role as co-ordinator of the evaluation system is mostly one of setting rules determining when and how a review or study is to be carried out. This situation should not be surprising given that the Government Accounts Act firmly places responsibility for the review of policy effectiveness with the responsible minister. If the Minister of Finance requires more information, he or she may ask line ministries to carry out specific evaluations based on the general principle of the Government Accounts Act (see Section 3.2).

For savings and reform options, the Ministry of Finance takes its own initiative. It should be noted that the latter types of evaluation are based on informal guidelines rather than specific formal regulations.

4.2.1. Ex ante *evaluations*

The Cabinet decided in 2000 that: *i)* methodological guidelines are compulsory for social cost-benefit analyses; *ii)* the Cabinet determines when cost-benefit analyses are obligatory; and *iii)* the Cabinet specifies the discount rate.

The decision to initiate and conduct an *ex ante* evaluation lies with the line ministry (often the Ministry of Infrastructure and the Environment), but the Minister of Finance does have the power to request such a study based on the Government Accounts Act. In practice, this principle was frequently used in the period 1995-2007 to request adequate cost-benefit analyses for a number of large infrastructural projects.

The social cost-benefit guidelines, authored by the Netherlands Bureau for Economic Policy Analysis and other research institutions (Eijgenraam et al., 2000), are by and large followed by those carrying out social cost-benefit studies. There is a technical interdepartmental committee on social cost-benefit analyses, chaired by the Ministry of Finance and mostly concerned with sharing experiences and methodological aspects of social cost-benefit studies.[8]

For other *ex ante* evaluations, there are no procedures describing a specific role for the Minister of Finance in the evaluation process.

4.2.2. Ex post *evaluations*

The Government Accounts Act stipulates that line ministries need to evaluate the effectiveness and efficiency of their policy programmes on a regular basis. In addition, the Regulation on Periodic Evaluation sets basic quality requirements, such as: conclusions should be based on all relevant information, the evaluation method should be valid and reliable, and (an) independent expert(s) are to be involved.

With respect to policy reviews, the Ministry of Finance formulates regulations (RPE) and checks whether the programming of the policy reviews covers all policy areas. Apart from that, there is no formal requirement that the Ministry of Finance be part of the policy review team, although in some cases a ministry actively seeks involvement of staff members of the Ministry of Finance. Important to mention is that, while legislation states that policy must be reviewed periodically, there are no rules to decide which policy area is to be reviewed when. Such a decision is up to the relevant ministry. In principle the Ministry of Finance can comment on the programming of the policy reviews, as the schedule is part of the budget documents, but in practice the Ministry of Finance staff take a more procedural role in checking whether each policy article is planned to be reviewed.

There is, however, an interdepartmental committee on policy reviews that meets regularly, chaired by the Budget Office. This committee has no formal status, but officials from different ministries come together to share experiences and methodologies. With the recent update and improvement of the Regulation on Performance Evaluation, the committee was involved in outlining and detailing the technical recommendations for changes to the regulation.

With respect to effect evaluations, line ministries are free to choose the specific methodology and frequency. Apart from the already mentioned general quality requirements, no other specific regulations on the exact methodology and frequency apply. This is due to the large variety of interventions, the availability of data, and the corresponding (im)possibilities to quantify or analyse all effects.

4.2.3. *Options for savings and reforms*

In contrast, the Ministry of Finance initiates and takes a very strong organisational role for those elements of the policy evaluation system that are not strictly embedded within legislation, i.e. the (comprehensive) spending reviews. There are no rules regarding when a spending review might be appropriate and in which specific circumstances the government should consider a comprehensive spending review.

The topic, terms of reference and composition of a (comprehensive) spending review's working group are outcomes of a negotiation process which is anchored to the annual budget process. The Minister of Finance presents the proposed topics and corresponding terms of reference for the spending reviews at the Cabinet meeting when the budget for the upcoming year is decided. This Cabinet meeting is referred to as the "Comprehensive Decision Moment". The terms of reference for the (comprehensive) spending reviews are subsequently published in the budget documents on Budget Day (the third Tuesday in September every year) for consideration by the Dutch parliament.

4.3. *Impact of the Dutch policy evaluation system*

For the credibility and authority of the report and studies – and ultimately the impact on the budget – the way in which decision making is structured matters (see Table 3). First, mechanisms for quality control may enhance the usefulness of evaluations for budgetary decision making. Second, a specified role for the Minister of Finance, to ensure involvement in subsequent decision making, strengthens his or her general role of controlling and prioritising expenditures.

4.3.1. Ex ante *evaluations*

For the *ex ante* evaluations, the process is not currently ordered or centralised in any particular way.[9] These evaluations are important input for "go/no-go" decisions, but the final decision does not necessarily hinge on them. In particular, there is no process that automatically involves the Minister of Finance in decision making on individual infrastructure projects after completion of the cost-benefit analysis. Decision making does not always take place in the Cabinet. If the Minister of Finance has objections, he or she actively needs to intervene (and invoke the principles of the Government Accounts Act).

Furthermore, while there are detailed handbooks for guiding the methodology of the studies, there is no formalised process or committee to determine whether the study was done according to this methodology, nor for mandatory "second opinions" for large projects. This does not mean that such studies are not of high quality – and the studies may indeed carry substantial weight in budgetary decisions (Rienstra, 2008). Politicians can still decide to embark on a large infrastructural project, even if the cost-benefit analysis was negative, based on a different set of priorities and political convictions.

Table 3. **Impact on budgetary decision making of elements of the policy evaluation system**

Instrument	Impact on decision making	Quality control (technical)	Specific role of the Minister of Finance	Impact on budget
***Ex ante* evaluations**				
Cost-benefit analyses	Input for "go/no-go" decision, but decision does not hinge on the analysis. More influential on choice for best project alternative.	The Netherlands Bureau for Economic Policy Analysis (CPB) or other designated agencies may provide a second opinion for cost-benefit analyses of large projects. No other specific process for quality control.	No specific process to ensure involvement in "go/no-go" decision for individual infrastructural projects. Cabinet decides on projects of national importance.	Medium; somewhat higher impact for large investments.
Other types of *ex ante* studies	May provide input for choosing between alternative policy programmes.	None	As above.	Low to medium.
***Ex post* evaluations**				
Policy review	Depends. May provide impetus for policy changes. May provide input for spending review.	Independent expert writes opinion on quality as an annex to policy review. Cabinet decides whether policy review may be sent to parliament.	Cabinet decides whether policy review can be sent to parliament.	Low, with some exceptions.
Effect evaluations	Depends.	Not organised; depends on situation.	No specific process.	Low, because effect evaluations are uncommon; but the impact is potentially high.
Evaluations for saving options and reforms				
Spending review	Can be high, depending on need for reform. Impact usually highest in preparation for new Cabinet period.	Interdepartmental committee chaired by Director-General of the Budget checks whether report adheres to terms of reference and to quality guidelines.	Cabinet decides on "Cabinet's View" and on publication of spending review report. Report and "Cabinet's View" are published together.	High, depending on need for reform (more effectiveness and efficiency) or for fiscal consolidation.
Comprehensive spending review	Can be high, when organised in case of need for fiscal consolidation. Impact usually highest in preparation for new Cabinet period.	Yes, idem.	Cabinet decides on publication of spending review report ("Cabinet's View" is possible, but not necessary).	High, depending on need for fiscal consolidation.

4.3.2. Ex post *evaluations*

The situation is somewhat different for the *ex post* evaluations, namely the policy reviews. While the legislation is very clear on the programming and publication of the policy reviews and on general quality criteria which need to be adhered to, the process for ensuring that learnings find their way into potential policy adjustments is not comparably structured. As a result, some policy reviews may provide considerable impetus for policy adjustments and garner public attention while others are hardly discussed (see Box 3 for an example of a review which had significant impact on policy and the budget).

Box 3. Impact of the policy review "Labour Market Reintegration"

In 2007-08, the Ministry for Social Affairs conducted a policy review on labour market reintegration policy. In the period under review (2002-05), annual spending on reintegration efforts by the Dutch government averaged EUR 2.6 billion. Each year, around 150 000 to 200 000 individuals enrolled in a reintegration programme.

The first part of the policy review re-examined why government involvement in reintegration is advantageous for society as a whole. The costs of the long-term unemployed or those on welfare are both economic and social, for example: lower labour market participation and lower economic growth, higher expenditures on unemployment benefits and welfare, more petty crime, higher health-care costs and social exclusion for the long-term unemployed. Even though seven out of ten unemployed persons normally find a new job on their own, government involvement was deemed necessary to prevent the other three from becoming long-term unemployed.

In the period reviewed, the reintegration policy consisted of many different instruments, from mediation between employers and the unemployed and placement in a reintegration programme (often carried out by private enterprises) to education, school-to-work projects, "work first" programmes, employer subsidies, continuation of benefits while working, and so on. Important to mention is that local governments, who are responsible for paying welfare benefits, have an incentive to get people out of welfare and into work: the saved money on welfare benefits can be reallocated to other priorities.

Based on earlier research, the policy review found a high gross effectiveness of the reintegration policy. In 2002, about 25% of the entrants found a job within two years. By 2004, the success rate was 40%. The gross effectiveness does not measure whether finding a job is the result of the reintegration efforts. The net effectiveness, therefore, was much smaller. The policy review found only a small net benefit of reintegration policies. The effectiveness also varied with the type of instrument and the recipient: the long-term unemployed benefit more than the short-term unemployed, the success rate is higher for females than for men, schooling alone is less effective than schooling combined with work, and tailored approaches work better than generic programmes.

After completion of the policy review, spending on the reintegration policy was reduced. In addition, the results of the policy review were used to fine-tune and improve existing policies. The length of unemployment benefits was shortened, the number of tailored reintegration programmes was increased (less high-volume contracts but more standardised programmes), collaboration was improved between the government and employers, a focus was put on the groups where the success rate is highest, and more scope was given for employer subsidies when they employ someone from a reintegration programme. These actions show that a thorough review provides relevant information for policy improvements, but also makes spending departments more vulnerable for future budget cuts, thus providing mixed incentives for future reviews.

The relatively low impact of policy reviews so far is also related to the current lack of information on effectiveness and efficiency in the reports.[10] In a study in 2012, the Court of Audit found that effectiveness was evaluated in only half of the policy reviews that were done, even though this is the explicit purpose of the reviews (Algemene Rekenkamer, 2012). Some civil servants may still happily engage in hallelujah storytelling instead of critical analysis.

Effect evaluations[11] can have a significant influence on budget decision making, but are not common. In the above-mentioned study in 2012, the Court of Audit also found that just about half of all policies have been evaluated for effectiveness in the period 2006-10 (Algemene Rekenkamer, 2012). This percentage may be too optimistic, as the quality of these evaluations was not taken into account in the study. According to the Court of Audit, it is not always clear why a certain policy area was not evaluated, and neither was parliament always adequately informed why an evaluation was not carried out.

A quasi-experimental design is needed to measure net effects, and this requires a careful construction of data. This type of evaluation is expensive and thus might not make sense for smaller programme areas. In these cases, other methods can be used to assess whether it is plausiblethat a policy is effective – for example, comparisons to similar policies abroad, case studies or systematic questioning by independent experts. For some policy areas (such as the availability of a national defence system), it is hardly possible to determine the degree of effectiveness. As information on effects needs to be available before efficiency can be evaluated, evaluations of efficiency are even more rare.

To stimulate the quality of effect evaluations – and because of pressure from the Court of Audit to improve the policy review instrument – it was agreed to clarify the quality regulations (a new RPE was recently published and came into effect in January 2013) and to strengthen the process for finalising the reports. In mid-2012, it was decided that the Cabinet will consider each policy review before it is sent to parliament, in order to ensure that the government takes note of the findings. This is in addition to the biannual letter that the Minister of Finance sends to his/her colleagues to monitor the progress of completion of spending reviews according to plans as published in the budget report. Hopefully, these modifications will help to improve the quality of the policy reviews in the near future.

4.3.3. Options for savings and reforms

Table 3 also shows that instruments aimed at designing savings and reform options and initiated by the Ministry of Finance arguably have the highest potential impact on the budget. These instruments are not embedded within formal legislation and regulations, but are guided by well-understood procedures and practices.

Moreover (but not shown in the tables), and even more loosely regulated, there are *ad hoc* working groups of top-level civil servants of both the Ministry of Finance and line ministries. These working groups may be constituted during the year to provide savings and reform options to both the spending minister and the Ministry of Finance, to deal with a specific budgetary problem or risk.[12]

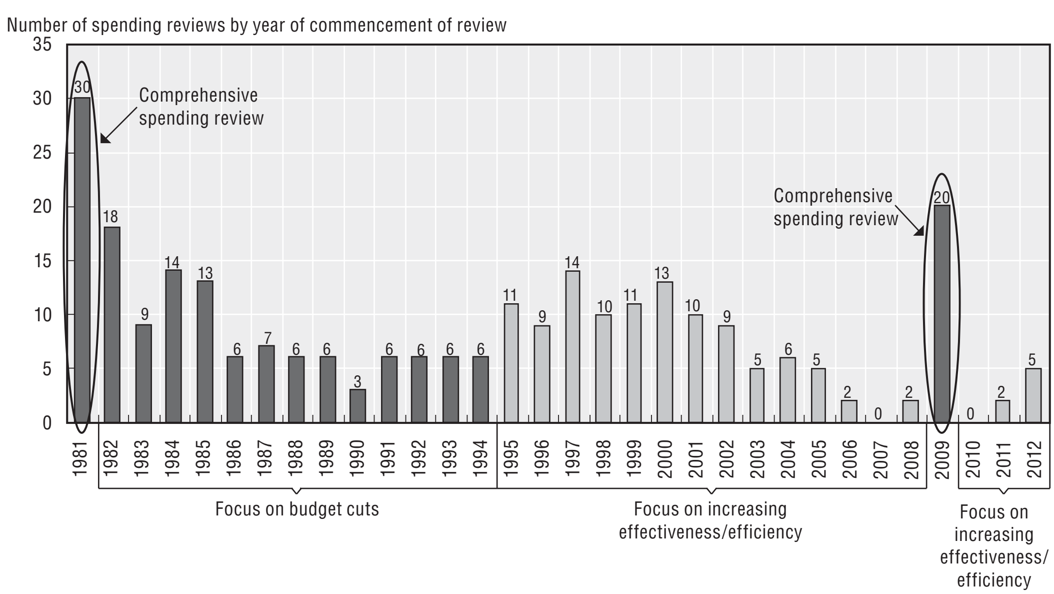
Finally, it is noteworthy that the Ministry of Finance not only derives options for savings and spending prioritisation from the entire evaluation system, but also from many other sources such as studies by (international) research institutions and the ideas of Ministry of Finance staff themselves, including suggestions for across-the-board spending cuts. These options are used by the Minister of Finance in the annual budget preparation process and may also provide input for the preparation of a new government term (elections and Coalition Agreement). As Sections 4.4 and 4.5 describe in more detail, the reports from both the spending reviews and the comprehensive spending reviews are extensively used.

4.4. *Spending reviews*

This sub-section describes the spending reviews in the Netherlands in some detail with respect to organisation, structure, involvement of the Ministry of Finance and impact. The purpose of the spending reviews is to provide alternative policy options for the future, including budgetary estimates. In principle, a spending review provides options for spending reductions or more value for money, and is not meant to present options that will result in structural additional costs. Each spending review must be underpinned by a thorough analysis of the effectiveness and efficiency of the policy area under review. The idea is that relevant findings of the policy reviews and other types of evaluations enter into the spending review through the analysis chapter. In addition, the spending review working group makes use of relevant international research, data, international comparisons, expert opinions, process information, and so forth. Perhaps the two most important rules are that *i)* the analysis and policy options can be contrary to the current policies and plans of the current Cabinet, and *ii)* the spending review reports have an independent, analytical, non-political status.

The spending review instrument was introduced in 1981 and, although related procedures have been altered, the purpose and operation of the instrument has not changed significantly. Figure 1 shows that the number and focus of spending reviews have varied over the past three decades. In the early years, the spending reviews concentrated on budget cuts, while during the mid-1990s the focus changed to concentrate more on value for money by increasing the effectiveness and efficiency of spending. The fall in the number of spending reviews during the 2000s can to some extent be explained by a different prioritisation of instruments by the Ministry of Finance. The two comprehensive spending reviews – the first in 1981 and the second in 2009 – were directly connected to the Cabinet decision to respond to a severe deterioration of public finances by carefully considering what expenditures can intelligently be cut (instead of across-the-board budget cuts).

Figure 1. **Spending reviews since 1981 (270 completed)**



Source: Ministry of Finance, Netherlands.

As discussed in the previous section, there are no rules determining the topic of a spending review: the choice of topic is an outcome of an annual negotiation process between the Ministry of Finance and the spending ministries, anchored to the budget negotiations. Ultimately it is the Cabinet that decides upon the topics for review for the upcoming year and presents these topics and terms of reference to parliament in an annex to the annual budget. Nonetheless, there is consensus that a topic for a review should have an interdepartmental nature, budgetary significance, and reasons for concern regarding effectiveness and efficiency of spending. For political commitment and support (and to ensure impact), it is important that spending review topics include all ministries during a four-year Cabinet period.

While there are no specific rules for a topic to be reviewed, the internal process led by the Ministry of Finance for topic selection, drafting of terms of reference and decision by the Cabinet is well-structured and understood. The spending review topics and terms of reference are explicitly decided during the same Cabinet meeting on the annual budget for the upcoming year. Depending on the topic, the terms of reference may prescribe at least one compulsory policy option which reduces spending significantly. Because the Cabinet is the principal of the spending review, the Cabinet will decide to send the report to parliament together with the "Cabinet's View". The Cabinet does not make alterations to the report itself. It is up to parliament if and in what form it will discuss the study and the corresponding "Cabinet's View".

The composition and organisation of the spending review working groups are significant elements of the success of the review. Of primary importance is that working groups are non-political and consist of civil servants and independent experts. The independent chairperson is normally a current or former director-general or an individual with similar stature responsible for a non-related policy area. Members of the working group are at the level of director or higher, and the Ministry of Finance and the Prime Minister's Office are as a rule represented in the working group. The spending review work is supported by a specific secretariat in which the most-involved department and the Ministry of Finance are represented. External experts – for example, from the planning bureaus – may be invited to participate in the working group to add expertise.

The key rule for spending reviews is that no working group member may "veto" another member's idea. This ensures that the Cabinet (and ultimately the wider public) is presented with a range of alternative policy options. Before a report is finalised, an interdepartmental committee chaired by the Director-General of the Budget checks whether procedural guidelines have been followed, whether the technical quality of the report meets minimum standards, and whether the report adheres to the terms of reference.

In general, it can be said that the spending reviews have had a catalysing impact on policy changes (perhaps that is why the choice of spending review topic and terms of reference is a toughly negotiated process). Recent examples of policy changes that have been inspired by spending review reports are: changes to financing of academic hospitals, large-scale reforms of unemployment benefits, and reforms and rationalisation of income-support regulations for households with children.

4.5. *Special case: Comprehensive spending reviews (2009/10)*

In 2009, 20 spending reviews were carried out simultaneously, also known as the Comprehensive Spending Review. In response to the severe deterioration of the economic and financial situation in the Netherlands, a temporary stimulus package was announced. Just after this package was negotiated, the Prime Minister and the Minister of Finance argued that a structural cost-cutting package would be critical to get public finances back on track. Given the circumstances, they argued that the package would need to contain fundamental policy choices, as across-the-board cuts in spending do not take into account the relevance, effectiveness and efficiency of spending.

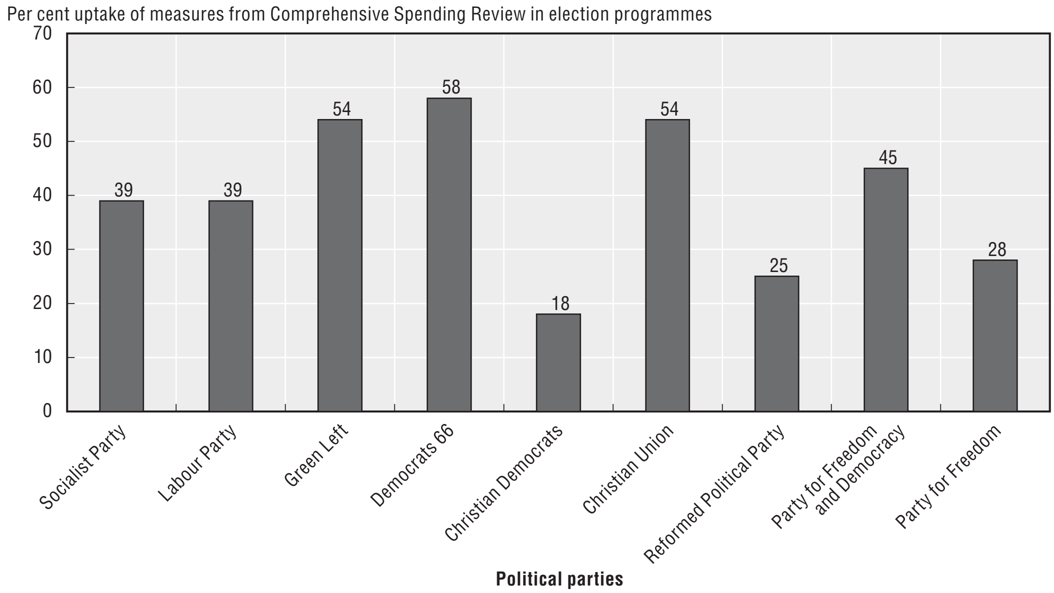
The topics and terms of reference of the Comprehensive Spending Review covered areas from defence spending to employment programmes for unemployed youths.[13] A common element in all the terms of reference was a compulsory option resulting in a 20% structural reduction in spending within the specific policy area. The Prime Minister and the two deputy Prime Ministers were responsible for the spending reviews. Their job was to oversee the process and to ensure that the working groups submitted all relevant information and analyses.

The Comprehensive Spending Review has had a significant impact on both the election platforms of the different political parties and on the subsequent Coalition Agreements. Figure 2 shows that the reports were extensively consulted by the political parties and used to draft their platforms during the 2010 elections. It is estimated that around 20% of the measures contained in the 2010 Coalition Agreement were directly taken from the Comprehensive Spending Review reports. Examples were one national police force, changes to the medical benefit package, and consolidation of employment programmes. Aside from the quality of the technical policy options, the success of the (comprehensive) spending reviews can be explained by the fact that they respect the roles and responsibilities of politicians and civil servants: politicians select policies and priorities, and civil servants prepare options and assess their impact in an objective and analytical way.

While the spending review reports were widely read and discussed by the public, it is interesting to note several common misperceptions. One of these was that the exercise was meant to cut total public spending by 20%. The compulsory 20% savings option was chosen to encourage creativity and think boldly. The second misperception was that it was only about spending. This was not true, as tax expenditures were also explicitly part of the terms of reference. Furthermore, some organisations had hoped that themes that were not part of the Comprehensive Spending Review would be ring-fenced from savings. This was not the case. Politicians have their own convictions regarding the relevance of different kind of expenditures. For example, in 2010 the new Cabinet decided to cut funding to the culture sector by more than 25%. The decision was not based on the Comprehensive Spending Review. Instead, this decision was a reflection of a new political priority.

The Comprehensive Spending Review unleashed a lot of energy, predictably within the Ministry of Finance but also within line ministries. Due to the involvement of line ministries and external experts, the exercise enjoyed more technical credibility than if it had been only a Ministry of Finance exercise. Even so, the process also brought to light the fact that, for a range of topics, little is known about the effectiveness and efficiency of spending – and that spending data at a more detailed level are not readily available.

Figure 2. **Influence of the Comprehensive Spending Review 2009/10 on the platforms of Dutch political parties during the 2010 elections**



Source: Ministry of Finance, Netherlands.

5. Reflection on the policy evaluation system: Lessons and challenges

What lessons can be drawn from the experiences in the Netherlands for finance ministries in other countries?

Because the Dutch budgeting system is decentralised, the Ministry of Finance has information asymmetry *vis-à-vis* the line ministries on the effectiveness and efficiency of current policies, and on options for savings or more value for money. Line ministries have accurate and detailed knowledge regarding their policies, which means that the Ministry of Finance is reliant on line ministries to understand which programmes are no longer relevant, which ones can be terminated because they are not effective, which ones can be made more efficient, or which programmes (still) justify their costs.

In the Dutch tradition of coalition governments, substantial policy reforms and termination of policies are normally part of the Coalition Agreement. This implies that the need for information on the effectiveness and efficiency of policies and on options for larger reforms is very intense just before national elections (once every four years, or more frequently if early elections are called). The annual budget process in this setting mainly serves to adjust policies and total spending to changing circumstances.

The type of information that is needed at the start of a new government term, compared to the annual budget process, is thus of a different nature: every four years, evaluations need to be available as input for significant policy reforms (for example, changing the nature and eligibility of unemployment benefits), whereas within this period information is more about adjustments (for example, savings that may be generated by increasing the deductible for medical expenses).

From the perspective of the Ministry of Finance, the evaluation system must be tailored to the budgeting system. Key elements for the Ministry of Finance are: *i)* flexibility in and choice of instruments; *ii)* timing of the evaluation reports with respect to the

Cabinet period and the annual budget process; and *iii)* selectivity (focusing on those policy areas that matter and where changes are politically possible).

A key lesson has been that the Ministry of Finance – in addition to setting specific regulations for evaluations organised by spending ministries – must also initiate its own instruments. Spending reviews and comprehensive spending reviews mainly serve this purpose in the Dutch system. These instruments enable the Minister of Finance to identify more easily which policies and programmes may be ended, how policies can be organised more efficiently, or which policies justify the corresponding costs. A necessary condition to ensure potential impact is a high-level principal for these instruments (namely the Cabinet in the Netherlands).

It is noteworthy that these latter instruments have been part of the Dutch system for many years, but are not encapsulated in specific legislation. It is important to emphasise, however, that this does not mean that a government-wide evaluation framework is unimportant. What does appear to be an important lesson is that, for the budget to function as a tool for expenditure prioritisation, a variety of elements and instruments are needed. In government-wide evaluation frameworks – such as described in the Government Accounts Act and the Regulation on Periodic Evaluation – the emphasis is on a wide and systematic coverage of policy areas, for example in the form of a requirement that all programmes (i.e. each budget article) are subject to an evaluation (policy review) over a certain time frame. These kinds of evaluations not only help ministries to improve their policies over time, but also provide the basis for the evaluation instruments that the Ministry of Finance needs to tailor information to the budgetary process.

A second key lesson is that some rules regarding quality and quality control may enhance the relevance and credibility of evaluations for budgetary decision making. For the credibility of the evaluation reports, it is important to draw a clear distinction between the technical evaluation phase (independent from current political preferences) and political decision-making processes.

Third, for a well-functioning policy evaluation system with impact on the budget, it is essential to find a balance regarding what to embed within rules and regulations, what to leave to negotiations, and what instrument is most appropriate to address which problem. Equally important, the policy evaluation system must respond to the needs of politicians and budget decision makers. Elements of the evaluation system not necessarily embedded in the legislative framework, but which are based on well-understood practices, have arguably more impact on budget decision making. Stricter formal regulations are not the answer to the problem of information asymmetry.

Fourth, the disincentive for a ministry to share information with the Ministry of Finance remains, as the content of the information may result in additional budget reductions (compared to those of other ministries). This disincentive has proven to be very difficult to solve within the context of the Dutch decentralised budget system and cannot be fully tackled by rules and regulations. This problem complicates evaluations, as the information from the ministries is an essential input for such studies. The Ministry of Finance tries to deal with this incentive problem in three ways:

- by using a variety of information sources (such as information from independent research institutions like the Netherlands Bureau for Economic Policy Analysis (CPB), universities, the OECD, and so forth);

- by involving independent experts in evaluations, ranging from independent chairpersons (for spending reviews) to a quality check by independent experts (for policy reviews);
- through specific tasks assigned by the Cabinet (i.e. in comprehensive spending reviews or similar projects) which oblige civil servants to work together and to share relevant information during this process.

Despite efforts to overcome this incentive problem, and even with the diverse types of evaluations carried out in the Netherlands, good information on relevance, effectiveness and efficiency in the right format at the right time is still not abundant: effect evaluations are scarce, the quality of policy reviews needs to improve, cost-benefit analyses are not yet strongly embedded in subsequent budgetary decision making, and spending reviews also vary in quality as they depend on input from other evaluations.

In the end, it is the politicians themselves who decide which spending to cut or to increase, based on their own priorities and assessment of the relevance of programmes. The evaluation system in the Dutch setting described in this article merely provides important input.

The purpose of this article was also to highlight ideas and practicalities for a budget office within a finance ministry and to indicate what works, what does not, and what should be considered when designing a policy evaluation system with linkages to the budget process. See Box 4 for several "tips and tricks" based on experiences in the Netherlands.

Box 4. **Tips and tricks for finance ministries and other central ministries, based on experiences in the Netherlands**

- Link the evaluation system with the budget cycle to ensure impact.
- Create instruments that identify savings options as well as options for more value for money, and involve a high-level principal (such as the Cabinet) to overcome information asymmetry and to make good use of existing evaluations.
- Collaboration with other ministries is a necessary condition for the quality of the analysis and policy options.
- Evaluate the evaluation system periodically.
- Be flexible and do not rely on just one instrument.
- Do not be impatient: a good evaluation system does not necessarily result in good policy immediately, but may over time – for example, at the start of the next Cabinet period.
- Resistance to evaluations and reviews is to be expected (especially when the evaluations and reviews are integrated with the budget cycle).
- Selection of appropriate staff is important: there should be a mixture of analytical and research capacity (introvert) and staff with the ability to network, to deal with resistance and to operate in a fluid environment (extrovert).

Notes

1. To fully appreciate the scope and reforms to the Dutch budgeting system, please refer to Jong et al. (2013).
2. Members of the Advisory Group on Fiscal Policy are senior officials from several ministries such as Finance, Health, Welfare and Sports, Interior, Economic Affairs, Social Affairs and Employment, and the Prime Minister's Office, and also from the Netherlands Bureau for Economic Policy Analysis and the Dutch Central Bank.
3. In the Dutch tradition, the platforms of all the political parties are validated by the Netherlands Bureau for Economic Policy Analysis (CPB): Do the numbers add up? What is the effect on economic growth, unemployment, the budget deficit, etc.?
4. Comptabiliteitswet 2001 [Wet van 13 juli 2002 tot vaststelling van de Wet inzake het beheer van de financiën van het Rijk (Comptabiliteitswet 2001)]; see also *www.wetten.nl*.
5. Frequently cited reasons are: the policy goal was not formulated clearly enough; the policy contains rules that are too complicated or restrictive in practice; the minister does not provide sufficient funding to the institutions that must implement the policy; the minister exercises too little control on the implementation of policy; and broader societal developments indicate that a policy's impact is not the intended impact.
6. See Eijgenraam et al. (2000). Since 2000, several additions have been made to these guidelines.
7. This requirement was introduced in 2006 to address shortcomings with the VBTB reforms.
8. Currently, a national guideline for social cost-benefit methodology is being redeveloped to include new academic insights and to broaden its applicability to non-infrastructural sectors such as health care and social protection.
9. There was a high-level committee from 1992-2007 that had a formal role in advising on infrastructural projects. The use of cost-benefit analyses on large infrastructural projects played an important role in its activities. The Netherlands Bureau for Economic Policy Analysis was part of this committee.
10. This situation has not changed significantly over the past few years. An evaluation of the VBTB reforms carried out in 2004 had similar conclusions.
11. Examples of recent effect evaluations carried out by the Netherlands Bureau for Economic Policy Analysis are: child-care subsidies and female labour force participation; innovation vouchers; subsidies for research and development for companies; and environmental policies.
12. Examples are the Task Force on Controlling Health-Care Spending (2012) and the Working Group on personal budgets to purchase long-term health care. These types of working groups normally follow procedures similar to the spending reviews: the terms of reference are usually a joint agreement by the relevant line minister and the Minister of Finance. Almost as a rule, senior staff of the Ministry of Finance are member(s) of the working group.
13. The following 20 policy areas were subject to the spending reviews: 1. Energy and climate; 2. Environment and nature; 3. Transport and water management; 4. Housing; 5. Child benefits; 6. Productivity in education; 7. Higher education; 8. Innovation and applied research; 9. Income support and employment programmes for people with few skills; 10. Unemployment benefits; 11. Curative care; 12. Long-term care; 13. Official development co-operation; 14. Asylum, immigration and integration; 15. Public safety and terrorism; 16. Tax administration; 17. Administration of income support; 18. Public administration; 19. Operational management in public sector institutions; 20. International security.

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Aggregate expenditure ceilings and allocative flexibility

by
Marc Robinson*

This article shows how to combine top-down budgeting – in the core sense of the establishment of a hard aggregate expenditure ceiling at the start of the budget preparation process – with flexibility in the allocation of the aggregate ceiling between spending ministries during budget preparation. It argues strongly against determining spending ministry shares of the aggregate expenditure ceiling without any prior opportunity for them to present formal new spending proposals. The keys to reconciling top-down budgeting with allocative flexibility are: the baseline/new policy distinction; good forward estimates; a government-wide new policy pool; and spending review.

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Keywords: Fiscal policy, budget preparation process, top-down budgeting, expenditure ceiling, bottom-up spending requests, fiscal space, multi-year ceilings, baseline ceilings, allocative efficiency, aggregate fiscal discipline, budgeting techniques

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1. Overview

Top-down budgeting is today widely regarded as a key element of good budgeting practice, and with good reason. In its core sense, agreed by all, top-down budgeting calls for the budget preparation process to be framed by a hard aggregate expenditure ceiling – approximately speaking, a limit which applies to the totality of government expenditure. The aggregate ceiling should be set in a top-down manner, which means that it is set at the start of the budget preparation process prior to any consideration of "bottom-up" spending requests from spending ministries. It should also be hard in the sense that, once set, it is essentially not varied during the budget preparation process. Establishing and enforcing such an aggregate expenditure ceiling is today generally viewed as crucial to ensuring that aggregate expenditure does not grow faster than is consistent with government's aggregate fiscal policy objectives, and in particular with deficits and debt discipline.

The view that hard aggregate expenditure ceilings should be set during the budget preparation for next year's budget represents common ground among all proponents of top-down budgeting. Some, but not all, top-down budgeting advocates go further and argue that the same should apply to the aggregate expenditure ceilings established for the outer years of the medium-term expenditure framework. In other words, they suggest that outer-year aggregate expenditure ceilings should also be hard, as is the practice in countries such as the Netherlands and Sweden. Such hard medium-term aggregate expenditure ceilings are seen primarily as a means of preventing pro-cyclical increases in expenditure during the upswing of the business cycle. This is essentially the same as the justification of expenditure rules.

All of this pertains to aggregate expenditure ceilings. However, there is a school of thought which advocates the application of the top-down approach not only to aggregate expenditure, but also to setting budget allocations of individual ministries. In other words, individual ministry shares of the aggregate expenditure ceilings also should be set in a purely top-down manner before ministry spending requests are considered. During the preparation of the annual budget, these ministry ceilings should in this view be hard, with ministries either barred or heavily discouraged from presenting spending plans which breach the ceilings they have been given.

Some among this school of thought go even further and suggest that hard top-down ministry ceilings should be set not only for the coming budget year, but for the outer years of the medium-term framework. In other words, they argue that in, say, 2013, the government should set hard ceilings for the Ministry of Health and all other spending ministries not only for FY2014, but also for FY2015 and FY2016.

This view has arisen as a simple response to the very real challenge of how to prepare the budget in the context of an aggregate expenditure ceiling. If one sets a hard aggregate expenditure ceiling, the practical challenge during budget preparation is how to share the aggregate ceiling between ministries, all the while ensuring that the ceiling is not exceeded. This is no trivial matter. The imposition of the aggregate ceiling is intended to contain the upward pressure on spending arising from large numbers of "bottom-up" spending requests from ministries during the budget preparation process. However, unless processes exist to contain ministry requests in some manner, budget decision makers may be tempted to increase the aggregate ceiling during the budget preparation process in order to escape the tough zero-sum constraint imposed by an aggregate ceiling.

This article challenges this school of thought. While strongly endorsing top-down budgeting in its core sense of the use of hard aggregate expenditure ceilings, the article rejects the application of a simple top-down approach to the allocation of the aggregate expenditure ceiling between individual spending ministries. It argues against setting ministry allocations before ministries have the opportunity to formally present spending proposals.

Moreover, with respect to the setting of ceilings for the outer years of the medium-term expenditure framework, this article suggests that setting hard outer-year ministry ceilings is appropriate only in a minority of relatively advanced countries. In most countries, outer-year ceilings should be indicative rather than hard.

The key problem with an entirely top-down process for setting ministry ceilings is that it can seriously undermine the pursuit of allocative efficiency by making ministry shares of the aggregate expenditure ceiling more rigid. Setting hard ministry ceilings before spending ministries have had the opportunity to present formal new spending proposals deprives the budget preparation process of an information input which is absolutely essential if government is to optimise the allocation of its limited resources. A completely top-down approach to setting ministry ceilings might appear to score high on the criterion of aggregate fiscal discipline. However, budgeting techniques should not be judged solely on this criterion, but also on the extent to which they promote improved expenditure effectiveness and efficiency. Microeconomic considerations should be given as much weight as macroeconomic ones.

In the light of this problem, the article turns to the best means of resolving the tension between a purely top-down aggregate ceiling and the bottom-up pressure for spending increases during the budget preparation process. The article outlines certain budget preparation techniques which can ensure that ministry allocations do not in total exceed the aggregate ceiling while at the same time preserving and enhancing flexibility in the reallocation of resources between ministries. In particular, it argues for:

- the use of the top-down approach to setting ministry baseline ceilings – that is, the component of their budget allocations designed to cover existing programmes and capital projects;
- the treatment of the available fiscal space – the funds available for new spending – as a government-wide new policy pool, to be allocated during the budget process taking into account ministry new spending proposals;
- the systematic scrutiny of ministry baseline expenditure via spending review to increase fiscal space through both efficiency savings and cuts to low-priority and irredeemably ineffective programmes.

The structure of the article is as follows. First, the scene is set by clarifying the concept of expenditure ceilings and briefly noting the benefits of setting an aggregate ceiling. Then the focus shifts to the process for setting ministry allocations consistent with the aggregate ceiling. The notion of top-down setting of ministry ceilings is critiqued, and an alternative approach outlined. In this context, brief consideration is given to the situation of less advanced countries which may not be able to fully implement relatively sophisticated budget preparation techniques. The article then turns to the question of medium-term ministry ceilings, considering the pre-conditions for an effective system of hard medium-term ceilings and the implications for countries which do fulfill those pre-conditions. Concluding remarks follow.

2. What is an expenditure ceiling?

Expenditure ceilings are quantitative upper limits on the amount of expenditure which are set for specific years and which are applied during the budget preparation process. For example, if a government decides early in the budget preparation process that aggregate government expenditure excluding interest payments will not exceed USD 380 billion in the coming year, it is setting an (aggregate) expenditure ceiling. Expenditure ceilings should not be confused with the expenditure limits set by parliament when it passes the budget law and which limit expenditure only during the execution of the budget. An expenditure ceiling constrains budget preparation as well as budget execution.

An aggregate expenditure ceiling is a limit which covers all or most government expenditure.[1] A ministry expenditure ceiling, analogously, is a limit which covers all or a large portion of the ministry's expenditure.[2]

A hard expenditure ceiling is, roughly speaking, a ceiling which is intended to be fixed and not open to variation during the budget preparation process. By contrast, an indicative ceiling is a ceiling which is understood as being open to some degree of modification during budget preparation but which is nevertheless expected to have some constraining impact on the levels of expenditure approved in the budget when it is finalised (otherwise it would not make sense to call it a "ceiling"). Both types of ceilings may be contrasted with expenditure forecasts – also known as forward estimates – which are mere projections and are not necessarily intended to influence or determine in any way the future evolution of expenditure (unless, of course, used as the basis for setting ceilings).

Expenditure ceilings are different from expenditure rules, which may be defined as limits on expenditure which are formulated in such a manner as to have continuing application.[3] A commitment that government expenditure will not exceed 35% of GDP is, for example, an expenditure rule. Expressed differently, an expenditure ceiling which applies to year n implies nothing about the limit, if any, which might apply to year n + 1. By contrast, an expenditure rule is formulated in such a manner as to apply to both years and subsequent years.[4]

Any expenditure rule must be given effect through the setting of expenditure ceilings for specific years, which are consistent with the expenditure. For example, if the expenditure rule is that aggregate expenditure will not exceed 35% of GDP, then at the start of the preparation of the FY2014 budget it will be necessary to calculate the dollar value of aggregate expenditure which this equates to during FY2014 and to then apply this as an aggregate expenditure ceiling. So if there is an expenditure rule, there must also be expenditure ceilings. The converse is not true, however: expenditure ceilings may be set even if there is no expenditure rule.

3. Why aggregate expenditure ceilings?

As noted above, the fundamental rationale for setting aggregate ceilings is to ensure that the ministry allocations decided in the budget preparation process are consistent with aggregate fiscal policy objectives. In the top-down process, the highest executive budget decision-making institution (which we will call the "Cabinet" as shorthand[5]) sets an aggregate ceiling which reflects macro-fiscal and revenue policy objectives prior to any consideration of ministry spending requests (Ljungman, 2009).

On the other hand, the main rationale for setting multi-year aggregate ceilings is to ensure that expenditure does not rise in tandem with purely cyclical revenue increases during the boom phase of the business cycle – in a way which would be possible if only budget deficit rules applied – leading to the structural deterioration of public finances. In addition, multi-year aggregate ceilings might also be employed to support medium-term debt reduction or tax reduction objectives (EC, 2010). To achieve any of these objectives, it is clearly important that the multi-year ceilings are hard rather than purely indicative. The use of hard multi-year aggregate ceilings was pioneered by Finland, the Netherlands and Sweden, but is increasingly now being extended to other countries. For the same reasons, there is growing support for the use of expenditure rules, such as the new EU approach which (simplifying) limits growth in aggregate expenditure to the trend growth rate of GDP.

4. Setting ministry shares of the aggregate ceiling

Once the case for aggregate ceilings is accepted, the question arises of how to operationalise them in the budget preparation process. On this question, there is a school of thought which holds that the answer is a two-stage budget preparation process in which, first, both the aggregate and ministry ceilings are set by the Cabinet and, second, ministries prepare detailed budgets within the ceilings given to them. In Tommasi's words (2010:89), there should be:

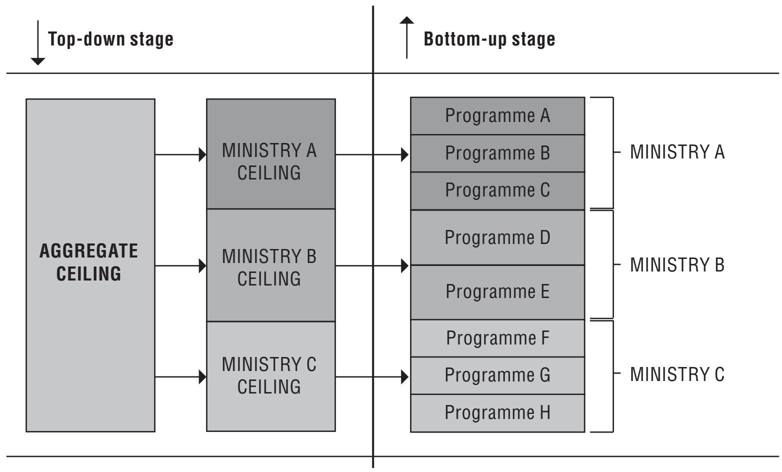
- "a 'framework' stage – often referred to as the 'strategic' phase – during which are determined the overall budgetary objectives (total expenditure, deficit, etc.) and the sectoral allocation of resources, including ministry expenditure ceilings…
- a stage of preparation by ministries of detailed expenditure estimates which respect the ministry ceilings which were set … during the strategic phase."

In this formulation, the determination of ministry ceilings becomes – like the setting of the aggregate ceiling – a top-down process in which ministries are quite deliberately excluded from presenting spending proposals before the ministry ceilings are set. The "bottom-up" part of the budget preparation process is entirely or largely restricted to ministries making proposals as to how they will spend their respective ceilings (Renzio and Smith, 2005; Kim and Park, 2006:88). As this implies, the ministry ceilings, once set, are hard during the preparation of the annual budget.

This wholly top-down view of how ministry ceilings should be set may be described graphically in Figure 1, where the preparation by each spending ministry of its budget estimates within the top-down ceilings allocated to it is represented as a process of proposing an allocation of its ceiling between the programmes for which it is responsible.

A variant on this approach calls for hard sectoral ceilings, rather than ministry ceilings, to be set in a top-down manner at the strategic stage. Sectoral ceilings cover several ministries, and in this variant of the process the allocation of each sectoral ceiling

Figure 1. **The top-down view of how to set ministry ceilings**



between sector ministries is determined in the second stage of the budget preparation process (e.g. Schiavo-Campo and Tommasi, 1999, Chapter 4:8). This model draws its inspiration from the "sector-wide" approach which Canada briefly applied to the expenditure allocation process before abandoning it (Good, 2007). For simplicity, this article focuses on the version of the model which requires the top-down determination of ministry ceilings. However, the problems discussed here apply equally to the sector ceilings version of the model.

The widespread influence of this purely top-down approach to setting ministry expenditure ceilings is highlighted in the World Bank's most recent volume on medium-term expenditure frameworks (MTEFs), which advocates an integrated budget preparation/ MTEF process in which "hard" ministry ceilings are set prior to the preparation and consideration of spending ministry budget submissions (World Bank, 2013: loc. 1200).

In the MTEF context, ministry expenditure ceilings are typically set for a three-year time horizon, which raises the question of how hard the outer-year ceilings should be. Many advocates of the top-down approach to setting ministry budget ceilings propose that ministry expenditure ceilings should be hard only for the coming budget year, and that outer-year ministry ceilings should be purely indicative. This was, for example, the view taken in the World Bank's seminal *Public Expenditure Management Handbook* (World Bank, 1998:47) which introduced the MTEF concept. The view that outer-year ministry or sector ceilings in the MTEF should be indicative rather than hard probably remains the majority opinion within the PFM (public financial management) technical assistance community. It is also predominant international practice, including in most advanced countries (ranging, for example, from the long-established Australian approach to medium-term budgeting to the new Austrian MTEF).

There are, however, many who believe that not only annual ministry ceilings but also outer-year ministry ceilings should in general be hard. As Kim and Park (2006:95) note, many advocates of top-down budgeting consider that "the top-down budgeting system cannot work as expected without an effective medium-term budget framework … [which is] operationalised by establishing **hard** budget constraints for individual ministries and programmes over a span of multiple years" (emphasis added). This is a point of view which advocates the generalisation to the entire world of the practice of a limited number of advanced countries which currently set hard ministry expenditure ceilings for the outer years of the medium-term expenditure framework (the United Kingdom being the prime example).

The analysis which follows examines, first, the proposition that ministry ceilings should be set in a top-down manner. It then critically assesses the proposition that medium-term ministry ceilings should be hard rather than indicative.

5. Top-down setting of ministry ceilings?

The case for using a top-down process to set ministry ceilings is that excluding the presentation of ministry spending proposals prior to the determination of ministry ceilings:

- prevents the finance ministry from being overloaded by large numbers of new spending proposals which in aggregate greatly exceed available resources and which it is beyond the resources of the ministry to review properly;
- saves spending ministries from wasting a great deal of effort preparing and costing spending proposals which have no chance of being funded given available resources;
- greatly reduces the likelihood that the political leadership will succumb to bottom-up pressure during the budget preparation process by deciding to increase the aggregate ceiling.

More broadly, setting both aggregate and ministry ceilings at the very start of the budget process seems like an obvious and simple way of ensuring that ministry ceilings do not in total exceed the aggregate ceiling.

It is crucial to note that only hard ministry ceilings could be expected to constrain new spending requests in this manner and thus produce the alleged benefits of the top-down ceiling-setting process. If ministries knew that ceilings were indicative and therefore open to modification, they would presumably not hesitate to present additional spending proposals in excess of the ceilings.

As attractive as the case for hard top-down ministry ceilings might appear to be from the point of view of aggregate expenditure control, there is a major downside – namely that determining ministry ceilings without any consideration of bottom-up ministry requests must inevitably undermine allocative efficiency. Allocative efficiency means choosing from among the available alternative expenditure options those which will deliver the greatest benefits to the community. Choosing the best available spending options requires prior knowledge of what those options actually are, and such knowledge will for the most part not be available to the Cabinet and finance ministry if spending ministries are barred from putting new spending proposals forward. Expressed differently, the information constraints facing central decision makers are so great that only with the assistance of extensive bottom-up expenditure proposals can they have any hope of doing a reasonably good job of allocating budgetary resources.

It is true that advocates of the top-down setting of hard ministry ceilings envisage that, even though bottom-up requests are to be banned, the ceilings will nonetheless be set "according to policy priorities" (e.g. Kim and Park, 2006:88). What this usually means is that, during the "strategic" phase of budget preparation, the Cabinet identifies the areas of government services to which it wishes priority to be given in the allocation of resources – presumably based on the emergence of new policy challenges or on changed views about priorities – and then sets the ministry ceilings based on these priorities. The problem with this arrangement is that the mere identification of priorities to which the budget should pay attention does not provide sufficient information to appropriately determine specific ministry ceilings. Ministry ceilings can only logically be set in the knowledge of the specific new programme/project options which can give effect to those priorities. Concrete new programme proposals must, in the main, come from the relevant spending ministries: in other words, they must be bottom-up.

It is undoubtedly good practice for the Cabinet to discuss expenditure challenges and priorities during the initial strategic phase of the budget preparation process, and to inform spending ministries of the government priorities it wishes to see reflected in their spending requests. But it makes no sense for the Cabinet to proceed directly from the consideration of priorities to the determination of ministry ceilings, skipping any intervening consideration of concrete spending proposals.

In any event, one should be very cautious about the feasibility of an entirely top-down determination of ministry ceilings. In practice, it is not possible to prevent ministries from putting forward some major new spending proposals during the discussions leading to the setting of supposedly "top-down" ministry ceilings. While a top-down process might eliminate the presentation of formal ministry budget requests prior to the establishment of ministry ceilings, it would certainly not eliminate the informal presentation of major new spending proposals. It is to be expected that, in the Cabinet discussions during the strategic phase of the budget preparation process, individual ministers would argue for increased ceilings for their own ministries largely by referring to significant new spending proposals which they would like to see funded. There is also likely to be considerable behind-the-scene lobbying of the president/prime minister, again based in large measure on specific new spending proposals.

This means that the supposedly top-down process of setting ministry ceilings ends up leading to the replacement of formal processes for the consideration of bottom-up spending proposals with informal processes. This is undesirable. One of the hallmarks of a good budget preparation process is the existence of clear formal routines for the presentation and appraisal of new spending proposals. These routines should include the requirement that all new spending proposals are presented with prescribed supporting information in a standard format, as well as a standard process for the review of such spending proposals by the finance ministry and other relevant "central agencies" such as the office of the president or prime minister. By encouraging the informal presentation of major new spending proposals during the strategic phase of the budget preparation process, the supposedly top-down process undermines these formal routines. The inevitable result will be the *de facto* approval of major initiatives by the Cabinet without the benefit of formal submissions or detailed critical analysis by central agencies.[6] In addition, because the time available for discussion during the Cabinet deliberations in the strategic phase of the budget preparation process will inevitably be very limited, it is likely that only a handful of the most powerful ministers will enjoy the opportunity to raise new proposals which influence ministry ceilings.

6. How hard are the top-down ministry ceilings?

It is therefore hardly surprising that in practice – as made clear by Kim and Park (2006:94, 107-108) – a number of countries with supposedly top-down processes for setting ministry ceilings in fact permit bottom-up new spending proposals before finalising the ceilings. A typical example is Denmark where, according to Blöndal and Ruffner (2004:58):

> Spending ministries … submissions are [supposed] to be in line with the expenditure ceilings given to them in February. In reality, the amounts are generally in excess – either due to the ministries claiming that the cost of operating unchanged policies is higher than what was assumed, or because they will be making claims for new initiatives. … the submissions by ministries reflect the fact that they believe that the Ministry of Finance has a "kitty" (reserve) at its disposal. This may or may not be the case in individual years. There are strong procedures in place to justify any bids in excess of the initial expenditure ceilings allocated.

Sweden is supposedly the prime example for top-down setting of ministry ceilings. In theory, the Swedish ministry ceilings are all set at a Cabinet retreat one month into the budget preparation process, prior to any bottom-up input, and these ceilings then remain hard. In practice, however, ministries do present budget requests in excess of their top-down ceilings (Gustafsson, 2004:63).

The advocates of hard top-down ministry ceilings have considerable difficulty with this issue and cannot be said to present a clear and consistent line. The World Bank's classic *Public Expenditure Management Handbook*, which advocated a quite top-down approach to setting ministry or sectoral ceilings, asserted that the "test of these envelopes [i.e. ceilings] is their credibility … It would be expected that they would [be] reasonably firm for formulation of the annual budget". The ambiguity of the word "reasonably" is notable, but it is clear that the emphasis is on firmness. Yet a couple of years later, the principle author of the handbook and architect of the MTEF concept is to be found quite correctly rejecting the notion:

> … that ceilings should be immutable once set at the outset of budget preparation. On the contrary, a central purpose of the budget preparation process is to ensure that resources are going to priorities and reflect information on what is working and what is not. (Holmes and Evans, 2003:24)

A similarly contradictory position can be seen in Schiavo-Campo and Tommasi (1999, Chapter 4:34-35) who, immediately after arguing for a completely top-down process of setting hard sector ceilings ("definite budgetary envelopes") in developing countries, contradict themselves by conceding the possibility that "additional requests from line ministries could be allowed for new programs" in which case only "the principal request [from the ministry] should be consistent with the notified ceilings".

Holmes and Evans (2003:35) try to square the circle by arguing that "ceilings must be sufficiently fixed … to be credible but sufficiently flexible to accommodate changing economic conditions, changing priorities and new information". But this is surely an impossible balancing act. If there is to be significant flexibility to reallocate resources between sectors or ministries, or if significant new policy proposals outside the initial supposedly top-down ministry ceilings are permitted, the system is no longer based on hard ministry ceilings, but rather on indicative ceilings. And it is no longer reasonable to expect that the ceilings will achieve their aim of preventing ministries from putting forward substantial numbers of new spending requests. The supposed advantages of top-down budgeting over bottom-up budgeting disappear.

One searches in vain in the works of advocates of supposedly hard top-down ministry ceilings for any principles which will determine how much money is to be made available for new spending proposals and how this is to be taken into account when the ministry ceilings are initially set. One is therefore left without any explicit mechanism for ensuring that the initial ministry ceilings, plus new policy proposals accepted later in the budget preparation process, are consistent with the aggregate ceiling.

Potter and Diamond (incidentally, advocates of indicative ministry ceilings) explicitly address the question of availability of funds for new policy proposals in excess of initial ministry ceilings in their classic budgeting manual. They suggest (Potter and Diamond, 1999:18) a "planning reserve" of 1-2% of the aggregate ceiling "so the ministry of finance can assign extra resources later during budget negotiations for the most urgent priorities, without breaching" the aggregate ceiling. Potter and Diamond are undoubtedly on the right track here in suggesting a government-wide pool of funds for new policy (see further on this topic below). However, with a reserve which is so very small, and the difficulty of cutting the initial "indicative" ministry ceilings once they have been advised to ministries, their proposal remains a recipe for allocative rigidity and incrementalism. The size of the planning reserve also seems entirely arbitrary, without any clear relationship to the underlying fiscal space available to government.

All these considerations point to the conclusion that the top-down setting of ministry ceilings, prior to the consideration of formal new spending requests from spending ministries, is in general undesirable and impractical. A sound budget preparation process must preserve the channels by which ministries can formally present new spending proposals prior to the finalisation of ministry ceilings, with those proposals being then subject to rigorous analysis and challenge by the finance ministry and other relevant central agencies. This conclusion is not changed by the fact that the exigencies of a major fiscal consolidation may justify the temporary adoption of a more top-down approach.

7. How to reconcile an aggregate ceiling with allocative flexibility

What type of budget preparation process is capable of reconciling allocative efficiency with aggregate expenditure ceilings? In other words, how can the budget preparation process be organised to give effect to aggregate ceilings while retaining maximum flexibility to allocate budgetary resources to where they will deliver the greatest social benefit? There is no single answer to this question which can be applied to all countries. Differences in technical capacity and institutional structure mean that one size does not fit all. Nevertheless, it is possible to draw on the experience of certain leading countries in order to present a stylised best-practice model which can at least provide a basis for considering how to reform the budget preparation process in specific countries.

The model takes as its starting point the distinction between new spending and "baseline" spending on ongoing programmes and projects. Baseline expenditure is the level of expenditure which would be required across government to continue to provide existing services, meet existing commitments and continue existing capital projects, assuming unchanged expenditure policy (i.e. that no existing services are eliminated or cut back, and that government policies about the level of service are honoured). New spending, by contrast, is funding for the creation of new capital projects, new services or the expansion of existing services. It is the forward estimates of expenditure (mentioned earlier) which provide quantitative estimates of baseline expenditure requirements over the medium-term time horizon. Fiscal space – assuming unchanged expenditure policies –

is then measured by the difference between the aggregate expenditure ceiling and baseline expenditure as indicated by the expenditure forward estimates.

Allocative efficiency clearly requires a budget preparation process which can allocate the resources available for new spending – the fiscal space – to those programmes and ministries where they will be most useful. This requires that fiscal space is treated as a government-wide pool whose allocation is based on the careful evaluation of the alternative spending options.

As a first approximation, fiscal space can be allocated in this way while respecting the aggregate ceiling through a budget process in which:

- all ministries are given hard "baseline expenditure ceilings" – that is, ceilings covering expenditure on their existing programmes and capital projects at their level – equal to the baseline expenditure requirements. These baseline ceilings are established for each ministry at the start of the budget process, in an entirely top-down manner;
- a hard government-wide new policy ceiling is set at the same time, equal to the aggregate ceiling minus the sum of ministry baseline ceilings.

The allocation of the new policy ceiling between ministries is then determined during budget preparation, based on both government priorities and bottom-up ministry proposals. The political leadership would provide guidance for the allocation process by considering its overall priorities at the start of budget preparation, without setting ministry ceilings at that stage.[7] Ministries would then make detailed formal bottom-up submissions for concrete new spending proposals, which would be subject to searching independent analysis by the central agencies. The allocation of fiscal space might also be framed by explicit principles guiding the division of fiscal space between current expenditure and capital expenditure.

In respect to baseline expenditure, this process would, ideally at least, be entirely top-down – that is, the baseline spending requirements of ministries would be calculated by the finance ministry without any consideration of requests from the spending ministries. "Bottom-up" budget requests would be confined to new policy. Moreover, a clear constraint would have been set on the total value of new spending proposals which could be accepted.

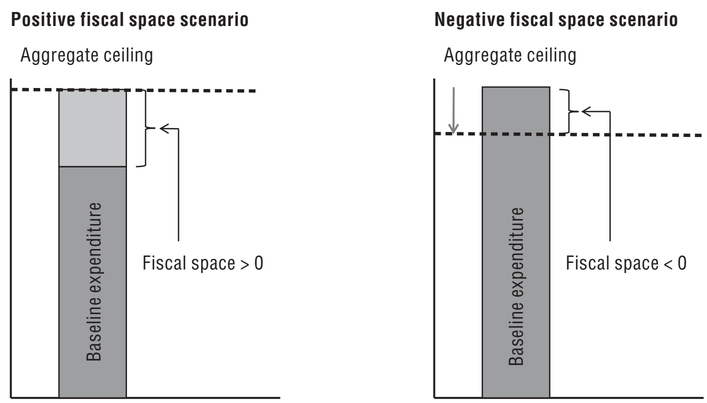
Such a process would score high points for allocative efficiency in respect to new spending. However, this is not enough. Allocative efficiency also requires a capacity to re-examine and reallocate baseline expenditure. A process in which ministry baseline ceilings were set in concrete at the start of the budget preparation process would unnecessarily limit the scope for such re-examination and the allocation. Expressed differently, it would institutionalise budgetary incrementalism (Schick, 2009:8).

The "first approximation" process as outlined above has the further disadvantage of being based on the assumptions that the fiscal space estimated in this manner will always be:

- positive – i.e. that the sum of ministry baseline ceilings (plus other "baseline" government expenditure) will always be less than the aggregate ceiling; and
- sufficient to provide scope for those new spending items which government regards as high priority.

However, it will not always be the case that fiscal space will be positive. Sometimes it may be negative, meaning that baseline expenditure requirements exceed the permissible aggregate expenditure ceiling. This type of situation is particularly likely to arise during phases of fiscal consolidation, when aggregate ceilings will be set at levels which require significant spending cuts. The contrast between positions of positive and negative fiscal space may be illustrated graphically in Figure 2.

Figure 2. **Positive and negative fiscal space**



Moreover, even if fiscal space is positive, it may be quite small and therefore insufficient to fund even the highest-priority new spending initiatives.

If fiscal space is negative or insufficient, the only way of respecting the aggregate ceiling while giving effect to important government new spending priorities is to reduce budget allocations to existing services – that is, to cut ministry baseline ceilings by providing less money than required to fully fund baseline spending.

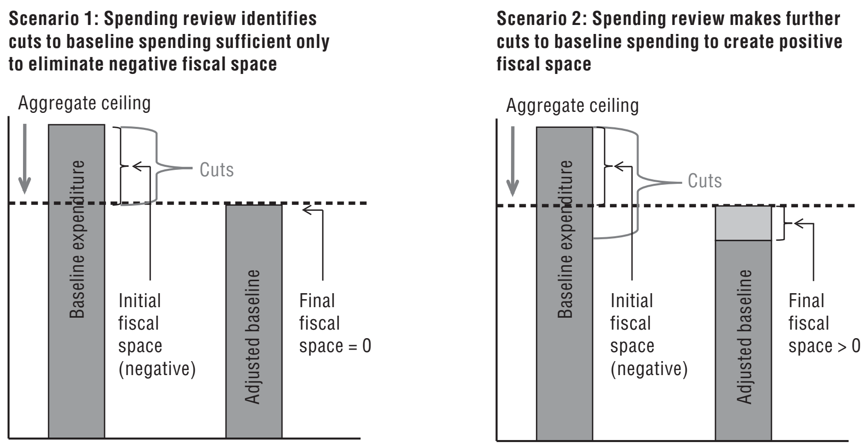
These considerations point to the need to incorporate into the budget preparation process a mechanism which makes it possible to review and cut baseline funding. An enhanced process consistent with this includes the following:

- The baseline ministry ceilings set at the start of the budget preparation process may incorporate cuts to existing programmes (e.g. as the result of any spending review conducted prior to the commencement of the budget preparation process).
- The baseline ministry ceilings are also made explicitly subject to possible reduction during the budget preparation process as the result of a spending review process[8] – and are therefore hard in the upward direction but flexible in a downward direction.
- Any cuts to baseline ceilings either prior to or during budget preparation increase the new policy ceiling – i.e. the amount of fiscal space available for new spending.

This process transforms the new policy ceiling into a net ceiling in the sense that it limits net new spending – i.e. new spending minus any cuts to existing programmes decided during the budget process.

To expand on the role of spending review in this process, consider the scenario where fiscal space is negative. In this case, it would be impossible for the government to give ministries budget allocations equal to their baseline expenditure requirements as indicated by the forward estimates. To avoid breaching the aggregate ceiling, it would then be necessary to set baseline ceilings sufficiently below the baseline estimates to ensure that fiscal space is not negative. If, in addition, the government wished to have room to fund any new policy under the aggregate ceiling, fiscal space would have to be positive and, to achieve this, baseline ceilings would have to be pushed down further. These scenarios are illustrated in Figure 3. On the left hand side is the position where, faced with a negative fiscal space, the government decides to cut baselines by only the amount sufficient to ensure that spending does not exceed the aggregate ceiling. In this scenario, there is no fiscal space for new initiatives. On the right hand side, the government goes further with the cuts to baselines, so as to create positive fiscal space to permit some new spending proposals to go ahead.

Figure 3. **Negative fiscal space scenarios**



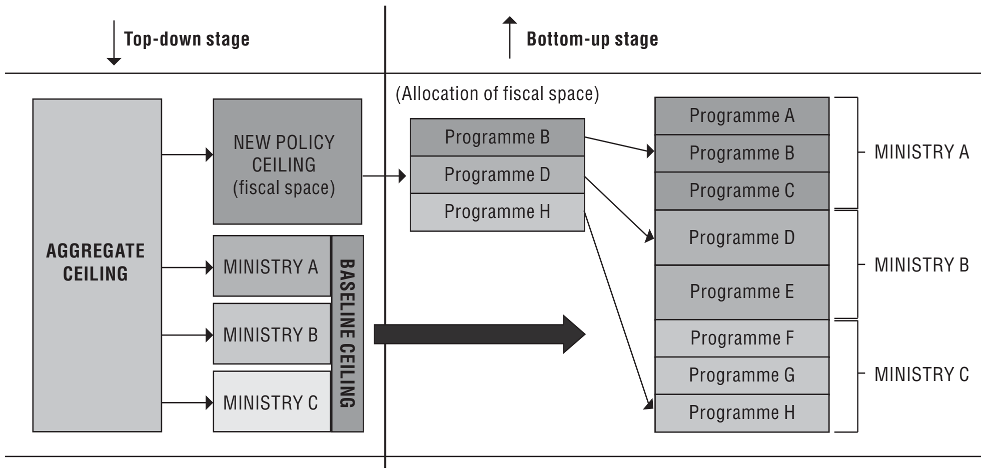
The budget preparation process outlined above remains a highly top-down one in which two types of hard ceiling are set at the very start of the budget preparation process, prior to ministry funding requests. At the same time, it is a process which has the advantage not only of avoiding incrementalism, but also of explicitly linking decisions about the amount of new spending to the matching decisions taken during the budget preparation process on cuts in baseline spending. This provides a pressure valve which permits the acceptance, if appropriate, of additional new spending proposals without raising the aggregate ceiling. To make this work, it is necessary for the finance ministry to maintain throughout the budget process a running tally of the net impact of new spending and cuts.

Such a system maximises allocative flexibility while ensuring respect for the aggregate ceiling. Of course, the capacity of countries to realise the benefits of such allocative flexibility will depend upon how good they are at spending review and the extent to which they have adopted the principles of performance budgeting.

In summary, this is a budget preparation process based on two key principles. The first is the separation of decisions on net new spending – i.e. new spending initiatives and expenditure cuts – from decisions about baseline funding for continuing programmes. The second principle is the imposition throughout the budget process of the constraint that net new spending must not exceed the aggregate expenditure ceiling minus baseline funding. This process may be represented graphically in Figure 4.

What about the top-down budgeting objective of preventing spending ministries from overburdening the budget process with too many new spending proposals? The existence of an explicit new policy ceiling helps, but this is of course a government-wide pool and will attract competing "bids" in excess of the amount available. Particularly important,

Figure 4. **Combining top-down discipline with allocative flexibility**



therefore, is the rigour of the information and analysis requirements which ministries must satisfy in their formal submissions for new spending proposals. If these are tough, they will significantly reduce the number of new policy proposals. In addition, the indication by the political leadership of the government's priority areas for new spending at the commencement of the budget preparation process should act to discourage – without totally preventing – ministries from presenting new spending proposals outside these priority areas. Finally, certain supplementary budget process rules – such as an expectation that ministries will fund minor new spending proposals through internal savings rather than funding requests – can help to contain the numbers of new policy proposals at manageable levels.

8. Technical capacity and the process for setting ministry allocations

In its pure form, the process outlined above requires quite advanced technical capacity in one important area: the preparation of reasonably accurate "forward estimates" of expenditure. Forward estimates[9] are projections of expenditure (and revenue) on a "current policy" basis – that is, projections of future levels of expenditure and revenue on the assumptions that there are no new spending initiatives and no changes to tax laws, and that all explicit and clear commitments made to future expenditure (including political promises) are taken into account.

The ability to prepare accurate forward estimates of expenditure at least one year ahead is essential if ministry baseline ceilings are, as suggested above, to be set in a purely top-down manner. It is essential because, if spending ministries are to be denied the opportunity to present their own views about the funding they need to continue "current policy" before ministry baseline ceilings are set, the finance ministry needs to be very confident that its own estimates of baseline requirements are accurate. Moreover, if hard multi-year ministry ceilings are to be set, the finance ministry needs to be able to prepare accurate forward estimates not merely for the coming year, but for several years into the future.

There are, however, many countries that are unable to prepare accurate forward estimates even one year ahead. Under these circumstances, to set ministry baseline ceilings in a purely top-down manner is clearly not feasible. Bottom-up representations from spending ministries on their baseline requirements cannot be denied.

In at least some countries, a modified version of the process for setting ministry baseline ceilings outlined above is, however, practical. In such a process, the finance ministry initially sets indicative ministry baseline ceilings which are as accurate as it is able to make them, but gives spending ministries the opportunity to formally request the revision of these ceilings. Crucially, however, the finance ministry tightly prescribes and limits the grounds upon which such revision may be requested. The most important of these would be mandatory expenditure requirements of which the finance ministry was not aware.[10] In such a process, the finance ministry permits bottom-up input into the determination of ministry baseline expenditure allocations precisely because it is aware that its expenditure forecasting capacity is not (yet) good enough to permit it to determine those baseline allocations unilaterally. However, with such an approach, the expenditure forecasting capacity of the finance ministry improves over time, and the setting of baseline allocations can become increasingly top-down.

Such an approach recognises something which is not acknowledged by most advocates of top-down budgeting – namely, that the degree to which budgeting can be made top-down is in part a function of the technical capacity of the country concerned. It is inappropriate to advocate equally top-down processes everywhere in the world.

9. Multi-year ministry ceilings

As noted at the outset, there are those who believe that not only annual but also multi-year ministry ceilings should be hard. Those of this opinion tend to look to the practices of the handful of advanced countries such as the United Kingdom where governments make hard medium-term budget commitments to ministries. Hard multi-annual ministry ceilings are seen by their proponents not only as tools for expenditure discipline, but also as a means of improving performance by providing ministries with certainty about future funding levels. Such certainty allows ministries to plan and manage on a medium-term basis.

The potential benefits of giving ministries medium-term funding certainty are clear, but there are two main obstacles which make this approach impractical in the majority of countries.

The first is, once again, the quality of forward estimates. If a country is unable to prepare reasonably accurate medium-term estimates of the "current policy" expenditure requirements of ministries, there will be a high risk that the ceilings set for many ministries in the outer years will be either too low or too high. This is not a problem if the ceilings are only indicative, but it is a major problem if they are hard. If the ceilings are too high, the available fiscal space will be underestimated and the capacity to fund new policy commensurately reduced. But if they are too low, the risk will be that, when the outer years arrive, the unrealism of the supposedly hard ministry ceilings will become apparent and the ceilings will probably end up being modified upwards. Expressed differently, the ability to make hard multi-year ministry ceilings stick depends upon the credibility of those ceilings.

Experience has amply demonstrated that poor-quality forward estimates undermine the entire medium-term budgeting process. Countries which have attempted to introduce MTEFs without investing significant effort in the forward estimates process tend, unsurprisingly, to have been disappointed with the results. In the absence of a system and capacity to produce quality forward estimates, projections of medium-term aggregate spending and revenue tend to be prepared on the basis of the crudest techniques (e.g. updating based only on the application of a general inflation factor) which fail to capture the dynamics of current policy. And the inevitable consequence is that the medium-term sectoral or ministry "ceilings" which are prepared on the basis of those forward estimates and approved in the MTEF have little impact on the actual expenditure approved in the annual budget.

Box 1. **Poor-quality forward estimates and MTEFs in the developing world**

Fölscher (2007:5) notes that, in Africa: "The quality of forward estimates is poor. They consist far too frequently of the proposed budget for the first year of a multi-year framework, followed by inflation adjusted projections of cost for the outer year … they pay little attention to, for example, the likely phasing of policy implementation, changes in demand that will effect spending unevenly or the impact of once-off capital spending on the base-year estimates. … A key aspect of embedding a medium-term perspective therefore is deciding what the rules are for rolling over and adjusting and determining the forward estimates."

Another typical example of the way in which poor-quality forward estimates have undermined the value of MTEFs in developing countries is Kyrgyzstan, where a review by the IMF in 2008 (Report on Observance of Standards and Codes, "fiscal transparency") noted that "the costs of government policies and programs are yet to be tracked with an acceptable degree of accuracy to serve as the basis for a well-developed forward estimates system and systematic preparation of the MTBF" (IMF, 2008:16). The following year, a review under the PEFA programme (Public Expenditure and Financial Accountability) made the following observation: "Starting from 2009 the annual budget law is produced for three years on a rolling basis. It is too early to assess the impact of these changes, but it seems that the budgets for the second and third year are merely projections on the basis of expected inflation" (Shambetova et al., 2009:38).

Arguably, countries that are unable to prepare forward estimates of expenditure should not pretend to be setting even indicative ceilings. A better approach for such countries would be to initially focus only on producing medium-term forecasts. Only at the point where these forecasts attain an acceptable degree of accuracy should they be used to set indicative ceilings.

The other danger of setting hard multi-year ceilings is that it will greatly increase allocative rigidity. Locking in ministry ceilings for, say, three years into the future means denying oneself the ability to reallocate resources during that period in accordance with priorities and performance. Unless the country concerned is very good at periodic in-depth reviews of expenditure priorities, the result is likely to be that ministries and programmes which should have their funding cut find themselves more protected from cuts, and ministries and programmes which should receive greater funding find it even harder to attract additional resources. The United Kingdom combined its system of hard multi-year ministry ceilings with periodic in-depth spending reviews. However, spending review – the critical examination of baseline expenditure to identify wasteful and low-priority spending which can be cut to free up additional fiscal space – is something which only a minority of countries around the world are able to do well. Moreover, undertaking a major spending review every three years is more demanding than undertaking some spending review every year. It follows that developing strong spending review capacity – and, more generally, performance budgeting – should be seen as a prerequisite (along with the ability to prepare good forward estimates) for moving to hard multi-year ministry ceilings.

10. Conclusion

Setting ministry ceilings in a completely top-down manner and then insisting that they be hard – possibly even on a multi-year basis – is superficially attractive to those who focus solely on aggregate fiscal discipline. However, it is crucial – particularly at a time when the need to restore public finances after the financial crisis and to meet longer-term structural fiscal sustainability challenges looms large – not to lose sight of the fact that good budgeting is not only about fiscal discipline, but also about allocative efficiency.

This article has aimed to show that it is possible to enforce hard aggregate expenditure control via expenditure ceilings while maximising the allocative flexibility of the budgeting system. The keys are: the baseline/new policy distinction; good forward estimates; a government-wide new policy pool; and spending review. The article suggests an alternative form of top-down budgeting in which it is not ministry ceilings which are set at the start of the budget process but rather ministry baseline ceilings and the government-wide new policy pool.

Notes

1. It might exclude certain categories of expenditure such as interest payments.
2. It might exclude certain categories of the ministry's spending such as entitlements expenditure which is determined by law (on the grounds that the ministry has no control over the volume of such payments).
3. This is consistent – subject to one qualification – with the IMF definition of expenditure rules (IMF, 2009:5) as "permanent limits on total, primary, or current spending in absolute terms, growth rates, or in per cent of GDP", which is in turn consistent with the widely accepted Kopits/Symansky (1998) definition of a fiscal rule (of which an expenditure rule is one type) as "a permanent constraint on fiscal policy, expressed in terms of a summary indicator of fiscal performance". The qualification is the substitution of "continuing" for "permanent" application. Replacing "permanent" with "continuing" recognises that a rule might be intended to apply for a defined period of time, or indefinitely, without necessarily being intended to be permanent. A concrete example of an expenditure rule which was intended to have continuing but not permanent application was that enunciated by the Australian government in 2009 as part of its deficit exit strategy from the global financial crisis. Under this strategy, the Australian government committed to return the budget to surplus by restraining real growth in spending to 2% a year once the economy recovered to grow above trend. Once the budget returned to surplus, and while the economy is growing at or above trend, the government committed to retaining a 2% annual cap on real spending growth, on average, until surpluses are at least 1% of GDP.
4. The distinction between expenditure rules and expenditure ceilings is, unfortunately, not always clearly maintained. For example, while the European Commission defines expenditure rules in accordance with the Kopits/Symansky (1998) definition of fiscal rules, it inconsistently treats expenditure ceilings as a type of expenditure rule (see, for example, EC, 2009:87, 90, 268-269, and EC, 2006:162). Similarly, a recent ECB publication appears to conflate expenditure rules and expenditure ceilings (Hauptmeier et al., 2010:11).
5. Of course, the highest decision-making institution on budgetary matters differs with the political system, and in some cases is not the Cabinet (council of ministers) but, say, the president.
6. In addition, the resource allocation bias towards the most politically powerful ministers would be exacerbated, because only they would in general have the weight to be able to raise major new spending proposals.

7. What this would mainly mean in practice is that the leadership would identify particular key problem areas which it would like to see addressed via new spending in the budget.
8. It should be noted that the potential downward flexibility of ministry baseline ceilings raises significant issues. These are perhaps best resolved in the Danish manner of excluding from the baseline ceilings specific programmes which have been identified as the subject of spending review during the budget cycle.
9. Also known by a range of other names, such as "annual reference level update" in Canada.
10. A mandatory expenditure requirement is an obligation to change the volume of services or transfer payments provided to citizens because of a legal requirement or an explicit government policy.

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Selected budgeting issues in Chile: Performance budgeting, medium-term budgeting, budget flexibility

by
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The Chilean government is exploring several important areas of public sector reform. This article discusses performance budgeting (including spending reviews, efficiency reviews, and the Chilean performance management system), medium-term budgeting (especially the use of forward estimates and fiscal rules), and flexibility and efficiency in budget execution. Chile's situation as of May 2012 was analysed in the light of OECD country best practices at the annual meeting of the OECD network on performance and results in November 2012, and the article makes several suggestions for reform.

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1. Current performance budgeting challenges

1.1. Introduction

Chile's interest in strengthening performance budgeting and medium-term budgeting reflects the political and fiscal circumstances of the country.

On the political front, the election in 2010 of a president from the conservative parties after two decades of centre-left government represented a significant change in the landscape. There is the common phenomenon of a new government suddenly finding itself in charge of the massive ship of state, discovering that it is no easy matter to fully master the controls and move public policies and expenditure in the direction of its priorities. President Piñera has sought energetically to put his stamp on government policy, including through the articulation of a set of high-level government-wide objectives and performance targets (so-called *Objetivos Estratégicos*; see Box 1) – mainly relating to high-level outcomes – broadly based on the model of the "public service agreement" targets of the former Labour government of the United Kingdom. The Chilean President has personal meetings with each spending ministry throughout the year to discuss advances in the execution of government priorities. However, there is acknowledgement of the challenge involved in imprinting government priorities onto the budget. As in many OECD countries, existing policies represent substantial funding which leaves less room for new initiatives. There is thus a need to increase the focus on how to create fiscal space within the current baseline. The issue is that the structure of the budget should link spending to government priorities in a stronger way.

Box 1. **"Strategic Objectives" set by the Piñera government in Chile**

The following are representative of the 27 "strategic objectives" set by President Piñera in his first presidential address after assuming office in 2010:

- Reduce the number of households which are victims of crime by 15% by 2013.
- Improve the labour conditions in the country by means of a 4% reduction of the rate of industrial accidents by 2015.
- Build 10 new hospitals and 56 new clinics by the end of the government's term.
- Eradicate extreme poverty by 2014.
- Enhance citizen participation (in the political system).

Performance budgeting has potentially two things to offer the government under the circumstances:

- the first is a clear link between government priorities and resource allocation in the budget;
- the second is increased fiscal space through carefully targeted cuts to baseline expenditure.

Effective performance budgeting helps the government to identify and cut low-priority and ineffective programmes, and to realise efficiency savings. It achieves this by making it possible to systematically use information about the objectives, effectiveness and efficiency of spending when making decisions about resource allocation in the budget.

As discussed below, Chile's existing performance management system aims, among other things, to make budgeting performance-informed. However, the impact of the system on the allocation of resources in the budget is unclear. Hence there is considerable interest in what can be done to strengthen the impact of performance and government priorities on the budget.

Chile's more relatively difficult fiscal situation reinforces the need to strengthen performance budgeting because the exigencies of fiscal consolidation add to the difficulties of finding fiscal space for the priorities of the new government and therefore make it more important than ever that options for savings in baseline expenditure are routinely considered during budget preparation.

1.2. Overview of performance budgeting[1]

Performance information – measures, targets and evaluations – enables governments to drive, monitor and assess progress towards achieving their policy and programme goals. For performance information to be useful to central government, it is important to have an appropriate system to monitor and evaluate performance. A consensus exists that any information captured should be specific, measurable, attainable, relevant and time-bound (commonly abbreviated as SMART) in order to be useful for public managers and decision makers.

Performance budgeting mostly focuses on the outputs and outcomes of government action. The precise definition of outputs and outcomes varies between governments and sometimes even within government. Outputs are generally considered as the volume, quality and value of goods and services produced by government organisations, i.e. the immediate result. Outcomes may be the aggregated impact of a variety of outputs (intermediate outcomes) or the eventual impact on society that can be significantly attributed to government outputs (final outcomes). Whereas it is usually reasonable to hold the government responsible for outputs, it is often not reasonable to hold them entirely responsible for outcomes. Many other factors beyond a government's control may intervene and influence the final impacts on society, typically referred to as antecedents or environmental indicators.

Almost all OECD countries use output and outcome information to measure programme performance. Over two-thirds (22) use a combination of outputs and outcomes. In addition, 12 countries include other forms of non-financial information. Only five countries use output measures but not outcome measures. In some countries, however, there has been a shift away from outputs towards outcomes and vice versa. In Canada, for example, experience has taught the government that focusing only on macro performance measures of outcomes or outputs alone may fail to identify the need for important modifications at a programme level.

Great variation exists in the numbers of performance targets. The United States has the most performance targets (3 700), followed by the Slovak Republic (1 641) and Korea (1 033). France, Japan and New Zealand have between 500 and 600 targets each, and Sweden has only 48. However, quantifying the number of targets used in the budget is not standard practice within OECD countries, so a number of countries were unable to report this information.

The locus of responsibility for setting and achieving performance targets provides an idea of the government's approach to performance management. In OECD countries, responsibility for achieving targets overwhelmingly lies with the relevant government organisation. Within the government organisation, however, the responsibility may fall on different actors. In Canada, the responsibility for achieving performance targets is shared between the relevant political head of the government organisation and the highest civil servant. In France and New Zealand, the central government places responsibility for achieving targets solely on the highest civil servant of the respective government organisations. In Belgium, responsibility for achieving targets depends on the target.

One key element is the degree to which the central budget authority uses performance information. Some hold that this should only happen for selected areas and only with the purpose of cost cutting or reallocating funds between line ministries. The same view holds that the central budget authority should not be involved with overall monitoring and follow-up of policy objectives, which should be the responsibility of the line ministries. The opposite view holds that the central budget authority should monitor all government performance to the widest extent possible. Only by doing so can prudent budgetary decisions on financial inputs be taken and line ministries be held accountable.

For OECD countries, it is generally the case that performance information is used more by the relevant line ministries implementing government programmes than by the central budget authority. Ministries are more likely to use performance information to allocate resources within their area of responsibility, to justify existing expenditures, to manage programmes and to set new performance targets. Evidence from the OECD survey (OECD, 2007b) finds that the central budget authority is more likely to use performance information to cut expenditures.

1.3. The Chilean performance management system

In discussing performance budgeting in Chile, the first point to make is that performance budgeting is part of a broader performance management system known as the "system of evaluation and management control". This system aims to improve the effectiveness of policy making and management throughout the central government, to create performance incentives for civil servants, and to make the budget results-oriented. It is useful to describe the system as a whole before turning to the specific question of how well it links to the budget.

The Chilean performance management system has been developed and managed by the Budget Directorate (the *Dirección de Presupuestos*, or DIPRES) of the Ministry of Finance, and more specifically by the Division of Management Control within DIPRES. There are five key elements to the system:

- the strategic framework;
- performance indicators and performance targets;
- evaluation;
- the process for presenting and appraising new spending proposals; and
- performance incentives, which are discussed later.

1.3.1. The strategic framework

The strategic framework is the starting point of the system. Each institution is required by DIPRES to develop a strategy statement (*definiciones estratégicas*) which is presented in a budget information paper (*Antecedentes Complementarios Control de Gestión Pública*). DIPRES policies require that this statement:

- specifies each institution's mission, strategic objectives, "strategic products" and clients/ users/beneficiaries;
- links institutional strategic objectives to "government priorities" and "government programmes";
- be based on the "logical framework" concepts of outcomes, outputs, processes and inputs.

DIPRES guidelines state that "strategic products" must be the goods or services (i.e. outputs) which serve the institution's strategic objectives. For example, the interior ministry's main sub-secretariat has defined six strategic products, including "public security", "public order" and "human rights". Expressed differently, the strategic products are supposed to be groups of outputs with a common outcome. In principle, this framework is a sound one. In practice, however, there are certain difficulties associated with it.

The first difficulty is that the way in which some institutions have formulated their strategic objectives and strategic products leaves room for improvement. Rather than being statements of the key outcomes which institutions aim to achieve, the strategic objectives are in too many cases focused more on outputs and processes. Moreover, rather than being succinct and easy to understand, they are often excessive and written in highly bureaucratic language. The specification of the "strategic products" – while generally quite good – could also be revised to remove the processes, support services and inputs which some ministries have mistakenly identified as outputs.[2]

The second difficulty concerns the relationship between the strategy statements that ministries develop for DIPRES and their own strategic plans. It appears that in at least some cases the strategic plans which institutions have developed and use in their internal management have little to do with the strategy statement which they provide to DIPRES. When this is the case, the danger is that the strategy statement becomes little more than a paperwork exercise.

The third difficulty concerns the relationship between the strategic framework and the budget. The DIPRES conception of strategic products as groups of outputs with a common objective means that they are precisely what programmes or sub-programmes should be in a programme budgeting system. However, as discussed below, the strategic products are not part of the Chilean budget classification (i.e. they are not used to classify and approve expenditure in the budget).

1.3.2. Performance indicators and performance targets

Performance indicators are developed for each of the "strategic products" in the institution's strategy statement, as a result of which approximately 1 200 performance indicators have been defined as part of the strategic framework. Performance targets are set for each of these indicators, and the performance incentive system (discussed later) delivers rewards which are to a large degree based on institutional performance against these performance targets.

1.3.3. Evaluation

The most distinctive feature of the Chilean performance management system is the degree to which it makes use of systematic evaluation, which is quite exceptional by contemporary international standards – at least outside Latin America.[3] Evaluations are managed by DIPRES, and the topics for evaluation are centrally determined. There are three different types of evaluation in the Chilean performance management system:

- Impact evaluations, the main focus of which is whether programmes have achieved their intended outcomes. Such an evaluation might, for example, examine a labour market programme whose stated objective is the reintegration into the labour market of the long-term unemployed, and examine the track record of participants from the target population to see whether the programme had actually succeeded in increasing their level of employment.
- Evaluations of government programmes (EGP): While EGPs measure some aspects related to efficiency dependent on available information, the main element of these evaluations is the analysis of what has sometimes been called the "intervention logic" of programmes. This means laying bare, and questioning the logic of, the causal chain by which programme outputs are supposed to generate specific programme outcomes and, through them, higher-level government outcomes. Taking the example of the labour market programme, such an evaluation will not indicate whether or not the employment level of the target population has been increased. It will, however, indicate whether or not it is reasonable to expect that the type of assistance being given to the long-term unemployed is likely to increase their employment level. An important point, discussed further below, is that the "programmes" which are evaluated are not the same as the programmes in the budget.
- Institutional evaluations, which often carry the potentially misleading name of "comprehensive expenditure evaluations" (*Evaluaciones Comprehensivas de Gasto*): These evaluations look at specific institutions or sectoral groups of institutions. They examine a range of issues including the consistency of institutional and sectoral objectives, organisational structures, production and management processes, resource use, and service-delivery performance.

The coverage of evaluation has progressively increased over time, with 33 evaluations in 2009 and 39 in 2010. The organisation and conduct of the three types of evaluation remain today essentially the same as described in the 2004 OECD budget review of Chile (Blöndal and Curristine, 2004) and elsewhere (e.g. Guzmán, 2007). The programmes and organisations to be evaluated are selected by a designated interministerial committee consisting of DIPRES, the Ministry of the General Secretary of the Presidency and the Ministry of Social Development, in consultation with the Congress. Evaluations are then carried out by external evaluators (consultants or research institutions) contracted by DIPRES who also provides the terms of reference and methodological guidelines. The unit in the budget office running the evaluations is not under the budget division (*Sub Dirección de Presupuestos*), but is located in a separate control pillar (*División de Control de Gestión*), answering to the Budget Director. All final evaluation reports are made available to the Congress and the public, and their summaries are included in the budget information papers in the form of "executive minutes". DIPRES and the relevant ministry discuss the recommendations of the evaluations and agree on the actions which should be taken in response to evaluation recommendations. This then becomes the subject of a formal agreement, the implementation of which is monitored in subsequent years by DIPRES.

1.3.4. New spending

The final key element of the system relates to the presentation and appraisal of new spending proposals. Institutions are obliged to present all new spending proposals in a standard format designed, among other things, to make absolutely explicit their intervention logic. "New spending proposals" refers not only to proposed new programmes but also to significant discretionary expansions of existing programmes. Associated with this, DIPRES introduced in 2009 a new formal mechanism of "evaluation" (i.e. appraisal) of new spending proposals. More recently, DIPRES has added a technical assistance service, by which DIPRES provides advice to entities on how to develop and present good-quality new spending proposals.

1.4. The impact of performance information on the budget

The Chilean performance management system has quite broad performance-improvement objectives, including improving policy design and management and increasing the performance motivation of staff. However, from the outset the system was also seen as an instrument for making budgeting more performance-oriented. In particular, one of the functions of evaluations has always been considered to be the provision of advice to assist resource reallocation in the budget by identifying potential savings.

Despite this, today there is a perception that performance information is not having a sufficient impact on resource allocation. In particular, it appears that while evaluations often do generate changes in programme design and management, they relatively rarely impact on budget funding of programmes. A DIPRES study of evaluations conducted between 2000 and 2009 found that only 7% of these evaluations led to the termination or replacement of the programme. By contrast, 37% led to design or process modifications, 25% to "substantial" programme redesign, 24% to "minor" changes, and 7% to institutional reassignment of the programme[4] (Arenas and Berner, 2010:69). This impression is reinforced by advice from DIPRES sectoral budget analysts that they do not often discuss evaluation findings with the affected institutions during the negotiations with line ministries, the so-called "technical commissions".[5] It is therefore hardly surprising that many within government consider that the performance management system is not functioning sufficiently as a performance budgeting system.

It is beyond dispute that the performance management system has produced a large body of valuable performance information over more than a decade. How is it, then, that this information is having less impact on budgetary resource allocation decisions than might be expected? In part, no doubt, the problem is that cutting ineffective programmes is never politically easy, because there is always someone who benefits from each programme and therefore some political cost to abolishing it. However, it is equally true that, when there is a top-down limit on sustainable aggregate expenditure – as there is under Chile's excellent fiscal framework – the only way of making extra room for new spending is by cutting baseline spending. At the technical level, four factors particularly stand out when seeking to explain the limited use of performance information in the budget, discussed below:

- weaknesses in the budgetary programme structure;
- the lack of a sufficiently strong focus in the evaluation system on supporting budget preparation;
- the weakness of priority analysis; and
- the lack of a spending review mechanism.

1.4.1. Weaknesses in the budgetary programme structure

Internationally, a programme classification of the budget is widely seen as a key mechanism for turning the budget into a document which expresses, and facilitates, allocative choices. In a programme budgeting system, the programmes in terms of which expenditure is classified and allocated in the budget represent, in general, groups of related outputs which share a common outcome – e.g. a preventative health programme, a primary school education programme, or a nature conservation programme. Importantly, these programmes are then broken into sub-programmes to give an even finer classification of expenditure by outcome. Reallocations of expenditure are then effected by transfers of budget appropriations between programmes, or between sub-programmes within programmes. Expressed differently, the programme classification of the budget provides the language in terms of which government expenditure priorities can be linked to budgetary resource allocations.

Chile has a programme budget structure. However, the prevailing structure has key significant weaknesses which undermine its value as an instrument for expressing allocative choices. In particular:

- The programme structure does not provide a sufficiently detailed classification of expenditure by objective. The programmes themselves are generally very high level, and there are no sub-programmes. Take the example of the Ministry of Environment: under a programme budgeting system, the programme structure of such a ministry would normally contain separate programmes for nature conservation and for anti-pollution. However, in Chile there is no separate anti-pollution programme, and it is not at all clear whether the expenditure on fighting pollution is entirely in one of the other programmes or is split between several.
- The programme structure within each ministry pays more attention to organisational criteria than to the objectives of expenditure. Essentially, each agency associated with the ministry has its own programme, and the ministry itself will have one or several programmes. This means that where both an associated agency and the ministry itself are active in a major policy area, the expenditure will be split between two programmes rather than showing up in a single programme. For example, there is a superior education programme (within the Ministry of Education) plus a separate programme for the Council of Rectors. (Note that there is also, for reasons which are quite unclear, a further ministry programme called "operational expense of superior education".)
- The transparency of the allocation of resources to policy objectives is blurred by the inclusion of large amounts of money in programmes which represent transfers that are paid by the organisational unit concerned to other organisational units, for objectives which are covered by other programmes. For example, there is a National Health Fund programme, and 80% of its expenditure involves transfers to other programmes such as the primary care programme (all of whose expenditure comes from this source). In a programme budgeting system, each programme should clearly show the full final expenditure of the government on the area concerned.
- There are too many cases of programmes that are not defined in terms of outcomes and outputs but according to some other criteria. For example, the education ministry has an educational infrastructure programme, whereas a basic principle of programme budgeting is that a single programme should cover both current and capital expenditure.

- The programme classification of expenditure in the budget is not accompanied by any statement of the objectives (intended outcomes) or key services (outputs) of the programmes. Thus readers of the budget papers must in some cases guess at precisely what the programme covers.

Partly as a result of these weaknesses in the budgetary programme classification, this classification is not integrated with the performance management system. In particular, the "strategic products" – key output types – which entities are required to define as part of their strategic frameworks (see above) bear no necessary relationship to the budgetary programmes. This is despite the fact that, as noted above, the DIPRES definition of a strategic product corresponds precisely to the way in which a programme or sub-programme is defined in a properly designed programme budgeting system – that is, as groups of output within common outcomes.

The failure to link the "strategic products" with the budgetary programmes has the serious consequence of separating the entity's strategic planning from its budgeting. In a properly designed programme budgeting system, the strategic framework should be integrated with the budget via the budgetary programmes. Concretely, entities are required to specify the objectives (intended outcomes) of every budgetary programme, and to develop performance indicators for each programme. However, in Chile performance indicators are linked to the "strategic products" rather than to budget programmes, and the objectives of the budget programmes are not specified.

The other disconnect between the budget and the performance management system is that the "programmes" which are the subject of the evaluations carried out by DIPRES ("evaluation programmes" for short) are not the same as the programmes in the budget and not part of the budget classification. Not surprisingly – given the lack of sub-programmes in a budget classification based on very broad programmes – the evaluation programmes tend to be more narrowly defined than the budgetary programmes. However, DIPRES budget analysts are themselves not always clear about the budgetary programme to which certain evaluation programmes correspond. The consequence is that DIPRES sometimes has trouble knowing how to give budgetary effect to the evaluations when it concludes that evaluation programmes are ineffective or that their intervention logic is dubious. And to those outside DIPRES – including in the Presidency and in the Congress – the relationship between evaluation findings and the budget is opaque.

For these reasons, Chile has decided to reform its programme budget classification so as to make it more consistent with the principles of programme budgeting. This reform, which is initially being implemented in pilot ministries, will involve the careful definition of budgetary programmes on the basis of outputs and outcomes, plus the creation of sub-programmes. The reform will also involve the full integration of the programme classification and strategic framework, with objectives, key outputs and performance indicators being linked to programmes. This will also provide an opportunity to fix the problems that currently exist in the way in which "strategic objectives" and "strategic products" are formulated by some institutions (see above). The opportunity should also be taken to explicitly link programmes to the high-level presidential *Objetivos Estratégicos*.

Fortunately for Chile, the new financial management information system (SIGFE 2.0) which came on line in July 2011 is fully capable of handling properly defined programmes, thus allowing the reform of the budgetary programme classification to be accomplished relatively quickly. SIGFE 2.0 began being implemented incrementally in 2011 and will be fully implemented by 2013.

1.4.2. Lack of focus in the evaluation system on budget preparation

In considering the contribution of evaluation to the budget, the key question that arises is the extent to which the DIPRES evaluation system is at present oriented to serving budgetary purposes, and what might be done to make it more so.

By way of background, it is important to note that evaluation can serve a variety of purposes, and that the type of evaluation carried out will reflect these purposes.

Evaluation serves the budget when its focus is on identifying potential expenditure savings, in the form of either:

- programmes or elements of programmes which are ineffective and cannot practically be made effective. These programmes can be phased out, and the resources which are freed can be added to the fiscal space available for effective and high-priority new spending; or
- savings which can be achieved through efficiency improvements.

Evaluation for budgetary purposes can be broadly distinguished from evaluation for policy/management improvement purposes. The latter type of evaluation aims to help institutions improve policy design – that is, to help institutions change the nature of the services they deliver to the community so as to make them more effective in achieving their intended outcomes – rather than to identify options for budget cuts. A policy/management evaluation can also aim to help institutions improve processes and management so as to make the delivery of services more efficient, but again without a focus on the budgetary implications of such efficiency improvements.

The evaluation system developed by DIPRES in Chile is not focused exclusively or even predominantly on serving the budget. It is rather a system designed to support performance management in general. The evaluations which are carried out have broad objectives, with a heavy emphasis on improvements in policy, process and management. The system evolved this way partly because, at the time it was first developed, there was relatively little evaluation being undertaken by government institutions for any purpose. As a result, the challenge was not perceived as primarily one of developing evaluation within DIPRES as a tool to support budgeting, but rather as one of developing evaluation more broadly within the Chilean government.

The broad focus of the DIPRES evaluation system is reflected in the wide scope of the issues examined by the evaluations and in the particular attention paid, in the standard terms of reference, to policy and management improvement issues. This is particularly, but not exclusively, the case for the institutional evaluations, which have a very wide performance-improvement focus.

The broad focus of the DIPRES evaluation system is also reflected in the choice of programmes and institutions for evaluation. If evaluation is going to make its maximum potential contribution to resource allocation, the programmes (or elements of programmes) and topics chosen for evaluation should be those which appear *prima facie* likely to yield budgetary savings. However, at present the DIPRES system does not choose programmes for evaluation primarily on the basis of the likelihood of realising budgetary savings. Rather, selection appears to reflect a goal of evaluating all programmes over time, together with a desire to pay greater attention to programmes which are seen as potentially needing policy redesign or management improvement. In the evaluations, there has also been a deliberate policy of including programmes which are seen to be good performers.

There would also appear to be certain weaknesses, particularly from the budget point of view, in the way the DIPRES evaluation system handles efficiency issues. DIPRES evaluations do focus on efficiency issues to some extent. The institutional evaluations look in part at the efficiency of the institutions concerned, and the standard terms of reference of the impact evaluations also ask for some examination of the efficiency of programmes. Two points, however, stand out.

First, to be useful for the budget, it is not sufficient that efficiency reviews identify inefficient practices and recommend steps to reform them. It is essential that efficiency reviews go further and provide the Ministry of Finance with estimates of the magnitude of the savings that could be achieved through improved efficiency, of the time required for the entity concerned to achieve those savings, and of any support that the entity may need to achieve them (particularly budgetary support, such as funding for investments in cost-reducing technology that will yield major budgetary savings over time). The DIPRES evaluations do not at present provide this type of advice. Rather, their focus is on advising the management of the institution concerned on how to improve efficiency.

Second, there is at present no mechanism for reviewing transversal efficiency issues – that is, efficiency issues which affect many government agencies, such as the organisation of support services or procurement practices. This situation contrasts with the strong focus of efficiency reviews in many other countries on government-wide efficiency issues. In New Zealand, for example, there has been in recent years a very strong focus on reviewing the efficiency of support services, underpinned by the development of key process efficiency indicators for cross-agency benchmarking (see, for example, New Zealand Government, 2011). The United Kingdom is another good example: over the last decade, successive governments have carried out a series of transversal efficiency reviews, including the Gershon review of 2004 (Gershon, 2004), the operational efficiency review launched in 2008 (HM Treasury, 2009), and the Green efficiency review of procurement which reported in October 2010 (United Kingdom Cabinet Office, 2010). In other countries, such as Denmark and Sweden, a productivity dividend mechanism has been put in place, as discussed in Box 2.

In the light of all this, it appears that a primary reason for the limited effect of the DIPRES evaluation system on the budget is that the system is not specifically designed to support the budget. It is rather a more "general purpose" system designed to support policy and management improvement.

It follows that, in seeking to increase the use of DIPRES evaluations in the budget, the obvious course of action is to target and tailor these evaluations more to this purpose. However, if DIPRES evaluations become more budget-focused, the question arises of what is to happen to the broader evaluation function. How does one ensure that the use of evaluations for broader policy and management improvement purposes does not suffer?

This question may already be in the process of being answered by the government plans that are currently under way to build at least one and possibly two evaluation institutions. One of these institutions will be part of the new Ministry of Social Development (created by law in October 2011) and is intended to exercise a wide evaluation mandate with respect to "social" programmes across a range of ministries (see Box 3).

Box 2. **Features of automatic productivity cut procedures in OECD countries**

A number of OECD countries have automatic productivity cuts (dividends) in place, including Australia, Denmark, Finland, New Zealand and Sweden. According to these countries, the main advantage is that automatic productivity cuts change the baseline of current policy that serves as the point of departure for the annual budget process. This is seen by finance ministries as a strategic advantage in budget negotiations. Automatic productivity cuts do not mean that the budget of all line ministries is substantially reduced from year to year. First, the cuts only apply to current operational expenditures which are generally a small part of ministerial budgets. Second, most ministries annually have new spending initiatives which may be larger than the automatic cuts.

Procedures for automatic productivity cuts can differ somewhat between countries. In most countries, the base is current operational costs. For example, in Denmark the cuts are applied to the last year of the multi-annual estimates (three years after the upcoming budget year). In this way, the cuts are "gradually phased in" and inserted in the multi-annual estimates that serve as the basis for budget preparation every year. Denmark has been working with the automatic cuts since the beginning of the 1980s. In Sweden, the multi-annual estimates are in real terms and are translated from year to year in nominal terms through an aggregated wage and price index. If the tasks are not changed, the operational budgets are the same as the previous year, corrected by the index. In order to put productivity pressure on the agencies, the index used does not fully take account of the real increase of wages in the market sector: the index is decreased by a moving average of the last ten years of the productivity increase in the market sector. New Zealand uses nominal current operational costs as the baseline in the annual budget cycle. This implies that inflation has to be absorbed (around 2.3% in recent years), but adjustments may be made for wage developments in the market sector. Some countries exempt sizeable portions of current operational expenditure from the productivity cuts, such as the armed forces, but may subject them to more tailored productivity cuts instead.

In principle, there are two approaches to the cut percentage. One is to differentiate the percentage on the basis of empirical productivity studies, either for the public sector units that produce the services or for private sector organisations providing similar services. The other approach is to use a government-wide percentage based on a reasonable average. Most countries use a uniform percentage. In New Zealand and Sweden, this is dependent on inflation and/or wage development in the private sector; in Australia and Denmark, it is set by a political decision somewhere between 1% and 2%.

Countries that do not use automatic cuts emphasise that productivity gains differ between policy areas and that, if a single productivity estimate is used for the entire government sector or for central government, sectors with relatively low productivity growth suffer. Moreover, these countries claim that the productivity growth percentage cannot be determined objectively. And since public sector productivity may grow less rapidly than private sector productivity, comparisons between public and private sector productivity in comparable areas are difficult and do not provide reliable results. The first risk has to be nuanced: the fact that the productivity cut uses a uniform percentage does not mean that all ministerial divisions and agencies must realise the same productivity gains. Line ministers are generally free to distribute the targets as they see fit. In practice, spending priorities play an important role in this distribution, apart from the potential for productivity growth. The second risk can be mitigated to a certain extent by the choice of a low cut percentage (substantially below the market productivity development). The percentage of 1-2% generally in use meets this condition. In the long run, this will still lead to substantial savings.

Source: OECD (2011), *Value for Money in Government: The Netherlands 2010*, Value for Money in Government, OECD Publishing, Paris, pp. 78-81, doi: *10.1787/9789264096097-en.*

However, there are also plans (though less firm) to develop an Agency of Public Policy Evaluation with a government-wide evaluation mandate. In this context, it could be possible for these institutions to take over the broader evaluation mandate and allow the DIPRES evaluations to focus exclusively on budgeting.

Box 3. **Ongoing reform in Chile: The creation of the Ministry of Social Development**

The reform aims to provide an institutional framework that can guarantee co-ordination and coherence and hinder duplication of social development policy in government. This effort is meant to strengthen one of the strategic objectives of the Chilean government – "eradicate extreme poverty by 2014" – by linking spending to government priorities. The law aimed to do this by creating the Ministry of Social Development and abolishing the current Ministry of Planning. Apart from strengthening social policy, the reform is also meant to increase fiscal space by eliminating low-priority and ineffective programmes and to realise efficiency savings.

A new kind of *ex ante* evaluation (i.e. appraisal) of social programmes is to be undertaken by the new ministry. The evaluation will assess the coherence, consistency and relevance of all programmes that are proposed or reformulated, and will be a precondition for any new programmes going forward. Such *ex ante* appraisal is by definition different from the three existing types of *ex post* evaluations (impact evaluation, evaluation of programmes, and institutional evaluations). The new ministry will also monitor implementation of existing social programmes by assessing programme efficiency, efficacy and focus. The evaluations will be delivered to the Social Development Committee composed of the Ministry of Social Development, the Ministry of Finance, the Ministry of the General Secretary of the Presidency, the Ministry of Education, the Ministry of Health, the Ministry of Housing and Urbanism, the Ministry of Labour and Social Prevision, and the Ministry of Women. This committee will create a list of current and proposed social programmes that can provide the basis for political prioritisation.

The main problems to be addressed by this new structure are a lack of coherence between various social programmes in different ministries and the duplication of programmes. One of the reasons for this situation is that actual policy programmes are not the same as those identified in the budget, which creates unclearness and confusion as discussed previously. In addition, few ineffective programmes have been cut, mainly due to entrenched stakeholder interests. By doing *ex ante* evaluation, it is hoped that ineffective programmes will not be set in motion.

The relationships between the new ministry, the Ministry of Finance's evaluation effort and the Ministry of Finance's Budget Directorate are not clear at present. In addition, the introduction of a spending review process cutting across all ministries would also need to be co-ordinated with this new effort.

The law creating the Ministry of Social Development and modifying the indicated legal bodies was approved by the Chilean Congress on 13 October 2011.

The other part of the solution may be increased efforts to promote the evaluation function within spending institutions. External evaluations are undoubtedly an essential part of the system; however, a limitation of external evaluation is that the institution being evaluated may not "own" the evaluation. Rather, it may regard the evaluation as an external imposition and, as a consequence, fail to make full use of its recommendations.

The maturation of the Chilean evaluation system should therefore in part involve a significant measure of decentralisation of evaluation.

With respect to efficiency reviews, there is an additional question whether it might be better to create an efficiency review process which is separate from the evaluation system, and which is at the same time explicitly designed to support the budget by going beyond recommendations on how to improve efficiency to the provision of concrete advice to DIPRES on the magnitude and timing of consequent reductions to the baseline budget allocations of the institutions concerned. Evaluation experts may not necessarily be the best people to carry out this type of efficiency review. Expertise in management and business processes may be more relevant, so that the expertise of former senior managers (from the private sector as well as the public sector) and business consultants may be at least in some cases more useful. It is important in this context to safeguard against any tendency of the professional evaluation community to claim all types of policy and management analysis and appraisal as their professional domain. The evaluation discipline has a great deal to offer, but so do other relevant professionals.

1.4.3. Lack of priority analysis

The discussion to this point has focused on the budgetary impact of analysis of effectiveness and efficiency. However, an important part of good resource allocation in the budget is priority analysis – in particular, the identification of programmes or elements of programmes which can be cut because they are low priority. This is a completely different matter from ineffectiveness or inefficiency. A programme might be highly effective and efficient, but still be very low priority because the outcomes which it aims to achieve are not very important to the community or are not rated as such by the government of the day.

The DIPRES evaluation system does not focus much on assessing programme priority. This is true also for DIPRES appraisal of new spending proposals, which is largely confined to assessing whether the proposed new spending is likely to achieve its stated outcomes rather than assessing the relative importance of those outcomes.

This observation is not a criticism of the system, because priority analysis is very different from evaluation. Priority analysis is inherently much more political, often requiring judgments influenced by perspectives on the appropriate role of the state and the nature of the key problems facing the society and economy.

It is therefore something of a problem that, in the Chilean system, there has been no institution with a specific responsibility for reviewing the priority of programmes (as opposed to their effectiveness and efficiency). This gap in the system leads to the next point: the absence of a spending review mechanism.

1.4.4. Lack of a spending review mechanism

The analysis so far has focussed on the efforts to increase the impact of performance information on the budget by improving the quality of that information – for example, by making evaluation more budget-oriented, by strengthening efficiency analysis, and by developing priority analysis. However, to maximise the impact of performance information, there is one further step which could usefully be taken: the creation of a spending review process.

The problem at present is that, even when evaluations do provide information which could be used to make recommendations for cuts to baseline spending, such recommendations are usually not developed and put forward during the budget preparation process. This is an institutional problem, in that there is no clear assigned responsibility for identifying and recommending options for cuts. The sectoral budget analysts do not necessarily see this as their responsibility, and in any event these decisions are too sensitive and political to be taken by middle-level technical staff alone. Nor does the group within DIPRES which manages the evaluation system (the *División de Control de Gestión*) see this as its function.

Spending review – as the term is used here[6] – involves the creation of a spending review team with the explicit responsibility of assembling options for cuts to baseline expenditure and putting those options forward for consideration by the political leadership during the preparation of the annual budget.

The spending review team draws on evaluations and efficiency reviews (as well as the opinions of budget analysts) but does not carry these out itself. Options for cuts are of three types: savings from measures to improve efficiency; the elimination of programmes (or elements of programmes) that are ineffective and that cannot readily be reformed to make them effective; and the elimination of programmes that are low priority.

The need for the spending review team to focus on priorities as well as on efficiency and effectiveness makes it important that it should not only be technically competent, but also sensitive to the priorities of the government of the day. It may also be useful for the team to include not only DIPRES officials, but also personnel from the Presidency.

Consideration would have to be given to the appropriate frequency of spending review, and in particular to whether it would be an annual or periodic process. One possible approach would be to have periodic in-depth spending reviews, and then a lighter spending review on an annual basis in the intervals. Because cuts to existing programmes usually create some political resistance, the best time to carry out an in-depth spending review may be at the start of each presidential term of office.

1.4.5. *The use of formula-based performance budgeting*

Chile funds a number of public services on the basis of formulas, including health and education. These formulas can be based on expected input needs, on payment per activity, or on actual outputs. For example, the primary education system is funded on a quasi-market voucher basis in which the government pays private and municipal schools according to student attendance. Higher education is also premised on running on a quasi-market basis, where competition is meant to ensure the good performance of institutions.

Some countries have tried to extend the formula-based funding mechanism to outputs and even outcomes in order for public institutions to focus on delivering value. More than 20 countries across the world today fund public hospitals on an output basis known as the "Diagnostic Related Group" funding system (see Box 4). Research has clearly demonstrated the success of this system in improving the efficiency of service delivery. Under the DRG funding system, public hospitals in a number of countries are funded principally on the basis of the services they actually deliver, with a different price set for every output type. For example, each treatment of a hip fracture patient is funded at a certain price. This means that hospitals make a loss (profit) if the actual cost of the service delivered exceeds (is less than) the price they receive. The hospital is only paid for the services it delivers to patients ("payment by results"), so a failure to deliver the expected volume of services results in reduced funding. Assuming appropriately calculated prices, the system creates a strong financial incentive for efficiency.

Box 4. **The DRG hospital funding system**

The DRG-based hospital funding system uses the "Diagnostic Related Group" output classification system for acute in-patient hospital treatment. DRGs are categories of patient treatment episodes that are relatively homogenous with respect to the resources used and that are therefore often referred to as "ISO-cost" output classes. By providing valuable information about the cost of providing the "same" type of product in different hospitals, DRGs facilitate the identification of significant inefficiency problems. As such, they were initially used, along with other performance information, as the basis for improved performance management – that is, for non-budgetary forms of managing for results. From the late 1970s, DRGs also began to be used as the basis of hospital funding systems.

The crucial move came when, following what were perceived as successful state experiments, the United States federal government in 1984 introduced the so-called Prospective Payment Systems (PPS) for Medicare payments to hospitals (subsequently extended to Medicaid also). Under this system, hospitals are paid fixed prices per unit of output actually delivered, with specific prices for each DRG output type. Any difference between the actual cost of treatment and the DRG price represents either a loss or a profit to the hospital. The setting of the DRG price is important. For example, if prices are set on the basis of the DRG costs of hospitals on average – approximately what happened when PPS was introduced in the United States – then hospitals which are more-than-averagely inefficient (efficient) are penalised (rewarded). To the extent that the tougher approach is taken of setting prices closer to the costs of the most efficient hospitals, the system even penalises average levels of inefficiency.

Since the way was paved by the United States, output-based funding using DRGs or similar output classifications has been adopted for public hospital funding in many other parts of the world, including Portugal (1990), Australia (from 1993), Norway (1997), Singapore (1997), and the United Kingdom (2004). There has also been increasing interest in the use of the DRG-type methodology in health service areas beyond hospitals.

DRG funding has multiple advantages. Because hospitals are only paid for the treatments they deliver, they have a strong incentive to increase their output with any given level of funding (i.e. improve their efficiency). In addition, funding follows patients rather than the other way around, which improves both client responsiveness and waiting times. Funding between different hospitals becomes more equitable, without (for example) the inbuilt funding inequities which tend to favour well-established hospitals over newer hospitals in traditional hospital funding systems.

Many countries use a somewhat similar approach for funding public education, with payments to schools and universities being based primarily on the number of student courses delivered (the output) and sometimes partly also on the basis of student success rates in passing exams (an outcome measure). One example is higher education funding in Denmark, where variable funding is tied to the number of students that actually pass their exams.

While Chile is at present making use of formula funding in various ways, it may be possible to tie funding and outputs closer together in particular fields. It might be beneficial to strengthen the analysis done by the Budget Directorate of the current formulas, to assess whether they are precise enough and whether they result in good performance.

1.5. *Suggestions for reform*

On the basis of the above discussion, the Chilean government could consider the following recommendations.

1.5.1. *A modified budgetary programme structure*

The programme classification in the budget should be reformed and developed so as to better serve the goals of performance budgeting. More specifically, this means making the programmes as useful as possible as a tool for expenditure prioritisation and, as part of this, for the integration of budgeting and strategic planning.

It would be helpful to overhaul the budgetary programmes on the basis of good practice from other countries. Concretely, this means:

- ensuring that the programme structure provides a more detailed classification of expenditure by objective, by *i)* breaking up certain highly aggregate programmes into two or more programmes, and *ii)* by introducing sub-programmes;
- giving priority to programmes that have particular political goals, not to inventing categories for activities to fit into the programme structure (i.e. purely administration in departments);
- for programmes that are not defined as cross-sectoral, eliminating the practice whereby the budgets of programmes include money that is in fact not part of the programme concerned but represents transfers to other programmes. In this way, the principle will be established that programme budgets should cover all direct expenditure on the programme's objectives;
- reviewing programmes to ensure that they are defined as groups of outputs with common outcomes, and not on some other basis;
- identifying more clearly the specific objective (intermediate outcome) of each programme;
- linking relevant outcome and output indicators to each programme and sub-programme.

For the implementation strategy and timing, the first step in the revision of the budgetary programme classification should be the rapid development of methodological guidelines (a manual) that clearly state the principles to be observed in the definition of programmes and in the linking of programmes to strategy. This is important because there are matters that, if not clearly resolved in such guidelines, will cause confusion and lead to conflicting approaches in different ministries or agencies, such as:

- the relationship of budgetary programmes to internal organisational units;
- the treatment of ministry-wide support services.

The overhaul of the programme structure could initially be piloted in a small number of ministries/agencies (e.g. food inspection, subsidy payment, social programme spending, health, education). The reform of the programme structure should then be extended to all ministries and agencies.

1.5.2. Linking government-wide priorities to the budget

The modified programme structure should be used to explicitly link the budget to government-wide programmes. Government-wide strategic objectives should in general relate to "high-level" outcomes such as strong economic growth. The objectives of programmes, by contrast, are in general "intermediate" outcomes that contribute to the higher-level government-wide outcomes. Once programme-specific outcomes are defined, they will serve as the means of making an explicit link to relevant government-wide priorities.

Regarding the implementation strategy and timing, the government-wide strategic objectives can be linked to the programme structure during its overhaul.

1.5.3. Introduce spending review

The creation of a spending review mechanism would enable priority analysis and create fiscal space. The spending review needs a political mandate at the presidential level to identify options for cuts to baseline spending to create more fiscal space for new priority spending. These options would then be considered and finally decided upon by the President and the Cabinet during the budget process, and subsequently endorsed by Congress as part of the budget.

The reasons for cuts should be: *i)* efficiency improvements; *ii)* programmes that are low priority; and *iii)* programmes that are not cost-effective and that cannot readily be fixed by changes in policy or management. However, the government should avoid the illusion that efficiency improvements alone will be enough to create substantial fiscal space in the short term. If significant fiscal space is to be created, it is essential also to be willing to cut programmes. Spending review does not focus on saving poorly performing programmes by policy or management changes. This is the responsibility of others in government.

There is always the political danger that a spending review will be attacked as a "small government" exercise. It is, of course, an essential tool for any government which wishes to reduce the size of the public sector. However, assuming that this is not the goal of the Chilean government, it should be stressed publicly that the objective is to reallocate rather than reduce aggregate government expenditure. The point should be made that reallocation is an essential way to fund new priorities while maintaining Chile's well-known fiscal discipline.

The institutional structure of spending review should include several elements:

- Create spending review as a function within (not outside) the civil service. *Ad hoc* external reviews (e.g. conducted by notable businessmen) have often not been successful internationally.
- Recognise that spending review is not a purely technical function. It should be under the direction of politically appointed officials who are sensitive to the priorities of the Presidency.
- In the light of this, a possible model for spending review would involve it being carried out by a small number of Ministry of Finance staff assigned full-time to the task, whose work would be guided by a small task force of senior officials from the Ministry of Finance and from the Presidency.

Regarding the frequency of spending reviews: because cuts to existing programmes usually create some political resistance, the best time to carry out an in-depth spending review may be at the start of each presidential term of office. The best approach to the conduct of spending review may therefore be to carry out an in-depth spending review in the first year of each presidential term of office, plus more limited spending reviews in other years.

It is too late to conduct significant spending review for the 2012 budget. Instead, the main options are:

- Option A: Start with an in-depth spending review during 2012 with the ambition of making major reallocations of expenditure in the 2013 budget. However, this may be politically difficult given the proximity to the 2013-14 presidential election.
- Option B: Establish spending review now, but conduct limited spending review during 2012 and 2013. Aim to develop the mechanism so that the first in-depth spending review can effectively be carried out in 2014. By not waiting until 2014, this makes it possible for spending review to create some fiscal space for presidential priorities during the term of the current President.

1.5.4. Improve analysis to support spending review: Ex post *evaluation and efficiency reviews*

The success of spending reviews in identifying options for cuts depends critically on ensuring that the officials who have responsibility for conducting a spending review have access to evaluations which are more focused on providing information that is useful in the budget preparation process, as opposed to evaluations which are primarily focused on recommending policy and management improvements. To this end:

- While it is tempting for the selection of programmes for evaluation to be focused on programmes that look like potential candidates for budget cuts, this has to be balanced against the fact that the evaluations will be met with strong resistance by the ministry concerned. Thus, selection should be balanced.
- The scope of the impact evaluations carried out should be tightened considerably to focus exclusively on issues relevant to budget preparation (e.g. by eliminating the standard requirement to review management processes).
- In order to more clearly identify programmes or elements of programmes which can be cut, the standard terms of reference of impact evaluations should be revised to require a clear assessment of the practicality of fixing (making effective) programmes that, as currently designed, are assessed as ineffective. This includes an assessment of the probable cost of fixing the programme. Parallel modifications should be made to the terms of reference of EGPs (evaluations of government programmes).
- Consideration could be given to whether the timelines of impact evaluations might be shortened (from the current 18 months to, say, 12 months or less) to make their findings more timely.
- Consideration should be given to whether the institutional evaluations (*Evaluaciones Comprehensivas de Gasto*) – which seem to be focused entirely or mainly on policy and management improvement – play a useful role in supporting the budget and, if not, whether the Ministry of Finance should cease carrying them out.

- Efficiency reviews – that is, reviews aimed at identifying opportunities for savings by delivering services at lower cost – should be given greater emphasis than at present. To ensure their relevance for budget preparation, the terms of reference of these efficiency reviews should require them not only to identify specific areas where efficiency can be improved, but also to quantify the potential efficiency savings involved and the time frame for their potential realisation.
- Efficiency reviews should include reviews of transversal efficiency issues (efficiency issues that affect many government agencies, such as the organisation of support services or procurement practices).
- Efficiency reviews should actively benchmark agencies and public institutions against each other, against relevant private sector entities and against similar institutions in other countries.
- Efficiency review should be carried out by business process experts, and not only by professional evaluators.

1.5.5. *The assignment of institutional responsibilities for evaluation*

It is recommended that the mandate of the evaluations be reviewed, in particular to decide:

- whether they should be re-defined to focus primarily on evaluation to support budget preparation, and more specifically to provide the information necessary for spending review;
- whether the role of evaluation in supporting policy and management improvement of programmes and institutions should be reassigned to other institutions (e.g. the planned new evaluation agency and the Ministry of Social Development);
- how to co-ordinate the role of the new Ministry of Social Development with regards to *ex ante* evaluations and evaluations of the existing stock of programmes. The potential for overlap and bureaucratic conflict between the Ministry of Finance and the Ministry of Social Development concerning this area cannot be discounted.

1.5.6. *Introduce a productivity savings mechanism (efficiency dividend)*

Another useful means of creating fiscal space is the introduction of a productivity savings mechanism. Under this mechanism, the current baseline budget of each ministry or agency is reduced by a small percentage (typically around 1.5-2%) each year. The justification is that ministries/agencies should be able to make such savings on a routine basis by improving their efficiency (e.g. from the savings created by information technology). The productivity savings mechanism creates some additional fiscal space which the government can then apply to new priorities.

Certain types of expenditure – particularly transfers – need to be excluded from the application of the productivity savings. Before introducing the mechanism, it is necessary to carefully define the expenditure to which it will apply. Consideration could be given to initially introducing the productivity savings at a quite low rate – say 0.75% – so as to make sure that any unforeseen design problems do not cause major problems for ministries. The rate could be kept at this low level for, say, two years while the design is perfected. After that, the permanent rate (1.5-2%) could be safely applied.

1.5.7. *Improve institutional strategy and indicators*

In order to tighten the institutional strategic planning framework and integrate it properly with the budgetary programmes, the following steps should be taken:

- Align institutional strategic definitions with the reformed programme budget classification in order to facilitate the integration of planning and budgeting. In particular:
  - Statements of programme outcomes should replace the present "strategic objectives". In other words, for each budgetary programme, the institution should be required to clearly specify the programme's intended outcome. Expressed differently, strategic objectives would be linked to programmes, and would as a rule refer to outcomes rather than outputs or processes.
  - Each institution's outputs – "strategic products" as they are called in the current strategic planning framework – should be clearly identified with the programme under which they fall.
  - Institutions' definitions of their strategic products (outputs) should be reviewed to eliminate strategic products that are processes or inputs rather than outputs.
- Provide methodological guidance to institutions on the strategic framework so as to ensure that institutions clearly state their outcomes and correctly state their main outputs.
- Review and further develop the key performance indicators reported to DIPRES and the Congress to improve their relevance, including by the development of more outcome indicators.
- Shorten and improve the accessibility of the budget information papers (*Antecedentes Complementarios Control de Gestión Pública*), particularly by replacing the long evaluation reports with brief summaries (not more than a half page) with guidance on where to find the full evaluation documents on line.

The methodological guidelines for the revised budgetary programmes should include guidance on the reformulation of institutional "strategy statements" (*definiciones estratégicas*), linking them to programmes and clarifying them.

1.5.8. *Strengthen the use of formula-based performance budgeting*

While Chile is at present making use of formula funding in various ways, it may be possible to tie funding and outputs closer together in particular fields. It might be beneficial to strengthen the analysis done by the Budget Directorate of the current formulas, to assess whether they are precise enough and whether they result in good performance.

It would be useful to investigate whether more output-based funding mechanisms are appropriate and viable, and to strengthen the scrutiny of the formulas currently in use in order to assess value for money. Institutions could be benchmarked against each other and compared to relevant private sector institutions where applicable.

In the absence of a more detailed review of the current position, it is not possible to specify the appropriate implementation strategy or to suggest the best time frame for this reform. The first step should therefore be to conduct feasibility studies.

2. Medium-term budgeting

2.1. Introduction

Chile is facing a challenging fiscal environment in the wake of the global financial crisis and the major earthquake of 2010. When the financial crisis hit, Chile wisely suspended its budget balance rule in order to engage in a substantial fiscal stimulus (of the order of 4% of GDP). The earthquake subsequently put considerably further pressure on expenditure as a result of the large reconstruction bill. Consistent with the country's strong bipartisan commitment to sound fiscal policy, however, the government has mapped out a clear fiscal exit strategy which sets annually reducing deficit targets, with the medium-term objective of reducing the deficit to 1% of GDP by 2014.

The fiscal situation puts the spotlight on the quality of existing medium-term budgeting processes. In the context of a medium-term fiscal consolidation programme, it becomes particularly important to be able to accurately measure the fiscal space available to government. The accurate measurement of fiscal space – and, underpinning that, the accurate measurement of baseline expenditure – is at the very core of a good medium-term expenditure framework (MTEF). As discussed further below, good projections of baseline expenditure and fiscal space are precisely what make possible the reconciliation of "top-down" fiscal policy and "bottom-up" expenditure and revenue policies under the MTEF. Chile at present produces medium-term baseline and fiscal space estimates. However, the Ministry of Finance believes that there is room for improving the quality of these estimates so as to make them a better guide for budget decisions.

2.2. Overview of the use of medium-term frameworks in OECD countries[7]

Medium-term frameworks are a top-down tool that strengthens the Ministry of Finance's ability to plan and enforce a fiscal path. They also help offset the annual focus of budgets which tends to impede effective expenditure management decisions on resource allocation covering a number of years. Many policies require an extended time horizon, such as large capital projects, new programmes and organisational restructuring. The forward estimates of spending beyond the budget year make clear the medium-term implications of budget decisions.

From the point of view of agency managers, medium-term frameworks put them in a better position to plan their operations, as they have some indicative level of funding beyond the next budget. This is especially relevant in a downsizing environment. Many saving options involve more than one year in order to reap the full benefits. Naturally this should be balanced against the need for budgetary flexibility.

Many OECD countries have introduced multi-year forward estimates (baselines) into the annual budget preparation process since the late 1970s and early 1980s. Today such estimates are presented to the legislature in 29 OECD countries. In preparing forward estimates, about one-third (12) of OECD countries present forward estimates at an aggregate whole-of-government level to the legislature, five prepare them at a ministry level, and eight at a line-item level.

Multi-year ceilings are prepared and presented to the legislature in 21 OECD countries, among which 11 set ceilings at an aggregate level. Some countries like the Slovak Republic and the United Kingdom establish medium-term ceilings at a ministry level; a few others like Belgium set them at a line-item level.

Most OECD countries (24) have expenditure estimates that are updated annually as part of the budget preparation process. Three countries prepare estimates twice a year (Australia, Canada, United States), while Ireland and the United Kingdom prepare them every two years. Turning to ceilings, 13 countries update the multi-year ceilings every year and four update them after an election (Austria and the Netherlands) or a change in government (Japan and Finland). The United Kingdom is the only country that revises estimates and ceilings together every two years.

While multi-year expenditure estimates have been nothing short of a "cultural revolution" for government, their use has often encountered certain challenges. In particular, countries have experienced difficulties modifying multi-year expenditure estimates *ex post*, since ministries tend to view them as entitlements even if they are based on unreliable macroeconomic forecasts. Moreover, the use of real rather than nominal values has placed pressure on public finances during times of high inflation or recession. In preparing multi-year estimates, 21 OECD countries base expenditure estimates on current legislation, 16 countries base them on anticipated legislative changes, and 11 do it for both. Four countries have estimates in real terms. Twenty-one OECD countries adjust estimates in accordance with official macroeconomic forecasts or adjust for demographic changes (17 countries).

It should be emphasised, however, that, in order to achieve the full benefit of the practice, it has to be part of a wider debate about the countries' fiscal position in the medium term. In other words, if the estimates show a spending increase in the medium term above the fiscal objectives, compensating cuts should be inserted into the estimates. In this way, the estimates will stay in line with the fiscal objectives and thus enforce fiscal discipline on a continuous basis.

2.3. The current situation in Chile

Since 2001, Chile has had a clear macro-fiscal framework featuring a rule with respect to the annual structural budget balance. Prior to the global financial crisis, the rule required a structural surplus of 0.5% of GDP (it was set at 1% from 2001 to 2007). During the crisis, the rule was suspended to permit a large fiscal stimulus, equivalent to 2.8% of GDP. Following the crisis, the government declared its intention to move back to sustainable fiscal settings over the medium term, and to this end has set a medium-term objective of reducing the structural deficit to 1% by 2014. It has also mapped out a transition path, setting annual structural budget balance targets for each year up to 2014, and will gradually move to this medium-term objective. In 2011, the aim was to reduce the budget deficit to 1.8%, followed by 1.5% in 2012, 1.3% in 2013, and finally 1% in 2014. The intention is that from 2015 a new structural balance rule will be put in place (see below).

For some years, the government has prepared medium-term fiscal projections and presented them to the Parliament together with the budget law (Table 1 shows the projections published with the 2011 budget). The aim of these projections is to show "the fiscal space which exists to expand or create programmes, and also to anticipate the need to take action to avoid any possible future disequilibrium". To this end, projections are composed of:

- the level of aggregate expenditure permitted by the budget balance rule or (in the present context) target, given projected revenue; and

- the level of committed expenditure (*gasto comprometidos*) – by which is meant what is often referred to in other countries as “baseline” expenditure.

The fiscal space is the difference between these two levels.

Table 1. **Medium-term fiscal projections in Chile, 2011-14**

Consolidated balance of central government; convergence to a structural deficit

	2011 proposed budget	2012 projection	2013 projection	2014 projection
Consolidated balance of central government (million pesos in 2011 and per cent of GDP)				
1. Total income	25 769 646	26 540 282	27 386 419	28 406 489
2. Total committed spending	26 693 480	27 134 671	27 353 534	27 145 499
3. Balance (1-2)	-923 834	-594 389	32 886	1 260 990
4. Balance (% of GDP)	-0.8%	-0.5%	0.0%	0.9%
5. Structural income	24 660 461	25 798 173	26 809 354	28 037 130
6. Structural balance (5-2)	-2 033 019	-1 336 498	-544 179	891 631
7. Structural balance (% of GDP)	-1.8%	-1.1%	-0.4%	0.6%
Convergence to a structural deficit of 1% of GDP in 2014				
8. Structural deficit target (% of GDP)	-1.8%	-1.5%	-1.3%	-1.0%
9. Spending level compatible with target	26 693 480	27 645 225	28 437 838	29 412 873
10. Spending difference (9-2)	-	510 554	1 084 305	2 267 374
11. Spending difference (% of GDP)	0.0%	0.4%	0.8%	1.6%
12. Actual balance compatible with target (1-9)	-923 834	-1 104 943	-1 051 419	-1 006 384
13. Actual balance compatible with target (% of GDP)	-0.8%	-0.9%	-0.8%	-0.7%

Source: Government of Chile (2011), *Informe de Finanzas Públicas Proyecto de Ley de Presupuestos del Sector Público para el año 2011*, Santiago, p. 62.

This type of fiscal forecasting exercise is at the very heart of good medium-term budgeting (see Box 5), the aim of which is to ensure the compatibility of tax and spending policies with good aggregate fiscal outcomes.

One other important feature of medium-term budgeting in Chile should be noted. This is the legal requirement that DIPRES provide the Congress with medium-term cost estimates of every new spending proposal which is placed before the Congress.

2.3.1. Quality of the forward estimates

Chile has clearly taken the right approach in seeking to estimate fiscal space over the medium term in order to know the room for new spending or, alternatively, obtain advance warning of the need for adjustments in spending or in tax policy. It is also commendable that these medium-term projections are made public in order to keep the Congress and public informed of the fiscal prognosis.

However, it will be clear that the value of the medium-term projections depends entirely on the quality of the forward estimates. Only if the forward estimates are of good quality will it be possible to have faith in the estimates of fiscal space and to let them guide policy makers in deciding how much new spending can be implemented.

DIPRES has put a great deal of effort over the years into revenue forecasting, and believes that the revenue forward estimates are of relatively good quality. This is not, of course, to say that revenue forecasting is easy. For example, projecting copper revenues is particularly difficult, given the sensitivity of copper prices to the international business cycle and the impact of exchange rate fluctuations on the copper revenues in local currency terms.

Box 5. **Core elements of medium-term budgeting**

The most fundamental aim of good medium-term budgeting is to ensure the consistency of bottom-up expenditure and revenue policies with top-down aggregate fiscal policy. Medium-term budgeting is therefore, above all else, a mechanism for strengthening the centre's capacity to enforce top-down limits on aggregate expenditure. In the top-down process, the highest executive budget decision-making institution – e.g. the Cabinet or the President – sets aggregate expenditure ceilings which reflect macro-fiscal and revenue policy objectives prior to any consideration of ministry spending requests. The challenge is then to ensure that these aggregate ceilings are adhered to during the budget preparation process. Medium-term budgeting is a powerful tool for ensuring this.

Medium-term budgeting requires good quality expenditure and revenue **forward estimates** in order to ensure the consistency of budgetary expenditure allocations with the aggregate expenditure ceilings. Forward estimates are medium-term estimates of expenditure and revenue on a "current policy" basis – that is, projections that indicate what the expenditure and revenue will be in each of the next three or four years if there are no new spending initiatives, no changes to tax laws, and all commitments of future expenditure (including political promises) are taken into account. Forward expenditure estimates cover what is often referred to as baseline expenditure.

The other requirement of medium-term budgeting is medium-term projections of the maximum level of aggregate expenditure that is compatible with aggregate fiscal policy goals (i.e. targets or rules for the budget balance and/or also for stock variables such as debt) given projected levels of revenue. For example, if the government has a rule that the budget should be structurally balanced, the maximum aggregate expenditure each year will be equal to projected structural revenues plus or minus any purely cyclical expenditure. In countries that set **aggregate expenditure ceilings** as part of their fiscal framework, these ceilings will by definition give the maximum permissible level of aggregate expenditure in any year.

Armed with these two elements, it becomes possible to compare the "top-down" aggregate expenditure limits with the "bottom-up" projections of baseline expenditure. The difference between these two is widely referred to as **fiscal space**. Positive fiscal space – that is, baseline expenditure below the permissible level of aggregate expenditure – gives a measure of the amount of new spending (or tax cuts) which can be undertaken consistent with aggregate fiscal policy. Negative fiscal space – that is, baseline expenditure in excess of maximum permissible aggregate expenditure – indicates that existing expenditure policies must be changed to reduce baseline spending (or, alternatively, taxes must be increased) if aggregate fiscal policy goals are to be achieved.

Within this framework, estimates of the medium-term cost of each potential new spending initiative and capital project can be used to ensure that the amount of new spending approved never exceeds the available fiscal space.

The quality of the forward estimates could however be improved with regards to providing a better measure of fiscal space.

What happens at present is that sectoral budget analysts within DIPRES each year prepare expenditure forward estimates for the ministries to which they are assigned. The principle is firmly established that these forecasts cover only the expenditure required by current law and policy, and exclude possible new expenditure laws. The sectoral budget analysts apply common assumptions about the evolution of key macroeconomic variables.

They also seek, for example, to adjust their projections to eliminate temporary expenditures which should be coming to an end. Once the sectoral budget analysts have prepared the forward estimates for their ministries, they are reviewed and consolidated by the studies group within DIPRES.

DIPRES acknowledges, however, that there is not yet sufficient methodological consistency in the approaches used by sectoral budget analysts for their ministries. For example, the demographic assumptions used are not necessarily uniform. There is also no clear common understanding of the level of service which "current policy" requires for those public services where there is no explicit government commitment about the level of services to which citizens are entitled. Does "current policy" require the maintenance of the same level of real government expenditure, or the same real per capita spending?

The Ministry of Finance is therefore working on gradually improving the methodology for the expenditure forward estimates. In doing so, it is grappling with a challenge which has not proven easy anywhere in the world. Projecting expenditure is inherently more difficult methodologically than revenue projection, where current policy is in general clearly laid down in law.

An important matter to consider in this context will be the respective roles of Ministry of Finance officials and spending institution officials in the preparation of the expenditure forward estimates. At present, the forward estimates are largely prepared within the Ministry of Finance, with limited spending institution involvement. However, it is often in the spending institutions that the greatest understanding of expenditure dynamics is to be found. Developing more of a partnership in the preparation of the estimates might therefore be a key means of improving their quality.

2.3.2. Ministry expenditure ceilings

Chile at present has strictly annual budgets. In other words, the budget authorises spending institution expenditure only for the coming financial year. Annual budgeting is, of course, the predominant international practice. There are, however, a limited number of advanced countries, such as the United Kingdom, that have multi-annual budgets in the sense that the government gives spending institutions firm medium-term spending ceilings covering a large part of their expenditure. There is a school of thought in Chile that would like to see the country move to this type of system. Thus in the first year of every presidential term of office, the Chilean Congress could approve a multi-year budget providing institutions with the funding required to carry out a government strategy that was also conceived in terms of medium-term objectives (like the *Objetivos Estratégicos* set out by President Piñera).

This innovation would undoubtedly present a desirable future direction for the Chilean budgeting system. However, there is an important obstacle to moving to firm multi-year ceilings in the short term: the quality of the expenditure forward estimates. If firm multi-year ceilings are to be set, DIPRES needs to be able to prepare accurate forward estimates of institutions' baseline expenditure requirements not merely for the coming year, but for several years into the future. If DIPRES is not yet able to prepare reasonably accurate medium-term expenditure forward estimates, there will be a high risk that the ceilings set for many institutions in the out-years will be either too low or too high. This is not a problem if the ceilings are only indicative, but it is a major problem if they are firm. If the ceilings are too high, the available fiscal space will be underestimated and the capacity to fund new policy commensurately reduced. But if the ceilings are too low, the risk will be that, when the out-years arrive, the unrealism of the supposedly firm institutional ceilings will become apparent and the ceilings will end up being modified upwards. Expressed differently, the ability to make firm multi-year ministry ceilings stick depends upon the credibility of those ceilings.

This problem suggests that, however attractive a regime of fixed medium-term ceilings may be, it is not a move which Chile should make immediately.

However, it is not necessary to wait until it is technically feasible to introduce such a regime to realise some of its benefits. It is generally acknowledged that there are two key benefits of well-developed medium-term budgeting: first, it strengthens the ability of the finance ministry to steer spending via the top-down set ceiling; second, it reduces uncertainty for spending institutions about future funding levels, leading to better planning and management on their part. This reduced uncertainty is greatest when the government gives institutions firm medium-term funding levels. However, even when firm ceilings are not set, good medium-term fiscal forecasting can greatly reduce funding uncertainty. This is because, to the extent that the forecasting process ensures that all expenditure policy decisions are fully consistent with aggregate fiscal policy over the medium term, it greatly reduces the fear that institutions' budgets will need to be suddenly cut in order to avoid breaching targets for the budget balance and other key aggregate fiscal variables. Under such circumstances, spending institutions can have considerable confidence that – at least barring government policy changes – they will receive funding for their projected baseline expenditure as shown in the forward estimates. Their forward estimates are, in a real sense, indicative ceilings.

In Chile at present, the expenditure forward estimates do not yet play the role of reducing spending institution uncertainty about future funding levels. This is because ministry-level forward estimates are purely internal to the Ministry of Finance and are not made available to the ministries and institutions concerned. This is deliberate: the estimates are kept confidential precisely to avoid creating any sense of a commitment to the future budgetary funding levels.

However, as the quality of the expenditure forward estimates is improved, it is important that they are used to realise the benefits of medium-term budgeting as an instrument for enforcing a centrally set top-down fiscal path, reducing funding uncertainty and improving planning and management. This requires, as a minimum, that ministries are aware of their forward estimates – a development which would be closely related to their participation in the preparation of the estimates.

Following this, the ministry forward estimates can progressively change from being mere projections to become the basis for ministry expenditure ceilings. Initially, the forward estimates should be used to set indicative (rather than firm) ceilings. In other words, it should be made quite clear to ministries that they are not firm commitments on the part of government, and that the government retains the prerogative to change expenditure policies at any time with consequent changes to the indicative ceilings. The forward estimates can also be used as the starting point for annual budget preparation, as in Australia. In the longer term, Chile can then, if it wishes, move to a regime of firm medium-term ministry ceilings.

2.4. The fiscal rule and the long term

From 2001 up to the financial crisis, Chile applied a fiscal rule pertaining to the structural budget balance. Initially the rule stipulated a surplus of 1% and, from 2007, this was reduced to 0.5%. This policy was designed to ensure fiscal sustainability while permitting counter-cyclical policy actions. In addition, it aimed at:

- protecting the competitiveness of the export sector and reducing the volatility of the exchange rate;
- reinforcing the Chilean government's credibility as a borrower on the capital markets;
- building public sector savings.

The surpluses accumulated with the application of this rule went into two funds – a Pension Reserve Fund and an Economic and Social Stabilisation Fund – as well as into bolstering the depleted capital of the central bank.

Even after the suspension of the rule during the global financial crisis, the structural budget balance has remained central to the Chilean fiscal policy. A strong feature of the Chilean system has been the high level of transparency in the application of the rule. The methodology for measuring the structural budget balance is clearly formulated and publicly available, and has been progressively refined over time. The actual calculation of the structural balance each year is done by DIPRES.

In the wake of the crisis, Chile is in the process of defining a "second-generation" fiscal policy. In 2010, the government appointed an independent committee of eminent economists and policy makers to give advice on these questions. After 33 working sessions, the work of the committee ended in January 2011 and the final report was uploaded to the Ministry website in June 2011. The issues addressed by the report were the following:

- the merits of rules versus targets for the structural balance;
- what the required structural balance should be (e.g. what percentage of GDP);
- whether the rule or targets should be set for the overall or primary balance (i.e. including or excluding interest payments);
- how to permit more scope for active counter-cyclical policy;
- whether to focus policy on the *ex ante* or *ex post* structural balance.

The committee's answers to these issues and others include:

- It is proposed to change the term "structural balance rule" to "cyclically adjusted balance rule" but maintain the methodology that was previously used: budget headings that are affected by the deviation of domestic GDP and the price of copper and molybdenum from their trends are adjusted, without considering other sources of deviation of transitory revenue to permanent revenue.
- The committee does not make an explicit recommendation regarding the cyclically adjusted target, leaving it up to the government. However, it is mentioned that, in order to define the cyclically adjusted target, it is essential to consider that the future contingent liabilities or deficits are the same as those presented in the report by DIPRES on contingent liabilities and deficits. In addition, it is advised to increase the coverage of the annual report on contingent liabilities.
- It is proposed to move to a target based on the primary balance.

- It is proposed to use an *ex post* criterion to adjust expenditure when relevant changes occur to the variables that determine the fiscal rule. When facing important changes in any of the parameters that would affect the cyclically adjusted revenues, partial adjustment mechanisms should be considered by the government to smooth the convergence towards a fiscal equilibrium. As a legal requirement, such deviations – and the measures that will be taken to correct them – should be reported in the annual government report on evaluation of the financial performance of the public sector.
- It is recommended to complement the rule with a component that would allow the executive authority to use *ex ante* counter-cyclical policy. Such a component would establish a variable target as a function of the estimated GDP threshold. The definition of the parameters that will activate such a component shall be made by the executive authority at the beginning of every presidential term of office.
- It is suggested to establish an independent fiscal council with the following functions: *i)* evaluate the methodology of the fiscal rule; *ii)* provide the economic assumptions and projections for the adjustment of the cyclical adjustment variables; *iii)* evaluate fiscal policy, the application of the rule, and the sustainability of medium and long-term fiscal policy; *iv)* produce an assessment on possible changes of principles and accounting methodologies used in the budget; *v)* evaluate the escape clauses and convergence strategy towards the cyclically adjusted balance; and *vi)* provide an opinion on the contingent liabilities report and the impact of such estimation on policy goals.
- Give official status to the Consultative Committee on Copper.
- Give legal status to the regular delivering of long-term actuarial fiscal projections.
- Improve financial information contained in proposed new legislation.
- Broaden the annual presentation of financial and fiscal medium-term projections, using a higher level of disaggregation in the medium-term financial programme and providing estimates of the cyclically adjusted balance rule year to year in a similar time horizon. This should include details of the main economic assumptions in order to evaluate the viability of achieving fiscal targets.

The budget office has recently published a report (Larrain et al., 2011) that includes the main elements of a second-generation structural balance rule that incorporates many of the measures proposed by the independent committee. The most relevant are:

- The term "structural balance rule" will be changed to the "cyclically adjusted balance rule" to better reflect its purpose. It will only be adjusted for cyclical incomes derived from GDP and from the price of copper and molybdenum.
- Other changes in incomes due to one-off factors will not be adjusted for.
- No cyclical adjustments will be made on interest gains on government assets. No adjustment will be made to "other incomes".
- The long-term price of molybdenum will be estimated on the basis of a moving average of the actual price for the last seven years.
- The rule will be calculated on the basis of the global balance of the central government.
- An *ex post* criterion for implementing the rule will be used. A section will be incorporated into the annual report on evaluation of the financial performance of the public sector describing the impact of adjustments and deviations from initial projections in the established policy targets.

- An independent fiscal council is to be created with the following functions: *i)* participate in the consultative committees for GDP tendencies and for the copper referential price; *ii)* verify that the mentioned variables are correctly reflected in the rule and its implementation; *iii)* provide advice to the Ministry of Finance on specific aspects regarding the cyclically adjusted balance rule; *iv)* assess eventual methodological changes to the rule proposed by the authorities; and *v)* verify mid-term projections of structural results included in the public finances report.
- The information about the methodology, variables and rationale for calculating the fiscal rule will be made available to the public.

2.4.1. Long-term fiscal projections

As a prerequisite for achieving these goals, the Ministry of Finance is focusing considerable effort on the preparation of long-term fiscal projections. This is an area to which OECD member countries have paid increasing attention over the past decade or so (see Box 6). The Chilean Ministry of Finance has carefully studied the practice of other countries in this area, including the European Commission's projections of the fiscal costs of ageing.

Box 6. **Long-term fiscal forecasts: selected international practice**

- Australia: Since 2002, the national government has published an *Intergenerational Report* every five years, providing 40-year fiscal projections.
- New Zealand: A report on the long-term fiscal position, with a 40-year time horizon, has been prepared every four years since 1993.
- United Kingdom: Since 2002, the Treasury has regularly produced a *Long-Term Public Finance Report* with 30-year projections.
- United States: The United States was one of the first in this area. The Office of Management and Budget (i.e. finance ministry) has published 75-year fiscal projections annually for the past 40 years.
- A number of other OECD countries, such as Norway and Switzerland, have recently started producing similar reports.

There are a few countries that link their budget balance targets explicitly to long-term fiscal considerations. One such country is Sweden (see Box 7), where one of the key motives for the choice of 1% as the target value for its long-standing structural budget surplus rule is preparation for the pressures on public finance that will arise as a result of population ageing. In other words, Sweden is seeking to pre-fund a significant portion of the future rise in age-related expenditure. Sweden does not, however, make public any specific methodology for this linkage.

In seeking to develop a clear link between its budget balance rule/targets and long-term public finances, Chile is addressing an issue which is at the cutting edge of fiscal policy at the present time.

Box 7. **Rationale for the Swedish choice of 1% for the budget surplus rule**

"The motives for the surplus target are that it shall contribute to:

1. The long-term sustainability of the public finances so that citizens, firms and financial markets have confidence in fiscal policy.
2. Adequate margins for avoiding large deficits during economic downturns even in connection with an active contracyclical policy. The surplus target contributes to a buffer being available for countering sharply falling economic activity without risking an unsustainable increase in debt.
3. A uniform distribution of resources between generations. In Sweden, as in many other countries, the proportion of elderly people in the population will become appreciably larger in the coming decades. Relatively high medium-term public saving during demographically advantageous years means that the large cohorts which will need medical care and social services in the years ahead are themselves contributing to the financing of these services.
4. Economic efficiency. The surplus target promotes economic efficiency by providing better conditions for a tax take which does not have to be increased, and does not vary over time on account of demographic changes."

Source: Swedish Ministry of Finance (2011), *The Swedish Fiscal Policy Framework*, March, Ministry of Finance, Sweden, *www.government.se/sb/d/14625/a/164299*.

2.5. Suggestions for reform

On the basis of the above analysis, there are a number of recommendations which the Chilean government could consider in order to further improve the medium-term budgeting framework and strengthen the longer-term budgeting perspective.

2.5.1. Medium-term forward estimates

As noted above, forward estimates need to become more reliable and disaggregated in order to permit more accurate estimation of the fiscal space available to Chile over the medium term. To achieve this:

- DIPRES should develop and apply a standard methodology for producing expenditure forward estimates (e.g. clearly distinguishing baseline expenditure from new initiatives, and defining the assumptions for the projection of baseline spending) which is critical to achieve a reliable multi-year path to the government's fiscal target.
- Revenue projection methodology should continue to be improved, and should in addition be formally documented.
- As recommended by the independent committee on the fiscal rule, Chile should provide estimates of the cyclically adjusted balance compared to the fiscal rule for the medium-term out-years in order to make it possible to evaluate how realistic the fiscal goals are. The proposed annual report on the financial performance of the public sector should serve this purpose well.

2.5.2. Medium-term budgeting and resource certainty for ministries/agencies

In order to enable the government to enforce a fiscal consolidation path more easily, one option is to give spending institutions greater certainty about future funding in order to permit them to plan and manage their expenditure more effectively. To achieve this:

- After the strengthening of the expenditure forward estimates (not before), ministries/agencies should be advised routinely of their medium-term baseline estimates, while making it quite clear that these are not a commitment by the government (i.e. they are not fixed ceilings) and that the government retains the right to change these as the result of spending review. By letting ministries/agencies know what they would receive if policy did not change, all things being equal, uncertainty about future funding would be reduced and improved planning and management would be facilitated. Possible productivity cuts and multi-year reform cuts should be part of the forward estimates.
- Each institution's baseline should then be used as the starting point for annual budget preparation, as in Australia.
- In the longer term, consideration can be given to the use of fixed multi-year ceilings, on the model of, say, the United Kingdom.

2.5.3. Long-term budgeting and fiscal rules

With respect to the longer-term budgetary perspective, Chile needs to focus on two key areas. The first is improved forecasting of longer-term expenditure and revenue trends, including in relation to the fiscal impact of demographic trends. The second is the linking of fiscal policy (specifically, the budget balance target or rule) to long-term sustainability considerations.

The recommendations of the independent committee address these issues in a prudent and appropriate way. Maintaining a structural balance rule which allows for a "time out" in exceptional circumstances of fiscal stress gives a sound basis for the fiscal framework of Chile. Importantly, a number of institutional efforts support this effort, including:

- an independent fiscal council;
- a stronger mandate for the Consultative Committee on Copper;
- transparency efforts in the form of enhanced reporting on liabilities and deviations from the targets.

These efforts should be pursued. DIPRES should continue to give priority to improved analysis of the long-term expenditure trends, particularly with respect to entitlement spending and health spending. Consideration should be given to investigating appropriate long-term objectives with a focus on fiscal sustainability which should guide fiscal policy. The new fiscal council could be charged with this matter.

3. Services flexibility and efficiency

3.1. Introduction

Most OECD member countries are placing a larger emphasis on budgeting, management and accountability to take them away from controlling inputs towards achieving results. There is a tendency to relax input controls to give government organisations greater flexibility and autonomy to achieve their objectives efficiently and effectively. The basic assumption is that heads of individual government organisations are best positioned to achieve their policy and programme objectives if enough flexibility in the management of financial and human resources is granted. Flexibility would allow taking into account the differences in the priorities and the functions performed by government ministries and agencies. In this context, flexibility can be defined as the extent to which an organisation can adjust budget appropriations and empower and enable public managers to adjust the number and competencies of the public workforce to the business needs of their organisation.

In this sense, the aim of this section is to review the Chilean management practices regarding budget execution and human resources. The Chilean government sector is characterised by high-quality civil servants and high performance standards. However, the current state of management procedures lead to the assumption that further efficiency and effectiveness could be achieved by modifying a number of managerial rules. This section explores the rules governing budget execution in the central government.

More managerial flexibility in Chile's central administration may constitute a driver for better performance. Less input controls in budget execution and human resource management have the potential to enhance efficiency in the management of public organisations and resources. Management flexibility is considered a necessary condition to motivate managers to improve their performance by rewarding them for accomplishing the goals or expected results. When agencies are allowed to retain surpluses, then they will strive to improve efficiency. If Chile is to improve the efficiency of the public administration by, among other things, enhancing managerial flexibility, then it has to find a healthy balance between accountability and control on one side and performance and autonomy on the other. It is not reasonable to make managers accountable for performance if they are not free to manage; and it is not prudent to give them operating freedom if their performance does not matter.

3.2. Towards more flexibility in budget execution

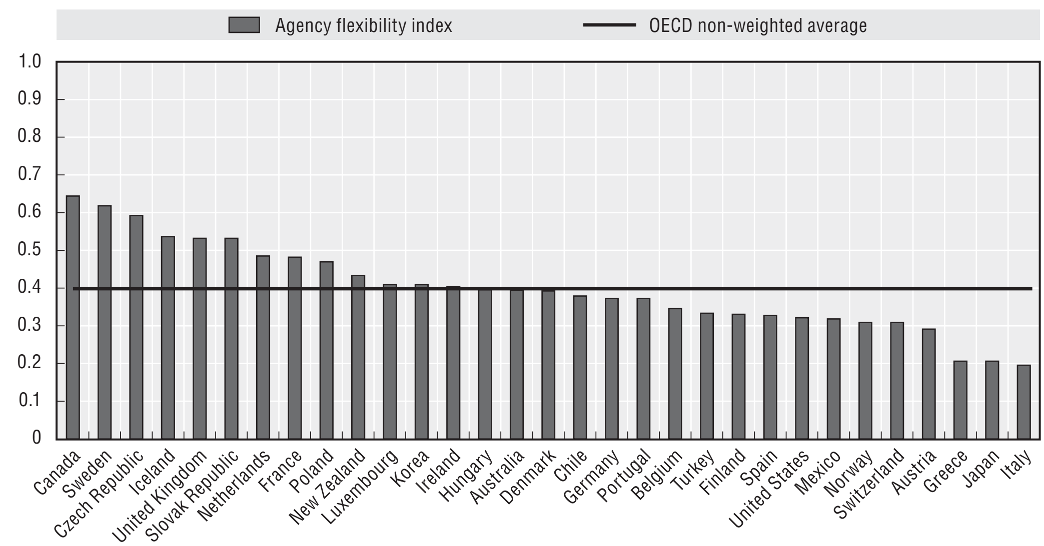
3.2.1. The situation in Chile

One of the fundamental challenges for Chile to improve the efficiency of budget execution and the management of the public workforce is to move from expecting conformity with tightly defined rules to a flexible system where managers are given the scope to achieve wider goals. This means that the management model should evolve to value management that takes calculated risks and that makes decisions based on performance rather than rules.

Article 26 of Law No. 1263 of 1975 regulates the procedures for transfers, increases and decreases of the budget. Article 26 states that the rules for changes in appropriations are to be determined in a decree issued in December of the previous year by the Minister of Finance. In Decree No. 1531 of December 2009, it is specified that carry-over and reallocations can take place by a decree issued by the Ministry of Finance. Certain appropriations, however, require a new law (transfers between ministries, transfers to state enterprises, and increasing the global amounts of a given appropriation). Both carry-over and reallocation require a special authorisation from the Ministry of Finance in the form of a decree. While this is legally the same process, it should be noted that – due to the broad programme definitions in Chile – relatively few reallocation decrees are necessary.

In Chile, the government may cut, cancel or rescind spending once the budget has been approved by Congress, with certain limitations. In principle, reallocation from investments to current spending is not permitted. The spending envelope permitted by the budget is firm; no overspending may occur without prior approval of a supplementary appropriation law by Congress. No borrowing against future appropriations is possible, but ministries may carry over unused funds or appropriations into the next budget year by decree of the Ministry of Finance. As Figure 1 shows, the level of agency (services) flexibility during budget execution in Chile is roughly in the middle of the field of OECD countries. Chile's level of flexibility is higher than in some of the most advanced OECD member countries like Germany, Japan, Norway, and the United States.

Figure 1. **Agency flexibility in budget execution**



Note: Index comprised between 0 (no agency flexibility) and 1 (high agency flexibility level). Cronbach's alpha: 0.470 (computed with SPSS). A Cronbach's alpha close to 0.6 or 0.7 indicates a high degree of correlation among a set of variables.
Source: OECD Budget Practices and Procedures in OECD Countries (database), *www.oecd.org/gov/budget/database*.

These results concur with the findings of the OECD mission. Except for specific issues, there is little evidence of fundamental line ministry or agency frustration with the level of flexibility. However, given Chile's well-functioning public sector, and its clear ambition to be at the forefront of budget reform, there is still room for injecting more flexibility into budget execution with the purpose of enhancing the efficiency and effectiveness of spending.

For operating expenditures, each ministry and agency (*servicio*) receives one appropriation for human resources and one appropriation for the purchase of goods and services. These are global amounts with no subdivisions among individual items of expenditure. The appropriations are considered maximums, and there is no obligation to spend appropriated funds. There are two types of restriction for each account. The first is common to all accounts and includes a maximum amount that can be spent on four items of expenditure: overtime, travel, training, and consultants. This degree of input control is somewhat unusual for OECD countries. The amount of the restriction originates with the Ministry of Finance in the budget proposal presented to the Congress. The budget also contains a ceiling on the number of staff (posts) and the number of vehicles that each ministry and agency may have. The second type of restriction is for specific appropriations: these generally earmark parts of a larger appropriation for specific projects.

The need for DIPRES approval (by decree) of reallocation makes the process somewhat heavy. For example, changes in Sub-title 29 (Acquisition of non-financial assets) between items 06 (IT hardware) and 07 (IT software) require the approval of the budget office and the corresponding line minister. Evidence indicates that, in reality, reallocation rules are not always followed. It should be noted, however, that changes in the appropriations for programme expenditure are in fact quite possible, since the appropriation is given at a relatively high level of aggregation – i.e. often to a group of programmes.

All expenditure transactions must be pre-approved by the Comptroller General in order to ensure their legality. There are very few instances where the Comptroller General vetoes a transaction. This would seem to indicate that this process is overly bureaucratic and does not add much value.

3.2.2. Suggestions for reform

While Chile does not have a strong need to enhance flexibility, there are cases where flexibility would probably enhance spending efficiency, especially if these measures are linked to a stronger performance management system.

In other OECD countries, reallocation rules usually vary according to the kind of expenditure to which they relate. Line ministries/agencies are typically allowed to reallocate a percentage (2-5%) of current expenditure appropriations within programmes and a smaller percentage between programmes. Usually, the approval of both the Ministry of Finance and Parliament is required for larger reallocations or for reallocations across ministries. Appropriations for salaries can typically be reallocated to other operational spending but not the other way around. Countries have different regimes regarding capital spending. Since entitlement spending is sanctioned in law other than the budget, the amount appropriated is usually a non-binding estimate.[8]

As mentioned above, reallocation is in general not a problem in Chile, due to the broad programme classification. There are, however, some minor changes (between categories within capital and operating expenditures) that could potentially be relaxed. Should a more detailed programme budget structure be put in place, as argued in Section 2, reallocation rules would have to be re-examined to maintain the current flexibility.

Borrowing against future appropriations is another practice that increases managerial flexibility, since it enables agencies to spend the year's funds without holding back spending to be sure to have sufficient funds. However, it goes against the one-year nature of most annual budget laws and decreases the power of the Parliament and the Ministry of Finance. Consequently, a vast majority of OECD countries do not allow ministries or agencies to borrow against future appropriations regardless of the type of expenditure. A few countries allow it, though: Mexico (with approval from the central budget authority), Belgium (for selected agencies), and Canada, Denmark and Sweden (within a preset sub-limit). At this stage, there does not appear to be a need in Chile to introduce borrowing against future appropriations.

A carry-over of appropriations allows government organisations to use a portion or all of an unspent appropriation after the time period for which it was originally granted (see Box 8). By using a carry-over, an organisation may use unspent money in the next fiscal year. As with reallocation rules, there is a great variation between OECD countries with regards to the rules governing carry-over. In many cases, there will be a distinction between the types of expenditure (current, capital, salaries, and entitlements). Depending on the country, carry-overs are allowed after a qualitative evaluation by the Ministry of Finance and/or based on a quantitative rule. Quantitative rules include: a limit on the amount of carry-over allowed in any given year (usually 2-5% of the appropriation); a ceiling on the amount of accumulated carry-overs; or limits on the draw-down of accumulated carry-overs. For instance, in Canada, unused funds from operating and capital budgets can be carried over up to a 5% limit. In Finland, most operating expenditures and investments may be carried over for a maximum of two years. In the United Kingdom, unlimited carry-over of both operating and investment budgets is permitted, but the approval of the finance ministry is needed to draw down the funds.

Box 8. **Preconditions for establishing a carry-over system**

End-year flexibility can simplify budget management and promote efficiency. However, before a country introduces a general system for carry-overs, the following six preconditions should be met:

- **Accurate appropriations.** Assuming that budget allocation is adequate for the task that is supposed to be carried out, the finance ministry must be reasonably confident that, if there are unspent appropriations, this is because of efficiency gains or implementation delays and not the result of over-budgeting. Past budgets can be compared with the outturns, to investigate if budget allocations were consistently bigger than the actual use of funds.
- **Well-developed accounting and reporting systems.** Carry-over regimes can only be implemented if it is possible to determine by how much the budget has been underspent at the end of the year. A government accounting regime that generates accurate outturn figures that can be compared with the budget is necessary. The outturn figures must be available reasonably soon after the end of the budget year, to give budget managers the information on how much carry-over is available in addition to the new year's budget allocation.
- **Access to financing.** The government must be in a position to finance payments when requested, so as to honour payments associated with end-year flexibility.
- **Well-functioning internal control and external audit.** The amounts that are carried forward should only be used for attaining meaningful government objectives. Unless this is the case, wasteful end-year spending would simply be replaced by wasteful carry-over spending. This points to the importance of internal control/audit and external audit systems that are able to prevent spending that is not in line with the government's intentions and that could be misused.
- **Devolved budget management powers.** One of the key ideas behind end-year flexibility is that wasteful end-year spending will be replaced by productive use of resources when the spending can be planned better. This pre-supposes a certain degree of managerial authority over the use of budget funds.
- **Medium-term approach to fiscal policy.** Implicit in the rationale for budget carry-overs is the assumption that the government is indifferent to the precise timing of expenditure. This is likely to be the case only where the government takes a medium-term approach to fiscal policy making.

A cautious approach is needed for general carry-over provisions for operational expenditures; in that case, many of these preconditions will be hard to meet.

Source: Lienert, I. and G. Ljungman (2009), "Carry-over of Budget Authority", *Public Financial Management Technical Guidance Note*, International Monetary Fund, Washington, DC.

It is recommended that Chile allows carry-over of appropriations for operating expenditures up to a set limit of, e.g., 2% of total appropriation within a finite time, after which the carry-over is lost. Any other changes should be subject to Ministry of Finance approval. A separate regime for capital budgeting should be in place, allowing the project to be fully funded from the outset and making the funds available for the entire project.

Less input control and less procedural control would relieve the Budget Directorate (DIPRES) and the Comptrollership of a great number of tasks. However, this might leave the government exposed to risk, which relatively free agents or managers are meant to manage. This should be countered by a phased, measured approach to new flexibility, enhanced performance management, a strengthened sense of collective responsibility among senior public servants, and strengthened accountability.

4. Conclusion

Table 2 sums up the public sector reforms in Chile, 2011-14.

Table 2. **Chile action plan overview**

	2011	2012	2013	2014
Programme classification (assuming a new structure needs to be developed)	Develop methodological guidelines/manual. Investigate whether a new programme classification should be developed or whether the existing one can be modified. Launch pilots in five agencies.	Programme budget annex with new structure for pilots. Pilot extended to all other ministries and agencies.	Programme budget annex covering all ministries and agencies.	Budget law based on the new programmes.
Institutional strategic framework	Revise framework of institutional strategy statements (*definiciones estratégicas*) and link to new programme framework.	As programmes are developed, clearly specify their intended outcomes and main outputs.	As programmes are developed, clearly specify their intended outcomes and main outputs.	
Link to government-wide priorities		Link the new programmes explicitly to the strategic objectives (*Objetivos Estratégicos*) of the government.	Link the new programmes explicitly to the strategic objectives (*Objetivos Estratégicos*) of the government.	
Performance report to Parliament	Develop a new, briefer and more accessible structure for the budget information papers (*Antecedentes Complementarios Control de Gestión Pública*).			
Performance indicators	Review performance indicators to improve their relevance.	Review performance indicators to improve their relevance.	Review performance indicators to improve their relevance.	
Spending review	Decide spending review mechanism.	Establish first spending review.	Second spending review.	Major spending review.
Performance-based budgeting	Initiate studies for the implementation of performance-based budgeting in the public hospital and education systems. Analyse the current formulas in place with regards to precision and value for money.	Complete studies and develop implementation strategy.		
Efficiency review	Create a new efficiency review mechanism.	Carry out the first cross-cutting efficiency reviews.		
Evaluation	Redefine the mandate of the DIPRES and make appropriate changes to the evaluation instruments.	Implement changes to the evaluation system.		

Table 2. **Chile action plan overview** *(cont.)*

	2011	2012	2013	2014
Productivity savings mechanism	Define the mode of operation of the productivity savings mechanism.	Apply productivity savings at initially low rate.		Raise the rate to the planned long-term level.
Baseline expenditure methodology	Develop methodological guidelines. Enhance the fiscal impact assessments of new legislation. Enhance the use of long-term budgeting.	Complete the methodological guidelines.		
Using the baseline in budget preparation				Begin using ministry baselines as starting point in preparing the budget. As part of this, let ministries/agencies know their baselines.
Medium-term revenue projections	Document revenue projection methodology.	Complete the documentation of the revenue projection methodology.		

Notes

1. See *www.oecd.org/gov/budget/database*.
2. For example, the Ministry of the Interior counts among its strategic outputs the "strengthening of state management of emergency operations and the management of risks" which is a process objective rather than an output.
3. Within Latin America, countries such as Colombia and Mexico also strongly emphasise evaluation as the cornerstones of their performance management systems.
4. The study did not provide any estimate of the extent to which evaluations led over time to budget savings through efficiency enhancements.
5. Technical commissions are the meetings held with institutions, during the budget preparation process, when each institution's budget requirements are discussed.
6. There is no standard definition of the term "spending review" and it is used in different ways in different countries.
7. See *www.oecd.org/gov/budget/database*.
8. See *www.oecd.org/gov/budget/database*.

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