A Contemporary Approach to Public Expenditure Management

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Foreword

In the last ten to fifteen years, a wave of change in the management of public budgets has swept through developed countries and has begun to engulf many developing countries as well. Much of this impetus was brought about by dismal macroeconomic performance as reflected in sustained structural budget deficits and balooning national debt. From New Zealand to the United States, developed countries embarked on a massive effort of "government reengineering" to restore discipline in the budget process and to better target dwindling budgetary resources towards higher priority uses. The resounding success of New Zealand and the more modest achievements of other developed countries have stimulated a renewed interest among developing country governments in public management reforms and more specifically on budget reforms. With their budgets under siege and their economies sagging, many developing countries have began to seek innovative ways of using the national budget more effectively to promote socio-economic development and to experiment with variants of the successful reforms in developed countries. Even the highly successful East Asian economies have began to focus very ardently at reforming their budgetary systems as they now confront the most serious economic crisis in thirty years, a shock that has put a serious dent on their public budgets.

In order to encapsulate and disseminate the wealth of knowledge embodied in these reforms, the Economic Development Institute of the World Bank has developed a course on Budgeting Processes and the Analysis and Management of Public Expenditures. Prof. Allen Schick has prepared this manuscript to serve as the main text for the course. A number of colleagues provided invaluable assistance in shaping the material. Sanjay Pradhan and Malcolm Holmes were particularly helpful in providing (sometimes) stinging but useful comments and suggestions.

I have had the great pleasure and privilege of working closely with Prof. Schick in molding the substance and charting the direction of the course and the manuscript. It is my hope that both will provide public officials, scholars, and practitioners around the world useful guidance in their efforts to study, develop, and/or implement much needed reforms in the public sector.

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Chapter 1
An Overview

Public expenditure management (PEM) is a new approach to an old problem. The problem is the allocation of public money through collective choice. For more than a century, these allocations have been made through the machinery of budgeting—the routines and procedures devised by governments to decide the amounts spent, the balance between revenue and expenditure, and the allocation of funds among public activities and entities. PEM operates through budget decisions, but differs in two important ways from conventional budgeting. First, it supplements the conventional procedural rules with substantive policy norms. In PEM, it is not enough that governments apply the right procedures; it also is essential that they strive to efficiently achieve desired policy outcomes. Second, PEM covers a broad range of institutional and management arrangements, not just those traditionally associated with budgeting. PEM recognizes that budget outcomes are not likely to be optimal if the public sector is poorly structured and managed, or if the incentives and information given policy makers and program managers impel them to act in ways that produce perverse results.

The first critical difference is that conventional budgeting operates through accepted procedural norms, while PEM emphasizes substantive outcomes. These outcomes pertain to (a) total revenue and expenditure, (b) the allocation of resources among sectors and programs, and (c) the efficiency with which government institutions operate. These elements and their salient characteristics are summarized

in Table 1.1. PEM recognizes that even when a government adheres to accepted budget principles, it may fail to obtain optimal fiscal outcomes. In fact, many developing countries have sound budget and financial management systems but still lack fiscal discipline, are unable to reallocate resources in accord with strategic priorities, and operate inefficiently.

To achieve its preferred outcomes, a government must manage public expenditures to implement avowed policy objectives. It must create an institutional framework that enhances the probability that actual outcomes will conform to professed targets. This consideration leads to the second difference between conventional budgeting and PEM. In the former, what matters is how the process of budgeting is organized; PEM by contrast, casts a broader net that takes into account how public institutions are managed. PEM is premised on the notion that budgeting is not a process unto itself but is part of a broader set of institutional and governing arrangements. To achieve positive public expenditure outcomes, it is necessary that information, incentives, and other institutional arrangements be properly aligned.

The reorientation from conventional budgeting to PEM has been driven by unsatisfactory public expenditure outcomes in many developing and developed countries. Developing

Table 1.1: Basic Elements of Public Expenditure Management

Aggregate Fiscal Discipline	Budget totals should be the result of explicit, enforced decisions; they should not merely accommodate spending demands. These totals should be set before individual spending decisions are made, and should be sustainable over the medium-term and beyond.
Allocative Efficiency	Expenditures should be based on government priorities and on effectiveness of public programs. The budget system should spur reallocation from lesser to higher priorities and from less to more effective programs.
Operational Efficiency	Agencies should produce goods and services at a cost that achieves ongoing efficiency gains and (to the extent appropriate) is competitive with market prices.

countries have long been afflicted by severe fiscal imbalances, the maldistribution of public resources, and chronic inefficiency in the provision of public services. Often these adverse conditions have persisted even when the government has implemented the standard budgetary rules and practices prescribed by international organizations. Similar deficiencies have cropped up in industrial democracies, though they often have been masked by affluence and the amplitude of public resources. But even in rich countries, the less robust economic growth of the past two decades has revealed entrenched shortcomings in the management of public expenditure. Many developed countries have experienced chronic deficits, a significant rise in public expenditure as a proportion of the gross domestic product, difficulty in reallocating public money from declining to emerging priorities, and weak productivity gains in government operations that have persistently lagged behind the gains achieved in the market sector.

This publication outlines the concepts of public expenditure management. It explains how PEM supplements formal budget process rules with behavioral norms for allocating and controlling public expenditure. This chapter introduces the core elements of public expenditure management; and it discusses how the various elements relate to one another. The next chapter explores public expenditure problems of developing countries. Each of the subsequent chapters elaborates on a particular element of PEM.

As an emerging field, PEM still is undergoing conceptual development and refinement as a management tool. The ideas and approaches discussed in this publication are provisional; they are likely to be modified and elaborated as PEM matures and experience on its application accumulates.

Due Process in Budgeting

The practice of budgeting emerged during the 19th century in Europe as a means of dealing with growth in public expenditure. Although the public sector was much smaller in all countries than it has become in the present century, it had grown sufficiently large to require regular procedures for allocating and controlling government expenditure. These procedures generally came to be regularized as budget practices. Since its genesis, budgeting has been defined as a set of procedures that recur, typically with little or no

change, year after year, by means of which governments ration resources among their agencies and control the amounts each spends. Budgeting is the routinization of choice with respect to public finances; this characteristic distinguishes budgeting from other governmental actions affecting public expenditure, such as national planning and cabinet policy decisions.

As routine, budgeting differs from one venue to another. Each government has its peculiar forms and procedures, its distinctive labels and language. Very early in the development of budgeting, however, efforts were made to codify the basic routines into a set of procedural rules that should be followed by all governments, regardless of the political-administrative framework within which budget activities are carried on. The basic principles have been elaborated and refined over the years, but they have had remarkable staying power. They include comprehensiveness (the budget should include all revenue and expenditure); accuracy (the budget should record actual transactions and flows); annuality (the budget should cover a fixed period of time, typically a single fiscal year); authoritativeness (public funds should be spent as authorized by law); and transparency (the government should publish timely information on estimated and actual expenditures).

The principles of budgeting are implemented and enforced through detailed procedural rules specifying the scope of the budget, the information to be included in it, the timetable for taking particular actions, the forms to be used, the authorization required before public funds are spent, and so on. Every principle is backed by formal rules which are enforced by budget controllers at the center of government and in the spending departments. The accumulated principles and procedures comprise due process in budgeting.

The term “due process” connotes the judgment that if the procedures are sound, the outcomes are the right ones. That is, the outcomes should be assessed in terms of the procedures that generate them, not in terms of substantive criteria. Whatever results ensue from a well-run budget process are appropriate. If, for example, the budget is comprehensive and all bids for resources are submitted and reviewed according to a uniform schedule, then the allocations made to departments or programs are to be accepted as legitimate and efficient. Due process norms are indifferent to

the outcome itself; these norms may result in balanced budgets or deficits, rising public expenditure or stable spending trends, frozen budget priorities or significant reallocations. Due process in budgeting is politically neutral; it can accommodate both left of center and right of center governments. With due process norms in place, actual outcomes are likely to vary with changes in political and economic conditions. As these conditions differ from one country or time to another, so too do expenditure outcomes. Due process in budgeting is analogous to due process in litigation. In the latter, if proper judicial procedure is followed, the ensuing verdict must be accepted as legitimate. Budgeting has the same mind set.

Due process in budgeting provides an active but limited role for international institutions. They may push for improved budgeting practices, demanding, for example, that the budget cover all public expenditures and that special funds and accounts not be excluded. They may insist on accurate budget data and sturdy controls to ensure that the budget is implemented according to plan. This is a politically limited role, for it stops short of dictating particular budget policies or outcomes. International advisers may caution recipient governments against excessive deficits or urge that budget allocations be shifted from one sector to another. But their main role is to recommend improvements in the machinery of budgeting. A major exception to this limited role occurs when international organizations such as the IMF impose conditions for providing financial assistance. These conditions usually pertain to fiscal outturns, such as the size of the deficit.

Due process in budgeting encourages governments to centralize the management and control of public expenditure. The strong hand of central authority is needed to ensure that the budget is comprehensive, that all spending entities conform to the rules, and that routine procedures are completed on schedule. Centralization goes hand in hand with uniformity in budgetary procedure. All spending units must use the same forms, operate according to the same timetable, and follow the same steps in implementing the budget. Agency initiative and variation are discouraged because they increase the probability that due process will be violated.

Due process fosters the notion that budgeting is a self-contained activity,

with its own rituals and roles, cutoff from other management practices. In all but the smallest government, the budget process is operated by a central office which makes the rules, monitors compliance, prepares the budget, and controls spending. Some budget offices have additional management responsibilities, but the budget is their bread-and-butter role and it shapes their posture on other managerial work. Rather than regarding the budget as part of a family of management practices, central control agencies seek to leverage their budget power to gain influence over spending units.

Inherent Shortcomings in Due Process Budgeting

A due process approach to budgeting has some important advantages. For one, it establishes the basis for financial control within government; for another, it seeks to ensure that financial information is reasonably accurate, uniform, and timely. These and other elements of due process are essential building blocks in public expenditure management. A government cannot effectively manage its expenditure if due process is materially breached. Nevertheless, due process is an inadequate basis for managing public expenditures because it systematically leads to unwanted or adverse outcomes.

Looking at the recent fiscal performance of both developed and developing countries, one is compelled to conclude that good budget practices regularly produce outcomes at variance with those sought by the affected governments or regarded as inefficient by outside observers. For decades, international institutions have assisted developing countries in installing sound budget practices, but in many cases the outcomes are as suboptimal today as they were years ago when the first budget reforms were introduced. Arguably, being poor has a lot to do with unwanted outcomes, but even if this point is conceded, one must question whether due process reforms suffice to make things much better. The typical reform package consists of procedural innovations: return excluded funds to the budget; tighten spending controls so that the budget is implemented as planned; install a new accounting system that produces timely, reliable information. As desirable as these reforms may be, they do not by themselves ensure improved budget outcomes in poor countries. If lack of resources is the root cause of adverse budget outcomes, proposed remedies must recognize this condition to produce realistic, achievable outcomes.

Fiscal outcomes generally appear to be more favorable in developed countries because they are not beset by the severe resource constraints that afflict poor countries. Nevertheless, the record in some is not one to boast about. Over the past two decades, many rich countries have had deficits that grew when the economy was weak and persisted when the economy recovered. Most have rigid budgets, with little opportunity for the government to shift public funds from lower to higher priorities. Many have had meager public sector productivity gains that have lagged behind those achieved in the private sector. There have been a few notable success stories; some of these are described in volume two (forthcoming).

Affluence and the availability of incremental resources made it appear that budget outcomes were more favorable in the postwar decades when economic growth was very high than in the more recent period when growth was more modest. When money is plentiful, governments can spend more without tripping alarms about the budget deficit; they can respond to fresh priorities without taking money away from old programs; and they can pay for stagnant productivity in public organizations by spending more on operations. When resource constraints tighten, however, the inadequacies in public expenditure management become more visible and less tolerable. Deficits become alarming because incremental resources are inadequate to pay for them, and citizens (faced with stagnant or declining disposable income) resist tax increases; old priorities get frozen into the budget and new priorities are frozen out; low productivity impels a shift in national income from private to public consumption. What is different in bad times may not be the performance of government but the awareness or the perception of low performance.

Why Good Procedures May Produce Bad Results

A key question that warrants consideration is why adverse outcomes result from the exercise of due process in budgeting. If robust budgetary procedures are integral elements of PEM, why shouldn't the results that ensue from them be favorable? Addressing this question elicits an important distinction between PEM and conventional due process approaches to budgeting. Procedural rules deal with the formal features of budgeting: how and when decisions are made, the structure

and form of the estimates, the scope of the budget, and so on. These rules do not take sufficient account of the interests and behavior of budgetary participants. In fact, seemingly good rules can generate perverse incentives and lead to unwanted outcomes. For example, rules requiring comprehensive budgets may be undermined by the establishment of extrabudgetary funds or by other actions that weaken fiscal discipline. Because of this, it is essential that expenditure outcomes be assessed independently of the process by which they are generated. PEM does so by focusing on incentives, that is, on informal aspects of budgeting: how participants behave, and how their actions are affected by budget rules.

In considering the behavioral dimensions of expenditure management, one is led to examine the incentives given those who bid for resources or control the pursestrings, the information available to them, and the organizational roles assigned to them. On all three of these counts, procedural due process can produce unwanted budget outcomes.

Incentives

Claimants for resources act on the basis of self-interest, but the collective results of their actions may not be in their interest. This "tragedy of the commons" problem is ubiquitous in budgeting. A common interest—whether it be in land, money, or anything else of shared value—often has three basic characteristics: it is a finite resource, it has many users, and it is depleted by overuse. Although it is in the collective interest of all users to ration use of the common resource, it is in the individual interest of each user to take as much as he can get. In budgeting, each agency may prefer that the government maintain a sound fiscal posture, but each acts in its self-interest by demanding as much as it can get. Because no single spending agency is responsible for total expenditures, it does not see itself as damaging the government's fiscal capacity, even though this may be the result of all individual spending actions.

Inasmuch as due process only regulates budgetary procedure, it does not resolve the question of what total expenditure should be. Conventional budget rules structure the process so that the aggregates are decided through competition among spending claimants. As long as the competition is comprehensive (no extrabudgetary spending), fair (no earmarked funds), and authoritative (no improper expen-

diture), then the outcome is deemed the right one. But suppose rather than competition there is collusion (claimants logroll to get what they want) or fragmentation (the various claims are decided sequentially, with little interaction or friction among different parts of the budget), due process will not assure favorable outcomes. Instead of prevailing through competition, spenders win by collectively taking more from the commons, that is, by increasing aggregate spending. When this occurs, fiscal discipline is weakened, and the budget's totals become hostage to individual spending decisions.

The "commons" problem also impairs allocative efficiency, for it discourages claimants from reallocating resources from lower to higher priority programs. Spenders get more by demanding incremental funds, not by volunteering to shift funds to more effective uses. Although they may want budget allocations that reflect the government's strategic objectives, they would be rational in refusing to give up what they already have in exchange for the opportunity to participate in a reallocative competition. They risk losing resources if they offer to reallocate without having advance assurance of what their future budget shares will be.

Operational efficiency also is degraded by rationally-behaving budget makers. The formal rules generally emphasize compliance and control, not managerial initiative and performance. These rules include: spend funds only as authorized by law; itemize expenditures and conform to the detailed schedules in the estimates and other budget documents; make sure to get advance approval before taking actions (such as hiring staff or purchasing equipment) that entail the expenditure of funds; all unspent funds lapse at the end of the fiscal period. These and other rules penalize managers for underspending, not for underperforming. They spur managers to seek more resources, even when these do not result in more output.

Information

Budget outcomes are affected not only by incentives but also by the information policy makers and managers have in spending public money. Information, like the commons, is a constrained resource, not only because it costs money to produce and distribute, but because the amount of information that can be generated and considered in the compressed budget schedule is severely limited. Ignorance

and information asymmetry are widespread behavioral conditions in contemporary budgeting, even in countries that have state-of-the-art expenditure management systems. These conditions are due to two related factors; the cost of generating and disseminating relevant information; and the advantages that information producers (agents) have over information users (principals).

Allocative and operational efficiency depend on an ample supply of relevant data on programs and operations. Almost everywhere, however, much less is known about the relative effectiveness of programs than is needed to make optimal budget allocations, and much less is known about the volume, quality, and cost of outputs than is needed to operate efficiently. A great amount of information is processed in the course of compiling budgets, but in the typical country, most of it describes ongoing activities and itemizes inputs. There are some notable exceptions, but even when program and output data accompany the budget, they rarely are the basis on which budget decisions are grounded. Thus, it is truly rare that increments of budget resources are directly linked to increments of budget outputs, or that funds are explicitly shifted from less to more effective programs on the basis of evaluative findings.

Why don't policy makers have appropriate information to make efficient budget choices? Part of the answer is that the structure of budgeting contributes to this informational deficit by making those at the top (in departmental headquarters or at the center of government) dependent on those in the middle or bottom ranks. Spenders (program officials and line managers) know more about their programs and operations than do those who pass judgment on their budget requests. It is to the advantage of the spenders to "capture" budget makers by supplying information that enhances the probability that they will get what they want. Spenders may know more about what works and doesn't, how funds actually are used, the interests and strength of program beneficiaries, and other relevant factors than do those who have nominal authority over budget allocations. Moreover, they have little incentive to be forthright in advising policy makers on program and operational issues. Central budget makers often try to redress the informational imbalance by commissioning special studies and analyses, by changing the informational rules for annual budget

decisions, or by strengthening their own capacity to monitor and assess performance. These palliatives may help for a while, but over time, spenders are likely to develop countermeasures that restore their informational advantage.

Formal Roles

In due process budgeting, central controllers have formal authority to decide everything—from the budget's totals to discrete spending items. This centralization reinforces the adversarial relationship between controllers and spenders, and encourages the latter to withhold or color information so as to gain some advantage vis-à-vis their adversaries. When this occurs, the formal powers held at the center of government are weakened, as is the ability of central controllers to reallocate or to extract efficiency gains from operating agencies.

Modern Public Expenditure Management

Contemporary public expenditure management (PEM) is interested in the process of budgeting primarily because procedural rules strongly influence expenditure outcomes. PEM takes the position that these rules are not substantively neutral; they affect three important outcomes: the total amount spent, the composition of expenditure, and the efficiency of government operations. PEM seeks procedures that increase the probability of achieving preferred outcomes. The key aspects of budgeting affecting expenditure outcomes are institutional arrangements, the types of information available for making and enforcing expenditure decisions, the incentives* provided spenders and controllers to behave in ways that promote desired outcomes, the issuance and implementation of substantive, ex ante budget rules, and ex post accountability for budget outcomes. These elements of PEM are applied in the follow-up chapters to the three basic objectives of modern public expenditure management: to strengthen aggregate fiscal discipline, to allocate public resources in accord with strategic priorities, and to promote the efficient provision of services. These PEM objectives are introduced in the remainder of this chapter.

Fiscal discipline requires effective control of budget aggregates: total revenue and spending and the balance between these totals. When aggregate control is effective, these outcomes are disciplined rather than accommodating; they result from explicit, enforced decisions on the aggregates by government. They are not merely the sum of powerful demands on the budget. PEM also seeks allocative efficiency, an expenditure mix that is responsive to changing government priorities as well as to evaluative findings on the comparative effectiveness of alternative expenditure programs. Allocative efficiency depends on the capacity to shift resources from old programs to new ones and from less to more productive uses, in correspondence with changing public policy objectives. Finally, PEM seeks efficiency in administrative operations, the progressive reduction, through productivity gains, in the running costs of government agencies and in the unit cost of services.

* Incentives are influenced/generated by institutional arrangements. *Ex ante* rules and *ex post* accountability for output are examples of institutional arrangements.

Although some of these terms may be unfamiliar to persons schooled in conventional budget processes, the three objectives represent ubiquitous tasks of budgeting. Every national budget system produces spending totals, retards or promotes allocative efficiency, and generates higher or lower operational efficiency. How government pursues these objectives distinguishes modern public expenditure management from due process in budgeting.

Aggregate Fiscal Discipline

Aggregate fiscal discipline requires that spending (and other budget) totals be set independently of and before decisions are made on the various parts of budget. If they are not, the spending totals will inexorably rise to accommodate demand. The totals must be reasonably firm—hard constraints rather than soft targets—and must be enforced throughout the year while spending is underway, not just during the period when the budget is being prepared. Moreover, the aggregates must be sustainable over the medium-term or longer through policies and instruments that enable the government to maintain discipline year after year. Table 1.2 sets forth basic arrangements for maintaining aggregate discipline.

Aggregate fiscal discipline deals with the interaction between two variables: revenues and expenditures. In a limited sense, a government can be said to maintain discipline even when spending (in real terms or as a share in GDP) rises year after year, as long as this increase is matched by revenue increases. In a broader sense, however, maintaining aggregate fiscal discipline

Table 1.2: Institutional Arrangements for Enforcing Aggregate Fiscal Discipline

Rules	Limits on total spending (in some cases sectoral spending as well) are established before individual spending bids are considered. Total spending must be consistent with these limits. The limits may be expressed in money terms, relative to GDP, as rates of change, or in terms of the balance between receipts and expenditures. The limits are set for the medium-term (3–5 years) and budget decisions are made within a medium-term expenditure framework.
Roles	A strong finance ministry is empowered to enforce the budget aggregates in bilateral negotiations with spending departments and Cabinet discussions. The finance ministry is the official scorekeeper of the budgetary impact of spending proposals and other budget actions. During implementation of the budget, it may intervene to block (or notify the Government) of actions that would cause the fiscal aggregates to be breached.
Information	The medium-term expenditure framework provides a baseline for measuring the budgetary impacts of policy changes. Throughout formulation of the budget, information is provided on changes to the baseline. During implementation of the budget, spending is monitored to ensure compliance with the fiscal aggregates.

entails enforcing spending limits that do not require ongoing increases in revenues. One way of accomplishing this would be to limit total spending as a proportion of GDP; another would be to set absolute limits (in money terms) on total spending; a third would be to specify the maximum amount by which expenditures will be permitted to increase over the previous year's or the baseline level. If total spending is not controlled, there is a strong possibility that the expenditure objective will be compromised and that the government will seek to achieve the desired fiscal posture by raising taxes or selling assets rather than by constraining expenditure.

Due process budgeting conventionally operates in a bottom-up environment. Spenders are invited to bid for resources through the recurring proce-

dures of budgeting, while controllers review the bids, compare their relative value, trim some bids, and decide on the amounts to be spent. In some governments, the process begins with tentative targets, either for total expenditure or for the amounts that particular spending units may bid for. But these constraints tend to be soft; they are provisional and often yield in the face of pressure for additional funds.

Soft aggregate targets were in vogue during the postwar Keynesian era, when many governments abandoned fixed budget rules (such as the balanced budget principle) in favor of flexible targets that respond to changes in economic conditions. They also were a byproduct of a fundamental change in the composition of national expenditure: relatively less spent on public consumption and investment, and much more on entitlements and transfers. The new mix served Keynesian objectives because, unlike consumption and investment expenditures which typically are limited in amount, entitlements usually are open-ended, with spending rising to satisfy all legally-sanctioned demands. This feature makes entitlements effective stabilizers and safety nets that respond quickly and automatically to changes in economic circumstances.

In retrospect, it is apparent that soft fiscal targets and the changed composition of public expenditure contributed to the postwar uptrend in the ratio of public spending to GDP in almost all democratic regimes. However, faced with chronic budget deficits and structural economic weakness, many governments have retreated from Keynesian demand management and have adopted fixed fiscal targets. The Maastricht norm of budget deficits no higher than 3 percent of GDP is an important manifestation of this trend. PEM is consistent with this movement, but it targets expenditure totals, not just net budget balance.

How hard are the new constraints on aggregates? Probably not as hard as advocates want, but not as soft as the old targets were. They cannot be truly rigid because contemporary governments cannot turn the clock back to the time, decades ago, when public expenditures were concentrated on consumption and investment rather than on transfers. Nor can developed or developing countries insulate themselves against the destabilizing impacts of recessions and other economic shocks on their budgets. It is an open question, therefore, whether national governments have the capacity to stay with

hard fiscal constraints for a period longer than the medium-term (3-8 years) business cycle. Few have tried, and fewer have succeeded. The true test of aggregate fiscal discipline is whether it can be maintained through bad times, when revenues drop and economic adversity generates pressure for more public spending and higher deficits.

But the good times also are a test of fiscal discipline. When the economy is booming and tax revenue is rising, there tends to be strong pressure on the government to spend more. During these times, hard constraints can strengthen the government's resolve to resist new spending demands and thereby mitigate the budget impacts of cyclical weakness in the economy.

Firm but not rigid, resolute but not obdurate—this is the posture that PEM takes with respect to budget aggregates. Effectively managed, even if fiscal discipline were weakened by political or economic force majeure, PEM would produce smaller deficits and less total spending than would ensue in the absence of aggregate constraints.

Allocative Efficiency

No government can effectively control the budget's totals unless it also controls the elements of expenditure. If it doesn't, sectoral pressures will impel the government to spend in excess of budgeted totals.

Tension between the totals and the parts is ubiquitous in budgeting. Without hard constraints, the totals are the sum of the parts; with constraints, the totals can hold only if sectoral pressures are disciplined. PEM tries to change the contest between the parts and the whole from one in which controllers are on one side and spenders on the other to one in which spenders are entrusted with responsibility for keeping within the constraints. See Table 1.3 for the main features of allocative efficiency.

Due process budgeting is predicated on the notion that controlling the parts depends on a process in which all claims on the budget compete against one another. When the budget is comprehensive, as due process dictates, central controllers can weigh the various claims, establish budget priorities, and allocate resources. The logic of this approach appears unassailable, but the practice often fails to live up to the promise. If spenders and controllers have antagonistic interests, the odds are that in many budget seasons the spenders will get much of what they want. Either within the bounds of due

Table 1.3: Institutional Arrangements for Improving Allocative Efficiency

Rules	Spending limits are established for sectors or portfolios, and ministers are encouraged to reallocate within these limits. Bids to reallocate must be based either on evaluative findings of program effectiveness or on plans to evaluate policy initiatives.
Roles	Strong capacity at center of government to define national priorities and objectives, and make cross-sectoral allocations consistent with its medium-term expenditure framework. Strong sectoral ministers with broad authority to reallocate within their areas of responsibility, subject to review by Cabinet and/or Parliament.
Information	Ministers and managers generate or receive information on the actual or expected effectiveness of programs, as well as on the social outcomes ensuing from ongoing programs, budget actions, and policy initiatives. They also receive information on the expenditure impacts (relative to the medium-term framework) of authorized and proposed budget actions.

process or by infringing some of the rules, spenders can outwit the budget's guardians, evade the controls, pressure the government to raise taxes rather than cut spending, and force it to accept incremental rather than reallocative outcomes.

During the past 30 years, democratic governments have sought to counter budgetary incrementalism in a variety of ways. One has been to link the budget to formal priority-setting procedures such as program budgeting or planning-programming-budgeting systems (PPBS); another has been to direct spending units to prepare zero-based budgets. Wherever they have been tried, these and similar approaches have failed to strengthen strategic reallocation or to weaken incrementalism's hold on the budget. Although each type of reform has its own deficiencies, all failed because they overloaded the information-processing capacity of central controllers and departmental spenders, they increased budgetary conflict between controllers and spenders, and they spurred those threatened with a loss of resources through reallocation to take counter measures that protected their interests.

Allocative efficiency can be advanced only if informational demands are manageable, budgetary conflict is muted, and spenders do not sabotage the priority setting and implementation process. PEM promotes these conditions by devolving major reallocative responsibility to sectoral ministers and officials. Rather than having all reallocations made by central controllers, PEM shifts a significant part of the burden to politicians and managers. Government still must adjudicate competing intersectoral demands; that is, it must decide how much should be allocated to each major sector or portfolio within the budget. Carrying out this responsibility requires that it have sufficient strategic capacity to establish spending subtargets and program priorities for each sector or portfolio. But once it has made broad inter-sectoral decisions, the government leaves the task of making most of the reallocations to those in charge of the various sectors. In this way, it enlists spending ministers and managers in the cause of allocative efficiency.

In this devolved environment, the big decisions on strategic objectives and priorities continue to be made at the center, but these represent only a fraction of the program decisions and reallocations made in the course of formulating the budget. Most adjustments to programs, including cutbacks, are initiated by the responsible ministers or their managers, not by the government as a whole or by those who operate the machinery of budgeting. This devolved structure (1) reduces information demands, (2) concentrates budgeting on major policy questions, (3) reduces conflict between spenders and controllers over the details, and (4) gives affected ministers incentives to reallocate rather than to fight spending shifts. The result may be more reallocation than occurs when the central machinery of budgeting is organized for reallocation.

At first glance, this conclusion seems anomalous. Why should allocative efficiency be more robustly pursued when the task is dispersed among spenders whose interests may be served by keeping with the status quo? The answer is that for significant reallocation to occur, spenders must be given strong incentives to cooperate; it may not suffice that reallocations are forced on them from the center. PEM encourages spenders to look to their own portfolios for savings because it denies them incremental resources though the annual budget bids and entrusts them with making most reallocations. Depending on the scope of

the reallocation and the policy impacts, in some cases spenders can reallocate only after receiving government approval, in others, on their own initiative.

For PEM to spur reallocation, ministers and managers must be given spending constraints within the government's global budget. In addition, budget decisions must be taken within a framework that enforces the rules of reallocation and discourages evasion. The elements of this framework are described in chapter 4. They include a multi-year budget, baseline projects of future authorized expenditure, an evaluation capacity for assessing the relative value of programs, and computational rules for measuring the budgetary impacts of proposed reallocations. Without these elements, devolving spending responsibility risks significant erosion in spending control.

Operational Efficiency

One of the oldest purposes of budgeting has been to economize on the operations of the government by controlling items of expenditure, the various things (personnel, supplies, equipment, and so on) purchased by government agencies. The conventional means of exercising this control is to itemize the amount that may be spent on each category of inputs purchased by spending managers. Where itemized input controls are exercised, spending units have to receive central approval before they employ staff, purchase items, or take other actions that spend public funds. Over time, many governments have consolidated the line items into broader categories and established systems of internal control that give managers increased discretion in spending appropriated funds. But in many countries, budgeting continues to focus on the amounts spent on the various inputs.

Input control retards operational efficiency, because it does not give spenders incentives to economize and does not relate the amounts spent to the outputs produced. Not surprisingly, therefore, many governments that maintain seemingly strict expenditure controls have been afflicted by the "relative price effect", the tendency of prices to rise faster in the public sector than in the market economy. Stagnant productivity resulting, in part from an input focus, gives governments little choice but to accommodate the demands of spenders for more resources: if they fail to do so, the delivery of services would suffer.

Table 1.4: Institutional Arrangements for Improving Operational Efficiency

Rules	Running (or operating) costs are cash limited, but managers are given broad discretion in using these resources, including (in some countries) discretion to carryover unused funds or to prespend a small portion of the next year's running costs. Running costs are progressively reduced by a percentage equal to all or a portion of expected efficiency gains.
Roles	Strong line managers authorized to determine the mix of operating resources within fixed limits. Operating discretion devolved to subordinate managers, including those infield or regional offices.
Information	Budgeted outputs are specified in advance, and actual outputs are compared to the targets. Costs are allocated (ideally, on an accrual-basis) to the activities responsible for them. Information on financial and organizational performance is published in annual reports and other documents.

In industrial democracies, erosion in operational efficiency has been masked for decades by the rise in entitlement spending. The assumption has been that inasmuch as government consumption has declined as a proportion of public spending, the problem must lie elsewhere. Moreover, governments have comforted themselves with the notion that consumption expenditure is controllable; they can (and often do) cut the amounts spent on personnel and other items. But despite periodic economy drives and nominal control over spending, in most countries public employment has risen as a proportion of the labor force as have other operating expenditures.

PEM bolsters operational efficiency by shifting the focus of spending control from inputs to outputs and by decentralizing the management of operating resources. These critical features of public management reform are underway in a number of democratic countries.

Operational reform is centered on the notion that managers should be given discretion to run their operations as they best see fit and should be held accountable for results, including the outputs produced.

The institutional arrangements that encourage better operational efficiency include hard constraints on running costs, use of efficiency dividends and across the board cuts to spur managers to be efficient, managerial freedom to spend running costs, output targets, and audit or review of performance. In pursuing operational efficiency, governments must guard against hidden reductions in service volume or quality. This is one of the reasons why they emphasize output measures, service quality, and performance reviews. Table 1.4 specifies institutional arrangements for operational efficiency.

Restructuring Budget Institutions to Manage Public Expenditure

Improving the management of public expenditure entails changes in budgetary institutions—the roles of spenders and controllers, the rules under which they claim, allocate and use resources, and the information available to them. Without institutional change, there would be no basis for expecting self-interested politicians and managers to behave differently. If they have incentives and opportunity to do so, they would continue to draw more resources from the public treasury while resisting reallocation and spending budgeted funds with little regard for efficiency.

Getting politicians and managers to change their behavior boils down to a matter of incentives. They have to have a strong inducement to abide by spending limits, and they must be willing to shift resources to higher priority programs and to rearrange operations so as to make them more effective. By changing rules, roles, and information, PEM seeks to alter the incentives available to budget makers. The changes are summarized in Tables 1.2, 1.3, and 1.4, and explained in the paragraphs that follow.

Aggregate Fiscal Discipline

In many countries, aggregate fiscal discipline has been undermined by self-interested spenders who benefit by taking more from the commons because they bear only a portion of the cost. As indicated in Table 1.2, PEM seeks to remedy the common resource problem by enforcing rules that limit the total that all spenders can draw from the pool. This solution is similar to that devised in medieval England when the commons were enclosed and grazing was restricted. In the case of public

expenditures, the limits have to be firm, though not unbending. They have to be established in rules and norms that cannot be easily changed by budgetary expediency or political whim, and they have to be enforced through changes in the balance of budgetary power between spenders and controllers.

The limits can be in the form of norms or targets, such as ceilings on the ratio of spending to GDP or on the size of the deficit. Limits may also be established for the public debt, the rate of growth in public expenditure, or the tax burden. To be useful, the limits must constrain; they should not merely accommodate all claims on resources, nor should they be adjusted whenever strong demands exceed the preset limits. Nevertheless, absolutely rigid limits are not likely to be enforceable when the force majeure of changing political or economic conditions compel politicians to breach the totals. But aggregate constraints should be enforceable in normal times or under moderate fiscal-stress. In these circumstances, yearly limits compel spenders to compete for resources within pre-determined budget totals and (in some cases) sectoral subtotals. For some claimants to get more others must get less.

Budget rules are not self-enforcing, nor can they be enforced when spenders have the upper hand in relations with controllers. In fact, the history of budgeting is strewn in many countries with aggregate constraints that have not worked. Effective limits on the fiscal aggregates require that the role of central controllers (in the ministry of finance or a similar organ) be bolstered, so that they have the authority to block spending actions during formulation or implementation of the budget that would cause the limits to be exceeded. Central controllers must be sufficiently powerful that they can enforce the aggregates, even in the face of opposition from spenders. But as they strengthen their grip on the totals, these controllers may find it expedient to let go of some controls, over personnel and procurement, for example, that finance ministries traditionally have exercised. Devolving responsibility for particular spending decisions to line ministers and program managers may facilitate enforcement of the fiscal aggregates by reducing the number of matters on which the finance ministry must negotiate with the spending departments, thereby reducing budgetary conflict and transaction costs.

Central controllers cannot be effective if they lack timely and accurate information on the status of the budget and on the potential impact of spending demands on future totals. PEM recognizes that asymmetry in the supply of information may undermine enforcement of the totals as well as of their expenditure objectives. When spenders know more than controllers about the political strength and budgetary impacts of ongoing programs and policy initiatives, they may withhold information or provide faulty estimates. To counter these possibilities, central controllers need their own capacity to project the medium-term cost of programs and the impacts on budget baselines. Using this information, central controllers become the authoritative scorekeepers of the budget process, determining whether particular spending bids can be accommodated within the approved medium-term expenditure framework.

With appropriate rules, roles and information in place, budgeting becomes more competitive and less prone to spending drift. Inasmuch as the rules and limits are set in advance, before claims on the budget are considered, central controllers have some advantage in the inherently adversarial contest between them and spenders. If the rules work as intended, rather than taking as much as they want from the commons, politicians are constrained to spend only up to the amount allowed by the rules. But this is a big "if", for rules that are made by politicians can be broken by them. In the concluding section of this chapter, we argue that politician-made rules can have teeth. Politicians can bind themselves, though the rules cannot be enforced in all circumstances.

Allocative Efficiency

Enforcing aggregate fiscal discipline is a mixed blessing for allocative efficiency. On the one hand, it may impel old and new claimants to compete for resources within or across sectors; on the other hand, fiscal discipline may make it more difficult to fund new priorities. Whether the first or the second outcome predominates depends on the institutional arrangements that encourage or retard reallocation. The main rules, roles, and informational requirements associated with allocative efficiency are set forth in Table 1.3.

Several conditions must be present to facilitate active reallocation. First, in terms of roles, government and its central organs should be

responsible for strategic guidance and for establishing the main priorities and initiatives for the medium-terms and (where appropriate) beyond. But line ministers and spending departments should be responsible for setting program priorities within the strategic framework laid down by the government. Second, budget rules should encourage reallocation by enabling politicians to shift within sectors without significant risk that doing so will cause them to lose resources. This condition is necessary because spenders will subvert reallocations if they are penalized for trying to shift resources from old to new uses. Reallocation also must be supported by information on program costs and effectiveness. Reallocation must be undertaken in a framework that enables budget controllers to assess the impact of spending shifts on aggregate and (where applicable) sectoral limits, and encourages spending ministers to assess the comparative worth of programs. Finally, spenders should be accountable for program results; if they are not, the government cannot be confident that reallocations will be in accord with its strategic objectives, or that they will promote allocative efficiency.

Operational Efficiency

The conventional rules of budgeting give self-interested managers a strong incentive to spend all available resources, even if the result is an erosion in the organization's operational efficiency. The disincentive to be efficient is summed up in the "use it or lose it" attitude which is said to influence agency managers. Managers routinely assume that if they do not spend all of this year's budget, they will be given fewer resources the next year. Many managers operate in a controlled environment in which their spending actions are overseen by outsiders whose approval is needed before staffing, purchasing and other decisions are taken. Moreover, spending units typically cannot retain unused funds. Finally, and possibly most important, the performance of managers typically is assessed in terms of compliance with procedural rules, not in terms of the outputs they produce or the efficiency of operations.

Operational efficiency depends on managers who are willing to take steps that reduce running costs or that boost the volume or quality of outputs. External controllers can create conditions that foster operational improvements; they cannot dictate these

improvements. Rather, the incentive to improve efficiency must come from the managers themselves, but they can be induced to behave efficiently only if conditions enable them to do so.

Foremost among these conditions are rules that give managers broad discretion in running their operations while holding them accountable for the cost, quantity and quality of outputs. The key rules change gives managers broad flexibility in using budgeted resources, including the opportunity to retain a portion of efficiency gains and to carryover some unused funds to the next financial year. The rules should also require that operating costs be cash limited, so that managers may not seek supplemental funds during the year. These rules changes have to be accompanied by adjustments in the roles and relationships of line managers and external controllers. In the new arrangement, controllers (in central agencies or departmental headquarters) specify performance targets and monitor results, but operating managers are given discretion to optimize the use of budgeted resources.

Promoting operational efficiency requires vast new amounts of information on the cost of producing budgeted outputs. This need has spurred some governments to introduce accrual accounting schemes and to improve cost accounting and allocation systems in departments. It also has led to the ex ante specification of output and service targets, and to the publication of annual reports that compare targeted and actual performance.

Integrating the elements of public expenditure management. In an unconstrained world, governments would seek concurrent improvements in all three elements of public expenditure management. Doing so may be difficult, however, because of the political and financial costs of reforming public institutions. Strong political interest and support usually are needed to impose aggregate limits and to transfer resources to higher priority uses. Political support also may be needed to overcome bureaucratic or legislative reluctance to give managers operating freedom. Compliance costs also are high because of the need to develop and maintain new reporting and control systems. Because of the various costs, governments tend to emphasize one or two PEM objectives, but not all three. For example, Australia has pursued a reform strategy focused on improving resource allocation in government, while New Zealand has con-

centrated on operational issues.

Nevertheless, important interactions among PEM's objectives may impel some governments to move on all three fronts. The task of maintaining fiscal discipline is eased when the government improves allocations (and thereby reduces pressure for additional spending on new priorities) and squeezes waste out of agency operations, thereby enabling it to reduce running costs. Moreover, strong constraints on fiscal aggregates may persuade politicians to finance emerging priorities through reallocation; they may spur managers to cover workload increases by improving productivity rather than by seeking incremental funds.

There are inherent linkages of allocation and operational issues. A government that is lax in managing operations does not have an optimal allocation of resources. The converse also holds: a government that drives to improve programs may seek to cut overhead and other operating costs so as to make more money available for policy initiatives. Over time, therefore, a government that pursues one PEM objective may broaden its reform agenda to encompass other objectives as well. A dozen years after Australia initiated reforms that emphasize program effectiveness, it adopted some operational improvements such as accrual budgeting and tighter cost controls. On the other hand, after its operational reforms were bedded in, New Zealand introduced new instruments such as strategic and key result objectives that upgrade the government's capacity to establish and implement strategic priorities.

As PEM matures and additional features are grafted onto older budget practices, compliance and other transaction costs are likely to escalate. At some time in the future, therefore, a new cycle of public expenditure management reforms may be needed to purge redundant or inefficient rules and procedures. Without the periodic consolidation of systems, the last generation's reforms become the next generation's routines, and the focus on budget outcomes, which is PEM's most distinctive feature, may be blurred by procedural rules that get in the way of results.

Do New Budget Institutions Make a Difference?

PEM purports to influence budget outcomes by changing the behavior of spenders and controllers. If the changes have the intended effects, spenders would conserve resources, allocators would reallocate, and managers would

perform, not just comply. One of the unsettled questions in institutional economics is whether changes in the rules of the game suffice to produce the intended results. The argument runs as follows. Rules are needed because without them rational spenders would misuse public resources. They would spend more than the government could afford, favor old priorities over new ones, and operate in a wasteful manner. But if spenders—whether politicians or managers—were driven to behave in these self-interested ways, why don't they break or repeal new rules that stand in their way? Why don't politicians who are inclined to give voters what they want violate or revise aggregate constraints that bar them from spending as much as they want? And if they are truly determined to protect existing programs against cutbacks, why don't they use their power to block reallocation? In other words, if rules are necessary because spenders want to spend, how can they be effective when they prevent spenders from doing what they want?

In the absence of long-term evidence on budget outcomes through one or more economic and political cycles, one can only conjecture on how PEM-oriented rules will work. The arguments run in opposite directions: some indicate a dismal prognosis for new rules of the game, others are more favorable.

First the downbeat arguments. It may be that rules changes have salutary effects in the short-run, when the new rules are fresh, have a lot of political support and attention, and politicians are on good behavior. Over time, however, constraining rules break down, either because of a buildup of deferred spending pressures or because politicians and others learn how to outwit them. As the rules become routinized, interest in enforcing them wanes, new tactics are devised to evade them, and the rules either are abandoned or are overtaken by events. For example, tough aggregate constraints may become counterproductive if they spur politicians to enact extrabudgetary means of financing coveted programs. Or in the face of economic stress, politicians may vote for more spending despite the impact on the deficit. Allocative efficiency may degrade over time as politicians and managers learn how to "game" the evaluation and performance measurement processes. And operational efficiency may weaken if the new freedom given managers is not reciprocated with more demanding

accountability for results. When these unintended behavioral changes occur, efforts to redirect funds to strategic priorities and effective programs may be defeated by spenders who give lip service to reallocation, program evaluation, outcome measures, and other results—enhancing processes, while protecting their vested program interests. Moreover, line managers may merely comply with the new routines rather than drive for further productivity gains.

But there is another side to the argument. Changing rules and roles can have positive impacts because the same politicians who are spenders also prefer prudent fiscal management, effective programs, and efficient operations. This is why they accept spending limits, new accountability requirements, and other constraining rules. Once the rules are in place, politicians and managers pay a price for violating them. The situation they face after new rules have been introduced is markedly different from the one they faced before there were outcome-based rules. Two additional factors may make them think twice before they stray too far. One is that because PEM rules are outcome-based, they can be more transparent than procedural rules, and violating them can entail high political cost. Second, the rules have enforcers, central controllers in some cases, the courts in others, international institutions in still others. Their job is to enforce the rules and restrain violators.

In the long term, the answer to the question "do new budget institutions make a difference?" will depend on the balance of power between controllers and spenders, guardians and claimants. When new outcome-based rules are adopted, the immediate effect is to empower the controllers and guardians. As long as they hold on to this advantage, the rules will make a difference. But, if because of economic, political or other developments, the balance tilts in favor of spenders and claimants, the rules will lose effectiveness. If this were to occur, further institutional changes can be expected in the future to reinforce PEM objectives and rebalance the relationship between spenders and controllers. ❧

Chapter 2
Managing Public Expenditure in Developing Countries

In all countries, managing public expenditure is an essential but difficult task. Governments in both developed and developing countries are pressured to spend more than the economic or tax base can sustain, to continue financing old programs even when new priorities are judged to be more urgent, and to pay the rising expenses of inefficiently-operated departments. In addition, many developing countries face special problems in managing public finance because their resources are extremely constrained, the stockpile of needed skills and information is inadequate, pressure to spend more than they can afford on unmet needs is very intense, and they have meager reserves to ride out shocks or unexpected difficulties.

This chapter is grounded on the argument that the budgetary predicament of poor developing countries is fundamentally different from that of rich developed countries, and that prescriptions and processes that are appropriate for the latter may hold disappointing results in the former. Developing countries generally have greater difficulty maintaining fiscal discipline and pursuing efficient budget outcomes. They have weaker control of their budgetary fate, and outcomes that appear to be the result of lax expenditure management often are byproducts of under-development. If this argument is right, it implies that while the basic objectives of public expenditure management may be similar, the path taken by developing countries may be somewhat different from the one usually taken by developed countries.

In seeking the root causes of budgetary differences, one is drawn to a basic

distinction between developed and developing countries. Developing countries are poorer, they have a lower, sometimes much lower, per capita GDP. Being poorer, they are heavily dependent on capital inflows; they have a large backlog of development needs; market transactions generally are more informal than in developed countries; they operate in an unstable fiscal environment; and much of the public sector also operates on the basis of informal rules and relationships.

More than two thirds of the countries in the world are "developing". This category includes indigent countries that are on the edge of subsistence as well as rapidly-growing countries whose standard of living has approached that of developed countries. The problems and tendencies discussed in this chapter are most pronounced in poor countries; they diminish as a country improves its economic condition. The reverse also applies: when an affluent country goes through severe economic stress, it sometimes behaves in ways that resemble developing countries.

Transitional countries are a mixed lot. Some are at an advanced stage of development, others are at a much earlier stage. In several aspects, the economic problems facing transitional economies generally differ from those common in the developing world. Many developing countries have a small public sector; government in transitional countries tends to be very large relative to the overall economy. Transitional countries have an immediate need to establish modern public management institutions; they do not have the option of allowing these institutions to evolve as the public sector grows. Moreover, they have to undo many of the rules and systems operated during decades of socialist management. They must replace subsidies with transfers, dismantle state enterprises, establish and administer new tax systems, and forge regulatory institutions that facilitate open, robust markets. The progress made by some transitional countries during the 1990s has been truly remarkable, but others have lagged behind and have been slow to transition. But even the most advanced of the transitional economies still have much unfinished business in managing its finances.

Differences between developed and developing countries both promote and impede reform. On the one hand, developing countries can adopt practices that have evolved over the years and have become widely accepted in the developed world; on the

other hand, the special problems facing poor countries may make them inhospitable venues for certain practices. Moreover, what is exported to developing countries are not just the tried practices but novel or experimental ones as well. Politicians and officials in developing countries sometimes are as eager to buy avant-garde practices as reformers are to sell them. When this occurs, the ambitious reforms typically fail to deliver the promised results.

On Being a Poor Country

Table 2.1 identifies various problems associated with being a poor country. Not every poor country has all of the listed problems, but many do. Generalizing about poor countries sharpens the distinction between them and rich countries and enables one to comprehend why solutions that make sense in one situation do not work in another.

Being poor means that a country lacks sufficient resources to respond to

Table 2.1: Special Problems of Some Developing Countries

Condition	*Impact on public expenditure*
Poverty	Lack of resources to respond to rising demands/expectations for public services
Economic Instability	Inadequate slack to "ride out" cyclical shocks and other disturbances
Low Revenue Base	Vulnerability to adverse shifts in commodity prices, terms of trade, and low access to capital markets
Informal Market Sector	Much economic activity is extralegal, in disregard of formal rules and regulations; weak enforcement of property rights and contracts resulting in relatively high levels of corruption
Informal Public Sector	Formal rules concerning civil service, public expenditure and procurement tend to be ignored or violated
Low Political Mobilization	Inadequate development of interest groups to express public opinion and monitor government performance

rising demands and expectations for public services. In most cases, it also means that the country lacks financial resources to pay for all ongoing programs. The pool of domestic savings is not likely to be adequate to finance the gap between current revenue and expenditure. Unable to explicitly rebuff demands or to trim public spending so that it fits within available resources, many poor countries overbudget; they authorize more in the budget than they actually intend to spend during the year. Hidden cutbacks enable some countries to maintain aggregate fiscal discipline, but at the expense of discrediting the budget and weakening democratic institutions. When the budget does not correspond to actual transactions, some poor governments may devise other means of falsifying the books, for it is only a short step from having budgets that do not disclose actual or intended expenditure to having corrupt budgets in which public money is used for private gain.

Poverty takes a toll in economic management as well. Poor countries typically lack sufficient reserves or slack to cushion cyclical shocks and other disturbances. An affluent country facing economic difficulty can maintain spending at budgeted levels and allow automatic stabilizers to enlarge the deficit, which it can finance by borrowing internally. Poor countries, however, lack this option; they are more likely to monatize the deficit, risking a capital outflow and deterioration in their already-weak financial condition. They may have to discard the approved budget and (as will be discussed below) redo the budget one or more times before the fiscal year is competed. With repetitive budgeting, unplanned changes forced by economic force majeure during the fiscal year often are greater than the spending changes planned between years.

Poor countries have difficulty generating sufficient tax revenue, either because much economic activity is informal or because enforcement of tax laws is weak. In some poor countries, revenues are highly sensitive to changes in commodity prices, making it difficult for the government to accurately project the amount it will take in during the next year.

Financial markets tend to be under-developed and poorly regulated, making public and private borrowers heavily dependent on inflows from international organizations and foreign

investors, and vulnerable to sudden outflows, especially when economic problems arise. Debtor countries often have no choice but to borrow short-term and to repay in hard currency. They therefore face significant interest and exchange rate risks in financing and rolling over their debt.

Much economic activity in these countries is informal and extralegal, and escapes both the tax collector and government regulation. Informal transactions are a mixed blessing, for they both enable small enterprises to operate and keep them small. Petty bribery is extensive, as informal enterprises pay for the privilege of operating without interference from government regulators who obtain payments for not enforcing the myriad rules and procedures that blanket virtually all business. Informal enterprises tend to be small, because their extralegal status blocks access to capital.

Informality spills over to the public sector where detailed rules that purport to govern the civil service, budgeting, procurement, and other managerial functions are routinely ignored or bypassed. There are the rules, and then there are the ways that wily politicians and bureaucrats get things done. As in the market sector, informality is a mixed blessing: it cuts through red tape, but it also perpetuates inefficiency and opens the door to corruption.

Finally, poor countries tend to have under-developed democratic political institutions, with low political participation and few groups monitoring government performance and demanding honest, fair and responsive public services.

Are the various shortcomings and disabilities listed in Table 2.1 the cause or effect of a country being poor? Are many less-developed countries poor because they have systemic corruption, lax tax administration, informal markets, and misguided regulation? Or is the reverse the case: less-developed countries are susceptible to these deficiencies because they are poor. A fair answer is that both tendencies may be at work: poverty generates dysfunctional institutions, and dysfunctional institutions keep countries poor. Regardless of the cause, the impact on public expenditure cannot be ignored. Poor countries do not manage their finances as rich countries do, and almost half a century of prodding them to do so hasn't turned the tide.

Government in poor countries budget for the short-term. In some, looking ahead as far as a single fiscal

year is difficult, for the conditions under which they operate are highly unstable and unpredictable. The standard prescription is to inject greater certainty into public expenditure management by adopting a long-term framework within which annual budgets should be prepared and implemented. Other prescriptions include strengthening adherence to rules by enforcing accounting and other financial management standards, emphasizing objectives and performance in allocating public resources, and installing modern, integrated information systems. These prescriptions have not fallen on deaf ears; they have been tried in quite a few countries, but their impact has been weakened by short-termism, uncertainty, informality, an inadequate informational and skill base, and other manifestations of national poverty.

One of the popular recent reforms has been to move away from centralized, ex ante input controls to systems that give line managers broad flexibility to operate within an accountability framework that measures the outputs and outcomes that result from public expenditure. The logic of this type of reform (which is discussed in Chapter 5) is that inasmuch as detailed restrictions on managerial discretion have been counterproductive, it makes little sense to try to purge corruption and inefficiency by imposing additional restrictions. Therefore, why not, try some of the new managerial institutions pioneered in New Zealand, Australia, Sweden, and the United Kingdom? As appealing as this argument is, it neglects the fact that these developed countries gave operating freedom to managers only after they had established reliable control systems, not before. Reversing the sequence risks giving managers license to do as they wish before a culture of compliance with the rules has been institutionalized.

Another popular innovation is to install integrated financial management systems that link accounting, budgeting, procurement, disbursement, and other financial operations. The reasoning here is that this type of system would train public managers in modern information technology and make public transactions more transparent and less vulnerable to corruption. An integrated system would make it difficult to hide transactions off the books or to have discrepancies between the amounts entered at one point in the system and recorded in another, for example, between the

amount specified on a purchase order and the amount disbursed to the vendor. Here, too, however, good intentions may run afoul of the limitations of poor countries. The test of these integrated systems is not in their design or in their initial application, but in their utilization over a period of years. It is not hard for corrupt persons in the right places to bypass an integrated system by maintaining covert or off-the-books accounts. And it is not easy for poor governments to properly maintain these systems when donor assistance dries up, the systems architects and operators take their marketable skills to the private sector, and a new generation of officials comes to see integrated financial management as just another set of rules that they have to comply with.

Aggregate Fiscal Discipline

A poor country tends to have pathologies in each of the three dimensions of public expenditure management. These pathologies arise out of its short-term behavior, informal governance and uncertain financial outlook.

Table 2.2 sets forth the practices that affect aggregate fiscal discipline; some of these pertain to allocative and operational efficiency as well, as will be discussed in the sections that follow.

Aggregate fiscal discipline is predicated on a norm that often is taken for granted in developed countries: the budget should express the true intentions of government with respect to future expenditure. It should not be a wish list, or a statement of what the government will spend if resources were available; rather, it should state the actual spending that will ensue during the fiscal period covered by the budget. But what should a government do when it is poor and wants to demonstrate that it is improving social conditions? One option would be for the government to be explicit about its fiscal impoverishment and to compile a budget that includes only what it actually intends to spend. Such a budget would be based on prudent, realistic revenue estimates that recognize the various things that can go wrong during the year. In effect, it would be a budget that announces what will not be done: the schools that will not be built or that will be under-resourced; the clinics that will lack medical supplies, the muddy roads that will not be paved. Alternatively, the government can prepare an unrealistic budget that trumpets the great strides that will be made in the year

Table 2.2: Aggregate Fiscal Discipline Problems of Some Developing Countries

Practice	*Problem*
Unrealistic Budgeting	The budget cannot be implemented as approved because it authorizes more spending than the government can pay for.
Hidden Budgeting	The "real" budget (actual revenues and spending) is known only to a small circle of insiders, or only in retrospect-after the fiscal year has ended.
Escapist Budgeting	Unrealistic budgets beget escapist budgeting: the government knowingly authorizes significant public spending that it knows will not occur so as to create the impression that it is responding to demands for social improvement.
Repetitive Budgeting	The budget is remade frequently during the year, in response to economic or political conditions.
Cashbox Budgeting	Government pays bills or undertakes spending as cash becomes available, not according to a preset budget.
Deferred Budgeting	The budget may report balance (or near balance), but only because some needs (such as maintenance) or liabilities (such as bills due) have not been paid. Deferred expenditures tend to escalate from one year to the next.

ahead. This unrealistic budget might authorize 120 percent or more of expected spending, but the real budget—what actually will be spent—is controlled by a small circle of opportunistic politicians and senior bureaucrats who collude to maintain their power while channeling funds to their favored priorities. Even when this behavior protects fiscal discipline, it undermines democratic institutions and fosters corruption.

When unrealistic, covert budgeting is practiced year after year, it may lead to escapist budgeting whose purpose is to create impressions that are at variance with the reality. The budget becomes a means by which the government escapes from its fiscal confinement by promising social improvements that it cannot deliver.

As noted earlier, maintaining fiscal discipline compels poor governments to engage in repetitive budgeting in response to changes in economic conditions or in its cash position. When a country is poor, it does not take much to jar the government off course and to rewrite the budget during the year. Once repetitive budgeting becomes institutionalized, the official budget loses its cachet as the authoritative statement of government financial policy and becomes merely the first round in an ongoing process of adjusting to uncertainty, crisis, and changing fiscal circumstances.

The final items in Table 2.2 reflect practices that while common in poor countries also are found from time to time in developed countries. One is to implement the budget as if it were a cashbox, with expenses paid or spending authorized on the basis of the government's cash position; the other is to defer disbursements or liabilities into a later fiscal year. Rich and poor countries differ, however, in the pervasiveness of these practices. In contrast to rich countries which may have cash flow problems during part of the year (for example, because tax collections are lumpy and not spread evenly throughout the year) or in the final months of the year during which they are striving to meet a budget constraint, in poor countries, cashbox behavior is year-round. In these countries, the amount spent is not determined by budget projections but by actual collections. The government spends what it takes in; if it doesn't receive the money, it doesn't make the disbursement.

Several of the budget pathologies identified in Table 2.2 enable poor countries to maintain fiscal discipline despite their economic straits. They spend cash only when they have it; they remake the budget during the year if conditions turn out more adverse than they had hoped; they underspend the authorized budget. But these tactics are purchased at a high cost in budgetary integrity.

Allocative Inefficiency

Getting allocations right is a difficult task in all countries, and even more so

in poor countries which have overwhelming unmet social needs and meager fiscal increments. Yet the stakes also are much higher. Improving budget allocations in affluent countries might raise per capita income by several percentage points; in poor countries, however, it might spell the difference between abject poverty and the capacity to satisfy basic needs. Table 2.3 spells out some problems in obtaining allocative efficiency.

The short-termism of poor countries hobbles their capacity to make efficient allocations. In all countries, reprioritizing the budget requires a medium-term perspective that takes account of the future financial and program implications of current budget decisions. A medium-term framework is necessary because relative priorities change slowly; indeed, major allocative decisions typically have a greater impact on future budgets than on the one for which they are initially made. But unlike rich countries which can allocate money to high priority programs in annual installments with reasonable assurance that all or most of the promised funds will be forthcoming, poor countries have difficulty making or honoring commitments that fall due in future budgets. If these countries have to rebudget during the year, what is the probability that they will stay on course over 3–5 years?

Paradoxically, medium-tern planning is important in poor countries, in some cases the plan is more prominent than the annual budget. But planning sometimes is escapist, with the government promising in the plan what it cannot afford in the budget. The tip-off that a plan is escapist is its relationship to the budget. When the plan ambitiously portrays a bountiful future with enhanced public services, but the budget fails to make a downpayment on that future—it does not allocate spending increases to social programs—then the government probably is using the plan to escape from its dire predicament.

Budget allocations in poor countries often differ markedly from those in wealthy ones. Poor countries typically spend a smaller portion of GDP and their budget on health services; sometimes education spending lags behind as well. They spend relatively more on operating government and, in some countries, on military forces. Why are allocations skewed this way? Why don't national leaders recognize the social returns from having a healthier, better educated population? There

Table 2.3: Allocative Efficiency Problems of Some Developing Countries

Practice	*Problem*
Short-term Budgeting	Government budgets one year at a time, without considering medium-term implications, such as the recurring operating costs of new projects.
Escapist Planning	Planning is politically important but the government promises in the plan what it cannot pay for in the budget.
Distorted Priorities	Scarce resources are spent on showcase projects that produce meager social return while the budget underspends on human capital (health, education, etc.).
"Enclave" Budgeting	Efforts (often by international organizations) to protect certain priorities by establishing special funds, separate investment budgets, social (or physical) investment programs, and other devices that wall off the "enclaves" from the rest of the budget.

are many answers to these questions, for each poor country has its own story. But one is that higher social spending is closely correlated with political and economic development. Citizens in rich countries have extensive social programs because they demand them and are willing to pay taxes for them. The lack of robust political institutions in many poor countries muffles citizen demands for better services.

An increasingly popular method for redressing the skewed priorities of poor countries is to wall off social programs with their own earmarked funds from the overall budget. Often external donors insist on special funds to ensure that assistance goes for intended purposes. One effect of establishing these financial enclaves is to remove major allocative decisions from the budget process. Although this diminution of the budget's role as an allocative instrument runs counter to widely-accepted (but often violated) budgetary principles, it recognizes that in poor countries, social programs would

lose out in the competition for public funds if they lacked preferential enclaves.

Operational Inefficiency

Poor countries have systemic inefficiencies in both the market sector and government, that is due in substantial part to extensive reliance on informal institutions. Private enterprises tend to be small, under-capitalized, and labor intensive, with low wages rather than high productivity giving them a competitive edge. This pattern is mirrored in many poor governments which have a large, low-paid civil service. In developing countries, there tends to be an inverse relationship between the size of the civil service and public sector wages: the larger the workforce, the more depressed wages are. Moreover, as the civil service grows, the decline in real wages accelerates.

This condition is a recipe for low productivity in the public sector, with large numbers of ghost workers, employees who are paid out of two or more budgets, under-investment in job training, and widespread cronyism in appointments and promotions. These pathologies flourish despite the installation of modern, merit and rule-based civil service systems.

Operating managers in poor countries have uncertain budgets. Even after the budget has been approved and the fiscal year has commenced, they cannot be certain that the specified amounts will be available for the next month or quarter. They are beset by several practices mentioned earlier: unrealistic, repetitive, and cashbox budgeting, so that they must vie with other spenders throughout the year to obtain promised resources. The lack of predictability reinforces short-termism and discourages managers from making investments that will yield higher productivity in the future. It also encourages them to sharpen skills in nominally complying with the rules while outwitting the system. Getting budgeted resources becomes more important than getting results.

These and other conditions described in Table 2.4 are breeding grounds for petty corruption in the public service. It is not hard for civil servants to justify their failure to put in a day's work on the ground that they are ill paid, or to channel contracts and other favors to friends or relatives on the ground that that's the way the system really works. And the system does work that way for those who are

Table 2.4: Operational Efficiency Problems of Some Developing Countries

Practice	*Problem*
Compensatory Spending	To ameliorate unemployment, the size of the civil service balloons, but real public wages decline.
Declining Productivity	Numerous ghost workers, underinvestment in training and information technology, poor working conditions and other practices degrade operational efficiency.
Disappearing Budgets	The resources available for operations are highly uncertain, even after the budget has been approved and the fiscal year has commenced, managers operate hand-to-mouth without knowing what resources they will have for the next month or quarter.
Detailed, Rigid Budgets	On paper, spending control is highly centralized, with detailed rules concerning civil service (numerous classifications and grades), external control of procurement and other items of expenditure, but these formal controls often are violated in practice.
Informal Management	Informal arrangements coexist alongside the formal rules. Extralegal arrangements dictate how government operates: how civil servants get jobs or promotions, their pay scale, how procurement is contracted for, etc.
Corruption	When the formal rules are unworkable and government operates through extralegal means, corruption rises. There is ample opportunity for corruption, which (though widespread) often is undetected or unreported.

trapped in it; only from afar can one see the costs of a system that works this way: inefficiency, loss of service quality, inattention to results, and failure to take measures that would improve longer-term performance.

Can Public Expenditure Be Better Managed?

In expenditure management, as in many other government activities, it is easier to diagnose shortcomings than to prescribe workable remedies. The fact that many countries remain under-developed after decades of external assistance and waves of reform attests to the difficulty of uprooting embedded pathologies. Informality thrives in the public and private arenas, not because it promotes efficiency, but because it enables politicians and managers to muddle through. Corruption persists, not only because some benefit from it, but also because it cuts through red tape and in a highly uncertain world brings a modicum of predictability to public and private transactions.

Despite the relatively low probability of sustained success, it is imperative that efforts to improve public management in poor countries be intensified. The 1997 World Development Report argues that an effective state is a necessary condition for robust markets and sustainable development. Contributions made by the state to open, formal markets through deregulation, privatization, arms-length relationships between it and financial institutions feedback to stronger rule-based institutions in the public sector. When the state lets markets develop, it creates the very conditions that make it more effective.

It would take this chapter far afield to specify the many economic and political changes that might be made to promote development in poor countries. But it should be stressed that at the end of the day, if the government still prepares unrealistic budgets, it will continue to be hobbled by the short-termism and other pathologies discussed in this chapter. If the budget is unrealistic, it will not be implemented as planned, the government will continue to treat it as a cashbox, covert budgets will substitute for the official ones, informal behavior will preempt rule-based institutions, and the government will continue to allocate and operate inefficiently.

A budget is realistic when it is based on assumptions that have a high probability of occurring and when it is formulated with the intent to implement the revenue and spending policies specified in it. Realism does not require budgets that can withstand all exogenous shocks, but budgets that are implemented as planned when assumed conditions materialize or when relatively minor disturbances intrude.

Realistic budgeting depends on basic capacities to plan, control, and account for public funds. These include having a strong budget planning and control agency at the center of government that maintains fiscal discipline, monitors revenue and spending outturns, controls the use of inputs, advises departments on means of improving efficiency, manages the governments cash and debt, and ensures that actual spending conforms to budgeted amounts. Once these and other basic practices have been institutionalized, it may be appropriate to introduce more flexible means of managing public expenditure.

Managing Public Expenditure During Economic Development

Not every country that was poor 30 or 50 years ago is poor today. Some have joined the ranks of developed countries; others are at the brink of doing so. As a country develops, the government's budget position improves. Large scale enterprises emerge, the informal sector recedes in size relative to the formal one, the government has more success in collecting taxes, and entrepreneurs more success in attracting outside capital. Public management also improves as merit-based civil service systems become more extensive and the skill level of public employees rises. Central budget and planning systems—often divorced from one another and entrusted to different agencies—mature. Typically, the government operates a line item budget and a uniform civil service system that emphasize the control of inputs and compliance with centrally-enforced rules.

As the economy develops, the government has more money to spend, but this does not mean that the task of managing public expenditure becomes less important. In fact, Table 2.5 indicates, new problems come to the fore, as the process of development unleashes demands for better schools, more health facilities, and other improvements in public services. Some of the spending increases are financed out of the dividends of a growing economy, but some may require tax increases or deficit financing.

Initially, the largest spending increases are likely to be in public consumption and investment, the latter to build infrastructure, the former because of voter and politician demands for more services. As development persists and incomes rise, pressure escalates to provide (or enhance)

Table 2.5: Public Expenditure Conditions Associated with Economic Development

As the economy develops	*Explanation*
Public Spending Grows As A Percentage of GDP	Rising expectations, strong demands for improved services, organization of interest groups, and easier availability of resources.
Consumption Expenditure Rises	Initial increases tend to be concentrated in services, such as health, education, environment, and sanitation.
Transfer Payments Rise Later	As development persists and matures, pressure rises to establish/enhance social security programs.
Aggregate Fiscal Discipline May Weaken	Depending on political conditions and institutional arrangements, budget deficits may rise as government overspends the dividends of economic growth and draws on its improved ability to borrow.
Pressure to Improve Allocative Efficiency by Shift from Subsidies to Transfer	Pressure to remove/reduce subsidies to firms and to protect disadvantaged/dependent persons through income redistribution schemes and expansion of "safety nets."
Operational Efficiency May Decline	Operational efficiency may improve as a result of citizen pressure for better services, but counter pressures include failure of government to pay competitive salaries as private employment opportunities advance, tendency to spend newly available resources on operations, inability of pre-development bureaucracies to keep up with new demands/opportunities, and greater opportunity for rent-seeking and corruption.

the social safety nets that are widely available in developed countries, such as income support for dependent persons (the elderly, ill, disabled, and unemployed). In the euphoria of growth, there may be little attention to the long-term commitment that the government undertakes when it enti-

tles a substantial portion of the population to future benefits. For the present, resources appear to be plentiful, and it seems appropriate to share the fruits of affluence with those who are left behind.

As a country develops, it is cross-pressured with respect to aggregate spending policy. On the one hand, growth schools political and economic elites in the advantages of fiscal prudence; on the other hand, it generates pressure to spend more, especially in countries where the national legislature enjoys budgetary independence and can vote on spending items not included in the government's budget. Typically, the government still maintains a short-term budgetary perspective, looking ahead only one year at a time, though it may have a separate planning apparatus (with its own power base) that generates expectations of future spending increases.

During rapid growth, allocative and operational inefficiencies become more pronounced or apparent, either because of higher expectations for public service, or because much of the additional spending goes to enlarge the bureaucracy or to build grand projects favored by national leaders and infrastructure projects favored by local politicians. Depending on how growth is managed, public sector productivity may decline as public salaries and career opportunities lag behind those in the market sector.

These possibilities suggest that during high growth periods, it may be appropriate to turn the spotlight on to allocative and operational issues. During these times, the government may have greater incentive to take a long-term perspective, it can more clearly discern the connection between having effective programs and economic development, and it has incremental resources needed to improve public management. Ideally, the private and public sectors should develop in tandem, with the government liberalizing the market at the same time as it strengthens rule-based budgeting, personnel systems, and other management practices. In many cases, however, public improvement does not take place and only after the deficiencies in its operations become apparent does it invest in medium-term expenditure planning while instilling a culture of performance and accountability in the public service. ❧

Chapter 3
Aggregate Fiscal Discipline

Controlling total expenditure is an essential purpose of every budget system. There would be no need for governments to budget if total spending were merely the sum of all claims on public resources. Budgeting is ubiquitous because claims always exceed what government is able or willing to spend. Without limits on the totals, unconstrained demands would likely result in chronically high deficits and a progressive rise in the ratio of tax revenues and public expenditure to GDP.

Aggregate fiscal discipline pertains to all key measures of fiscal performance: total revenue, the financial balance and the public debt, in addition to total spending. It makes little sense to establish spending constraints without also deciding revenue totals, budget surplus or deficit, and the debt burden. Typically, therefore, spending discipline is accompanied by constraints on other budget aggregates. If it isn't, the government may find it easier to meet deficit targets by allowing revenues to rise than by reducing public expenditure.

Constraining the totals is not easy because claimants have a strong incentive to demand all they can get from government. For most claimants, the benefits ensuing from higher government spending outweigh any resulting increase in their tax burden. Inasmuch as program benefits tend to be concentrated while the tax burden is dispersed, particular beneficiaries have more net gain from demanding additional spending than by advocating fiscal constraint. These unbalanced incentives lend self-interested claimants to demand more resources than they would want government to spend. This "common pool" or "tragedy of the commons" problem is exacerbated when programs are debt financed and the government shifts costs to future taxpayers. What constrains claims on the budget is not only the prospect of higher tax burdens (or other costs such as rising inflation or weaker economic growth) but the impossibility of all claimants getting what they want. This impossibility is rooted in a fundamental condition of government: resources are more constrained than demands. Giving everybody what they want would exhaust current revenue and the government's capacity to borrow. To counteract the inclination of claimants to push for more, governments constrain the spending totals. The question is not whether spending totals should be constrained, but how hard a constraint should be applied. Enforcing aggregate fiscal discipline is a contest between claimants and controllers; the latter can prevail only when decisions on spending totals are made somewhat independently of annual demands on the budget, and when these decisions are enforced by budget rules that limit what claimants can ask for and get, and when controllers are armed with roles and authority than enable them to enforce fiscal discipline. To the extent that budgetary rules and roles differ among countries, governments vary in their capacity to maintain aggregate fiscal discipline.

This chapter discusses aggregate fiscal discipline in the light of contemporary public expenditure management (PEM). The next section discusses the evolution of aggregate spending practices over the past century. It is followed by a consideration of the conditions that reinforce aggregate discipline: institutional arrangements, informational flows, and resulting behavioral changes.

The Three Stages of Aggregate Budget Policy: Lessons from Experience

There are important differences between PEM and previous approaches to aggregate fiscal discipline. PEM builds on and deviates from two earlier doctrines—the balanced budget norm and dynamic fiscal policy.

Prior to World War II, virtually all democratic regimes embraced the balanced budget norm. The operative rule was that spending during a fiscal year should not exceed that year's revenue. Governments differed in applying this rule: some applied it only to current revenue and expenditure, others to investment income and expense as

well. Some included money carried over from previous years in calculating available revenue, others included only funds received during the fiscal year. The balanced budget norm did not distinguish between periods of economic growth and stagnation, nor did its time horizon extend beyond a single fiscal period to a full economic cycle. Because it was rigid, the balanced budget norm was not always adhered to. Few countries managed to keep total spending within revenues during wartime or recession; some even had difficulty during good times. But although the norm often was dishonored in practice, governments paid it lip service as the right thing to do. Moreover, even when the budget was imbalanced, governments used the norm to constrain spending demands.

Inasmuch as prewar governments were relatively small and tax rates were relatively low, much of the burden for maintaining balance fell on the expenditure side of the budget. Balance was enforced by ex ante controls on the items of expenditure. Spending control was centralized and reached individual transactions, such as decisions on hiring personnel and purchasing supplies. Moreover central controllers in the finance ministry or similar organization were empowered to block spending that was not authorized in the budget, was deemed by them to be unnecessary or wasteful, or that would, in their judgment, unbalance the budget. Some governments went a step further and required that all spending actions be approved in advance by central controllers. The rationale was that total spending could be effectively constrained only if particular spending items were controlled. With the bulk of public funds spent on the running costs of government, controlling the items of expenditures usually was a manageable task.

The strict budgetary balance norm was superseded after World War II by a flexible rule that allowed the totals to accommodate cyclical changes in economic conditions and secular changes in government policy. The new rule came in several versions. One was that government should maintain balance over the course of an economic cycle; another was that total government spending should not exceed the revenues government would take in if the economy were at full (or high) employment. Governments differed in the extent to which dynamic fiscal response should result from built-in stabilizers or from discretionary fiscal policy. Over time,

dynamic fiscal policy came to mean that government should act to reduce the gap between actual and potential output. Even when the economy was strong, deficit spending was common in many democratic countries, along with a steady updrift in the ratio of public expenditure to GDP. With aggregate constraints loosened, claimants had the upper hand in demanding more from government. Claimants also were advantaged by changes in budgetary rules and roles, for in many countries, spending items were consolidated into broad categories, and the government shifted emphasis from preaudits and external control to postaudits and internal controls. These and related changes enabled spending agencies to use budgeted funds without obtaining central approval, thereby reducing the authority of central controllers to intervene in agency spending decisions.

Spending demands were strengthened in most industrial democracies by a fundamental change in the composition of national expenditure, with much more spent on transfers to households and relatively less on consumption and investment. The changing mix of expenditures weakened aggregate fiscal discipline and promoted dynamic fiscal policy. An increasing portion of public expenditure was determined by statutory formula rather than by annual budget decisions. This portion of the budget has to be spent regardless of other claims on public resources and whether or not government has sufficient revenue to cover the mandated entitlements. For example, governments typically are required by law to pay social security and other pension claims, regardless of the overall condition of the budget. In many countries, these payments are funded by statutory or permanent law, not by annual appropriations. Moreover, the year to year rise in statutory payments often exceeds the incremental increase in tax revenues, forcing governments to raise the tax burden and/or accept deficit spending. Most importantly, the rise in transfer payments has made public expenditure much more sensitive to changes in economic conditions.

Aggregate fiscal discipline was a casualty of these changes. Government outlays soared in virtually all democratic countries. In OECD countries, they averaged 28 percent of GDP in 1960 and about 40 percent two decades later, a growth rate in excess of one half percentage point a year. In many countries, higher expenditure

and lax fiscal discipline were justified in terms of the economic and social gains achieved through government expansion and flexible fiscal responses.

Whatever its virtues, an accommodating fiscal posture was called into question by the deterioration in economic performance of most industrial countries after the oil shocks in the mid-1970s and early 1980s. With economic improvement no longer taken for granted, many countries encountered increased political resistance to tax increases. High deficits came to be seen as structural problems that persist even when the economy recovers, not as cyclical responses to short-term economic difficulties. One after the other, developed countries concluded that they had to exert more discipline over the budget aggregates, including total public expenditure.

In seeking to reassert fiscal discipline, governments had to devise new approaches that differ from both the balanced budget rule and accommodating fiscal policy. A strict balanced budget requirement is unworkable because the budget is sensitive to economic fluctuations and cannot be kept in balance when output falls and unemployment rises. A zero deficit norm would be violated during most (and in some circumstances all) years of the economic cycle, not only during recession but also in its aftermath. When recession ends, its impact on the budget lingers for some time, because revenues remain lower and interest charges and certain transfer payments remain higher than what they would have been in the absence of the downturn. Some countries have redefined the balanced budget rule to focus on the primary balance, which excludes interest payments. During periods of sustained economic growth, when the deficit recedes and the budgetary effects of the previous recession dissipate, some governments renew their commitment to strict budgetary balance, but then they are jarred by the next recession into realizing that this rule cannot be enforced during economic downturns.

If the balanced budget norm is an unsustainable policy guide, so too is an accommodating fiscal posture and lax financial discipline. Some countries have come to the conclusion that active demand management is not a viable option when structural budget deficits are high; many now regard prolonged fiscal imbalances as a drag on their future economic capacity. Almost all perceive that the once-com-

mon distinction between cyclical and structural deficits is misguided because one year's cyclical deficit often worsens future structural imbalances. There are both fiscal and political reasons for the structural difficulty of fine tuning cyclical budget policy. Cyclical deficits add to spending demands on future budgets by raising interest charges and other payments. Moreover, when a government loosens the purse strings by permitting cyclical deficits, it changes the behavior of politicians and others with an interest in higher spending. Cyclical policy strengthens the hand of those who justify higher spending in terms of short-term improvement in economic well-being; and it spawns incentives to engage in creative bookkeeping practices that veil increased public spending and deficits.

When the government has an accommodating posture, fiscal discipline is loose both when the budget is formulated and during its implementation. In the 1970s and the 1980s, it was not uncommon for within-year changes to be greater than those made between budget years. When this occurs, the budget appears out of control, overtaken by exogenous circumstances such as worse-than-expected economic performance. The budget no longer does what it is supposed to do—decide the totals.

Faced with the impracticability of a strict balanced budget rule and the undesirability of accommodating budgets, industrial democracies have muddled through to a targeting strategy that permits controlled deficits that are expressly set by the government and are enforced through spending limits and other budget rules. *Like the balanced budget rule, targets are fixed rather than accommodating, but unlike this norm they usually are decided by the government, not by an a priori norm.*

Most early targets—those announced in the 1980s—were political statements, not operational policies, that were only loosely linked to the budget and lacked strong enforcement mechanisms. Often, the announced targets were unrealistic; even with genuine effort, they could not be achieved. They typically focused on short-term outcomes rather than on longer-term fiscal stabilization. Although they generally were ineffective, the first-generation targets signaled important changes in government policy. They rallied public support for a tougher fiscal stance and put claimants on notice that the era of lax spending control was over.

Some countries have achieved temporary success in disciplining the totals when the economy was robust, but they have been compelled to ease aggregate fiscal controls when the economy has weakened or spending pressures have escalated. According to a report by the U.S. General Accounting Office, four countries (Australia, Germany, Japan, and Mexico) that managed to restore fiscal balance during the 1980s experienced resurgent deficits during the early 1990s, demonstrating that although "significant structural improvement in fiscal policy is possible in modern democracies...such progress is difficult to sustain."

The ineffectiveness of the early targets has let to more sophisticated approaches that integrate target-setting with formulation and implementation of the budget, specify constraints on revenue, spending, the deficit, and (in some countries) the public debt, establish subtargets for major spending sectors, and take account of cyclical gyrations in fiscal outcomes. It will take years of experience, through one or more economic cycles, before the impact of aggregate fiscal constraints on budget outcomes can be assessed.

Implications for Types of Fiscal Constraints

For fiscal limits to constrain revenue and spending decisions, they must be imposed before the budget is formulated. In contrast to the balanced budget era, when unwritten constraints sufficed because they were widely accepted, now the constraints are formal and explicit. Moreover, in contrast to the Keynesian era when revenue limits were set (and often changed) in the course of making and implementing the budget, the current emphasis is on setting them in advance, and independently of annual budget decisions.

Aggregate constraints take many forms, ranging from constitutional limits on the power of government to tax, spend or borrow to indicative statements that set forth the government's fiscal posture but are not legally binding. The constraints may be self-imposed or externally prescribed through conditions set by international organizations or other entities. Some limits are established one year at a time, others extend to the medium-term (3-5 years) or beyond. The constraints may pertain only to the deficit or cover other fiscal aggregates. They can be expressed in money terms, as rates of change, or as percentages of

GDP or of other indices. They can be confined to the aggregates or cover major spending categories (such as sectors, portfolios, or budget functions) as well. The constraints may deal only with formulation of the budget, or they may include mechanisms for limiting parliamentary action and implementation of the budget. They may have tough enforcement mechanisms that entail corrective action if the constraints are breached or they may not require any intervention.

Because of their variety, the constraints cannot be displayed in a single table. This section maps out some of the alternatives available in designing and implementing aggregate fiscal discipline.

Permanent Versus Annually Reset Constraints

In seeking to discipline the aggregates, government may decide to operate under fixed rules that continue in effect from year to year, or according to a process in which new decisions are taken on by the aggregates each year. The rules may be prescribed by constitution, statute, international agreement, or some other binding decision. The Maastricht criteria for the European Monetary Union are in this category, as is the American Gramm-Rudman-Hollings law enacted in 1985. A somewhat more flexible approach is to decide the limits each year and then to consider budget estimates within the agreed constraints. In Australia, the forward estimates are the authoritative starting point for considering departmental bids for resources; in Sweden's reformed budget system, the totals are decided by the government and parliament each year, before work commences on the annual budget. Another variant comes from New Zealand where the government presents a policy statement to parliament several months before it submits the annual budget. This statement indicates the government's fiscal objectives for the medium-term and longer; it is updated half-yearly, as well as during the runup to national elections.

At first consideration, it may appear that the more constrictive the constraint the more effective it is likely to be in controlling the aggregates. Indicative statements would appear to be considerably less effective because they do not formally bind the government and no specific action (other than revision of the statement) is necessary when fiscal conditions veer off course. Yet there may be circum-

stances in which annual constraints have greater influence than permanent ones, and indicative policies are more effective than constrictive rules. This argument rests on two premises: first annual policies tend to be more realistic and achievable than permanent rules; second, annually established constraints may have more political support than standing rules which have not been endorsed by current politicians. No matter how hard they are, constraints cannot be achieved if they are unrealistic or lack political support. When both conditions are lacking, politicians may conspire to evade the constraints by delaying payments, resorting to extrabudgetary arrangements, underestimating expenditures, and other bookkeeping tricks.

Constraints tend to break down over time. When they are fresh and backed by political commitment, the constraints may discipline budgetary decisions. But as they age and encounter new conditions, they often lose effectiveness. Moreover, over time spenders learn how to circumvent the controls while paying lip service to them. Periodically, therefore, fiscal constraints may have to be renewed to restore their effectiveness.

The choice between constrictive and indicative rules depends on institutional conditions, which vary from country to country. This conclusion is elaborated in the next section, but can be summarized here as follows: Indicative constraints effectively discipline the aggregates when institutional arrangements promote fiscal prudence. On the other hand, constrictive rules might be appropriate in countries when institutional arrangements promote or tolerate fiscal laxity. If this is true, fiscal discipline must come to grips with an anomaly: when hard constraints are most needed, they may be least workable; where conditions are most hospitable for fiscal constraints, they may be least needed.

External Versus Internal Constraints

This anomaly suggests that self-discipline may be in short supply in countries that need it the most. Ideally, democratic governments should establish and enforce their own fiscal rules, but when they are unable to do so, external pressure may have a salutary effect. Quite a few European countries have accepted fiscal austerity in order to meet the criteria for entering EMU. Over the years, many developing and transitional countries have constrained

their fiscal appetites in response to conditions imposed by IMF and other international organizations.

These pressures may work because they change the balance of political power within affected countries and enable politicians to shift the blame for taking unpleasant measures to outsiders. Nevertheless, external pressure may be a weak substitute for self-discipline because external controllers must rely on the government to implement and enforce the constraints. Some governments are adept at holding outside controllers hostage to their domestic interests, with the result that even with their best efforts, international organizations often do not always get the promised outcomes.

Annual Versus Multi-year Constraints

Budgets usually are made for a single year, and fiscal constraints usually are expressed as annual targets. However, one-year-at-a-time constraints may induce spenders to defer expenditures to subsequent years, enabling the government to claim that it has achieved the current targets while making it difficult to meet future ones. The tighter the fiscal constraints, the greater the incentive to avoid hard choices by postponing the day of reckoning. These considerations suggest that a medium-term expenditure framework is a useful, perhaps essential, instrument of fiscal discipline. When it is properly applied, a multi-year framework compels the government to assess the impact of current spending actions on future budgets. Of course, if, as is normally the case, the framework extends only to the next 3-5 years, spenders may have incentives to shift expenditures (or other actions that weaken fiscal discipline) to still later years. Nevertheless, the incentive and opportunity for politicians to break fiscal discipline diminish when the framework covers future years.

Australia's forward estimates system described in Box 3.1 establishes the fiscal framework within which annual budget decisions are taken. Although they can be altered by the government, the approved forward estimates are the fiscal boundaries within which departmental spending bids are fitted. These bids are considered in terms of spending impacts on the forthcoming budget and on the forward estimates for the following three years.

Box 3.1: Australia's Forward Estimates System

Since the early 1980s, Australia has made annual budget decisions within the framework of estimates for the financial year immediately ahead and forward estimates for each of the next three years. The forward estimates have structured budget work during periods of program expansion as well as during periods of contraction, and they have survived several changes in Government leadership.

Australia introduced the forward estimates because of serious deficiencies in one-year-at-a-time budgeting. It entered the 1980s with an annual budget process that focused Government and Parliamentary action on estimates and appropriations for the next fiscal year. The outyear implications of budget decisions often were ignored. Moreover, budgetary work was concentrated on the details of expenditure, with lengthy debate in Cabinet and Parliament on the estimates, even when no significant policy of financial issues were involved.

The forward estimates establish an authoritative baseline or starting point for work on each year's budget. When a Minister proposes a program change, she or he adjusts to the forward estimates accordingly. Rather than reviewing the detailed estimates, the Cabinet evaluates program initiatives and sets inter-sectoral priorities by taking decisions on proposed changes to the forward estimates.

The forward estimates are rolled forward each year, and adjusted for government decisions, changes in economic conditions, and revised estimates of the costs of various programs. During formulation of the annual budget, Ministers are encouraged to finance spending initiatives out of savings in existing programs. The Department of Finance oversees departmental bids to endure that adjustments to the forward estimates (both savings and proposed additional spending) are accurately calculated. A proposed initiative must estimate outlays for each of the next four years. If the government accepts not to adjust the forward estimates, a Minister who seeks program initiatives must offer savings elsewhere in the portfolio.

The forward estimates are not designed to cut back expenditures or to down-size government, though they can be used toward these ends. Rather, they enable the government to set program and spending priorities within an aggregate fiscal framework that disciplines claims on future budgets. In a period of constrained budgets, the system has eased the inevitable frictions of budgeting and has permitted the government to finance new priorities while slowing the growth rate of public expenditure.

Some countries that budget within an annual framework nevertheless consider the outyear implications of fiscal decisions. Sweden's new budget system fits this model (see Box 3.2), but inasmuch as it has been in place only since the mid-1990s, there is insufficient evidence for assessing its effectiveness.

Expenditures and Other Fiscal Aggregates

In managing its finances, a government produces at least four fiscal results: total revenue, total spending, the deficit (or borrowing requirement), and the public debt. Governments that budget on a commitments basis also have data on the total commitments issued or outstanding. Separate aggregates may be calculated for loans guaranteed by the government and for other contingent liabilities. Finally, governments that publish consolidated financial statements produce data on assets, liabilities, and net worth. The various aggregates may pertain only to the central government, or to other portions of the public sector as well, such as social security, subnational governments, public enterprises, and other entities that normally are excluded from the national budget.

The various fiscal aggregates can be targeted in different ways: in money terms, as a percentage of the gross domestic product or of some other index, in real (inflation adjusted) terms, or as a rate (or amount) of change over a previous fiscal period. Expressing public expenditures and other aggregates as a proportion of GDP facilitates comparisons over time and with other countries, and recognizes that the affordability of a government's spending depends on (among other measures) the volume of national output. Nevertheless, focusing on expenditures (or revenues) as a percentage of GDP may bias public expenditure upward. If the government seeks to stabilize public spending as a percentage of GDP, it may accept real spending increases when the economy expands but find it difficult to reduce spending when the economy stagnates. Over the course of an economic cycle, this pattern may result in a progressive rise in the ratio of public spending to GDP.

Constraining a single fiscal aggregate also is likely to generate distortions in budgetary behavior. If only the deficit is targeted, the government may contrive to meet the constraint by selling assets, postponing expenditure, or resorting to nonrecurring revenue sources. Moreover, a fiscal constraint confined to the deficit may impel politicians to meet the target by raising revenue rather than by cutting expenditure. A broad set of constraints that targets several fiscal aggregates may discourage this behavior, especially if the targets include the government's net worth, a measure that is not affect-

ed by asset sales or by the shift in receipts or payments from one fiscal period to another. It should be noted, however, that few governments currently produce the consolidated financial statements needed to calculate net worth.

Many developed countries pay closer attention to the debt to GDP ratio than they once did. This development has been spurred by the steep rise in debt burdens and by the Maastricht Treaty which conditions initial membership in EMU on holding gross public debt below 60 percent of GDP. This ratio is an indicator of the sustainability of chronic budget deficits. In contrast to the deficit which measures financial balances within a short fiscal period, the debt to GDP ratio signals changes in financial condition over an extended period. A rise in this ratio means that the debt burden is increasing faster than economic output. This trend cannot be sustained indefinitely, and can be reversed only by curtailing annual deficits to a rate that is less than the rise in GDP.

The debt to GDP ratio usually is calculated on a gross basis; it measures the total owed by the government. This ratio is not reduced by money owed to the government or by other assets held by it. In contrast to the balance sheet which measures net worth (assets minus liabilities) the gross debt measures only liabilities, and only those liabilities that are in the form of debt. It is an incomplete measure of the government's financial condition that does not reflect net worth. The government can lower the gross debt to GDP ratio by selling physical or financial assets and using the proceeds to repay a portion of the debt. This transaction would change the composition of assets and liabilities, but not the government's net worth.

The gross versus net basis also pertains to constraints on total expenditure. Just about every national government obtains some income from user charges, state-owned enterprise, and other commercial type activities. If it accounts for finances on a gross basis, this income would be budgeted as revenue; if it uses the net basis, some or all of this income would be budgeted as an offset to expenditure. Netting versus grossing does not affect the size of the deficit, but it does affect total spending; hence, the issue is important when a government imposes a fixed constraint on total spending. The net basis is popular in some countries because it encourages spending depart-

Box 3.2: Strengthening Fiscal Discipline in Sweden

The Swedish Government (and the public sector) have had recurring budget deficits since the mid 1970s. The typical response has been for the Government to adopt austere budgets which, through a combination of spending cuts and revenue adjustments, reduce the deficit to manageable size or eliminate it altogether. For example, in 1982, the Government implemented a "crisis program" that progressively reduced the deficit and briefly eliminated it by the end of the decade.

However, a recession in the early 1990s, combined with upheavals in financial markets, resulted in a budget deficit that reached approximately 13 percent of GDP, far higher than the imbalances experienced previously. At about the same time, a comparative study of budget practices (led by Jorgen von Hagen) concluded that Sweden's budget process was very weak compared to that of other European Community governments. It further found that lax budget procedures are closely correlated with higher deficits and a growing public debt.

Sweden introduced a reformed budget process in 1996 that has more than doubled its score on the von Hagen fiscal stringency scale from 25 to 58. Prior to the reforms, Sweden ranked 12th among the 13 EC member states on this scale; post reform, it ranks 3rd.

The centerpiece of the reforms is a new two-step budget procedure. In the Spring, the Government establisheds a multi-annual expenditure ceiling for each of the next three years. The ceiling is expressed in nominal terms, and is subdivided into 27 expenditure areas. In the first years that it has been applied, the ceiling included a margin (equal to approximately 2 percent of central government expenditure) to cover overruns and unanticipated circumstances. The spending ceiling is a gross amount. The Government also submits an indicative spending ceiling for local governments. The first stage of the process concludes with adoption of the spending ceiling by Parliament.

Stage two entails preparation of the annual budget bill by the Government and voting of appropriations by Parliament. Both the budget and appropriations must be within the pre-approved spending ceilings. As a result, preparation of the Government's budget has become more of a top-down process (though bilateral negotiations between line ministries and the Finance Ministry continue as before). In Parliament, work on appropriations is assigned to various committees, each with its own spending ceiling. In contrast with past practices, budget amendments must have offsets, so that total spending is within the ceilings.

The reformed process provides for close monitoring and periodic reports on budget outturns, as well as for handling expenditures in excess of the approved amounts.

In the first years that the new system has been applied, Sweden's fiscal posture improved considerably. But it is too early to determine the extent to which this is due to overall improvement in economic conditions or to more stringent budget rules.

ments to charge users for the benefits they receive while making it easier for the government to adhere to a constraint on total spending. Sweden, however, recently rejected the net basis; it now budgets for gross government spending. In the Swedish system, amounts paid to the European Community are budgeted as expenditures and amounts received from it are budgeted as revenues. The two flows are not netted out. This approach was selected by Sweden because it emphasizes control of total spending.

Controlling the Main Expenditure Components

Maintaining aggregate fiscal discipline obviously requires that the government control the budget's totals. Decisions on the elements of expenditure would came later, in the course of preparing estimates and reviewing expenditure bids. Arguably, however, effective control of spending requires that decisions on the totals be coupled with decisions on major subaggregates, such as sectors, portfolios, or budget functions. This argument rests on the notion that if agreement has not been reached on the main components, the government might be unable to withstand pressure to raise the totals when individual spending claims are considered. But if allocations to sectors or other major categories also are set, these subtotals would constrain the amounts that claimants may bid for.

Contemporary budget reform in developed countries suggests several approaches to constraining expenditure subcomponents. In Sweden's new budget system explained in Box 3.2, when the aggregates are decided, spending is broken into 27 sectors; each is given its own allocation. When Parliament votes appropriations, it must adhere to the agreed sectoral limits. Australia's forward estimates are structured into 17 portfolios, each of which is the responsibility of a Minister. While the Government may increase spending in the course of developing the budget, the expectation is that ministers will first look for savings in their portfolios before seeking additional funds. In the United States, when Congress adopts a budget plan, it divides total spending into approximately 20 budget functions. These allocations, however, are indicative; they do not constrain subsequent appropriations.

The question of whether it is desirable or necessary to couple sectoral and aggregate limits may turn on the cohe-

siveness of the government. When budget making is highly centralized, the government may be able to keep to the agreed totals even though it has not made any sectoral decisions. But when the budget is decided by Cabinet in a collegial manner, or when Parliament authorizes more spending than was requested by the government, early controls on sectoral allocations may strengthen aggregate fiscal discipline.

Institutions: Rules, Roles, and Information

Maintaining aggregate fiscal discipline almost always entails changes in institutional arrangements; these influence the incentives and, therefore, the behavior as well, of claimants and controllers. The key requirement is that budgetary controllers be sufficiently powerful to enforce fiscal discipline; if they are not, claimants will behave as self-interested takers from a common resource pool—taking as much as they want until the pool is depleted.

Rules

Budgetary institutions are the rules according to which budgets are prepared, approved, and carried out. These rules may be formal or informal: formal rules spell out legal requirements for preparing, approving, and implementing the budget, as well as the types of information, the powers of the Finance Ministry and other participants, the scope of changes that may be made by the legislature, and adjustments that may be made during the fiscal year, in the course of implementing the budget. Informal rules pertain to the actual behavior of participants; these have a wider scope to the extent that formal rules are ignored or evaded, or do not specify how particular situations should be handled. The formal rules specify how the budget process should operate; informal rules specify how it actually does. For example, formal rules may provide for the government to intervene when spending exceeds targets, while de facto, the government may simply accept the additional spending without taking remedial action.

A growing body of empirical research demonstrates a close correlation between budget rules and outcomes. Although the research methods may appear to be somewhat deficient—they generally rely on questionnaire responses, subjective assessments by observers or participants, and crude weighting schemes—the fact that various studies concentrating on different

regions (Asia, Latin America, and Europe) have come to approximately the same conclusion adds to the strength of the findings.

Various studies have found a strong correlation between the stability and cohesiveness of the government on the one hand and the deficit and debt to GDP ratios on the other. A key finding is that fragmented governments (such as multi-party coalitions) have less capacity to assemble and maintain a majority in support of the tough measures needed to maintain fiscal discipline. Cohesive governments, in which a single party constitutes the government (in parliamentary regimes) or controls both the executive and legislative branches (in presidential systems) have greater ability to constrain the aggregates and withstand pressure to spend or borrow in excess of targeted levels. In general, the more parties that comprise the coalition, the less able the government is to establish and enforce stringent fiscal discipline. Aggregate discipline may be particularly difficult to maintain when (as sometimes happens in coalition governments) one party controls the finance ministry and another controls one or more of the major social portfolios.

The same vein of research, however, also indicates that the checks and balances of fragmented or divided government lead to less total spending than in majoritarian regimes. Apparently, when government is split, its capacity to expand programs is diminished, either because a majority is lacking to support the initiative or because parties do not want to vote for additional spending that might occur while they are out of power.

While these studies focus on broad political institutions, a more direct approach has been to examine the relationship between budget rules and outcomes. The relevant rules pertain to the three critical stages of budgetary decision and action: formulation of the government's budget, review of the budget and appropriation of funds by the legislature, and transfer or supplementation of expenditures during execution of the budget.

In studying budget preparation rules, researchers have found that collegial forms of decision-making lead to more lax fiscal discipline than authoritarian rules. Collegiality refers to rules that give all ministers approximately an equal say in budget decisions, the finance ministry decides spending levels in bilateral negotiations with line

ministers, and the Cabinet collectively approves the budget. Authoritarian rules give a strong advantage to the Prime Minister (or the Finance Minister) who can overrule the demands of spending ministers in negotiating the budget. In these types of regimes, fiscal targets are likely to drive budget decisions, in contrast to collegial systems in which spending demands drive the fiscal totals. Authoritarian rules emphasize discipline and consistency, collegial rules favor compromise and consensus.

Differences also emerge during legislative action on the budget. Here the contrast is between restrictive procedures that bar amendments that would increase spending (or reduce revenues) versus open procedures that do not constrain budget amendments. An intermediate arrangement would permit amendments increasing spending provided that overall balance is maintained by requiring offsetting cuts in other expenditures. In open systems, legislative amendments are not matters of confidence; in restrictive systems, they may be. Given the localized political base of most national legislatures, it is highly likely that open rules would encourage amendments that increase total spending, and have an adverse effect on fiscal balance.

Finally, a distinction can be drawn between flexible systems that permit spending increases during execution and rigid systems that either bar such increases or require that they be consistent with agreed fiscal aggregates. Flexible systems tend to have liberal rules that permit the transfer of funds between votes or accounts in contrast to rigid systems that restrict such transfers. In some flexible systems, the government does not need to obtain legislative approval for spending increases until after the additional funds have already been spent, sometimes years later; while in rigid systems, any such increases must be approved in advance.

There are nuanced differences in the terminology and findings of various empirical studies, but inasmuch as they all point in the same direction, there are not significant; overall, the findings justify the conclusion that a government bent on enforcing aggregate discipline must do more than merely establish fiscal limits.

Roles

Budget rules are not self-enforcing. The fact that a government restricts certain actions that would weaken dis-

cipline does not mean that it follows the rules when they become so constraining as to prevent a political majority from getting its way. Except when they are inscribed in the constitution or in some superior law that cannot be changed by majority vote, restrictive rules can be brushed aside. The same politicians who make the rules can break them.

Why, then, don't politicians change or breach the rules when they prove to be too constrictive? Why do rules make a difference at all? Part of the answer is that once budgetary rules are in place, politicians may pay a price for violating them. The rules change the incentives of politicians. Another part of the answer is that rules work when they have enforcers, that is, politicians and officials at the center of government who have the will and the authority to maintain adherence to the rules.

In virtually all countries, budget enforcement is centered in the finance ministry or the central budget organization. This unit has the lead role in maintaining aggregate discipline; it must be strong enough to withstand pressures to evade spending targets by removing some transactions from the budget or through other ploys, and to override the targets when politicians or sectoral interests regard them as too constrictive. There is good reason to believe that enforcing fiscal discipline depends on the strength of the finance ministry and its budget unit vis-à-vis other government entities. In general, the relative strength of the budget office is enhanced when it is located in a finance ministry that has broad governmental powers. Germany and Japan, for example, have powerful, encompassing finance ministries; over the full post-war period, they have been among the most successful in maintaining aggregate fiscal discipline. The German Finance Minister may be overruled by the Cabinet only when the Chancellor sides against him; Japan's Finance Ministry has had extensive regulatory powers extending to financial institutions, securities, and other sectors, in addition to its powerful role in revenue and spending policy. But even in these countries, fiscal discipline has been undermined: in Germany, by spending pressures following unification; in Japan, by the deepest recession since World War II.

The targeting process and the changed composition of public expenditures have affected the manner in which the central budgeting organiza-

tion maintains fiscal control. In classical budgeting, the budget office reviewed detailed bids for resources and recommended the amounts that should be made available. It also policed implementation of the budget to ensure that public funds were spent only on approved items and that the amounts spent did not exceed authorized levels. In this model, controlling the totals was a byproduct of controlling the items. The budget office presumed that total spending could not be controlled unless the individual items were. Contemporary fiscal discipline is moving in the opposite direction. *It emphasizes that the totals should be controlled independently from the parts; disciplining the totals must be a central responsibility; responsibility for spending items can be devolved to sectoral ministries or operational entities.*

In some countries, the budget organization has disengaged from the items of expenditure and has taken the position that it can more effectively constrain the totals by concentrating on subaggregates, such as departmental running costs or total resources allocated to each portfolio. The central budget office may be willing to concede discretion over the spending items to various departments in exchange for firm limits on the total each may spend. This quid pro quo may promote allocative and operational efficiency, two key objectives of public expenditure management, in addition to enhancing aggregate spending discipline.

The United Kingdom and Australia are among the countries that have vigorously moved in this direction. Following a "fundamental expenditure review" of its operations in 1994, the U.K. Treasury staff was reduced by about one-quarter as it withdrew from various itemized controls that had been maintained for a century or longer, and sharpened its focus on macro-budgeting. In Australia, the Department of Finance introduced running cost arrangements that give departments control over operating resources in exchange for tighter controls over total spending and portfolio allocations. In these and other countries, the central budget office has devolved control over administrative expenditure while strengthening aggregate spending discipline.

Spending controllers deal as much with assumptions as with hard data. The typical budget baseline is composed by making assumptions con-

cerning future prices, program workloads, and other factors affecting expenditure levels. Estimates of the spending impacts of program initiatives and legislative actions rely on similar assumptions. One of the critical tasks of public expenditure management is ensuring that actual spending does not deviate significantly from projected levels. This is a difficult task which depends on government capacity to accurately measure the assumptions that drive its budget projections.

Building Support for Fiscal Discipline

Budget controllers cannot maintain fiscal discipline if they stand alone without strong allies in government. They need both political allies who accept the political risks of constraining public expenditures, and managerial allies who accept the imperative of operating within agreed constraints. It is unlikely that they will win every battle against wily and politically potent spenders whose weapons include proposals that hide the true cost of policy initiatives, resort to extrabudgetary funds, and bookkeeping arrangements that underestimate budgetary impacts. Under PEM, it is necessary to guard the budget against these and other devices. Ironically, as fiscal norms become tougher and more constrictive, budget claimants have greater incentive to evade them. Over the medium-term or longer, budget guardians will not be able to uphold fiscal discipline unless they have steadfast political support.

Politicians need incentives for buying into fiscal discipline. They must have actual or expected gains, such as success at the polls, acclaim in the media, or the conviction that they are doing the right thing. But incentives are not a one-way street; for every gain that accrues to politicians from exercising constraint comes the cost of cutting programs, raising taxes, or rebuffing claims on the budget. These costs must be manageable and (in some political calculus) less than the expected gains. Costs are made manageable by having realistic targets, spreading the constraints over a period of years, softening the aggregate targets, controlling net spending (total spending minus income from user charges or other earmarked revenues) rather than gross spending, and allowing relatively minor overshoots of the target. The common element in these approaches is that aggregate fiscal discipline may be

stronger when the constraints are a bit more accommodating.

Opportunistic Budgeting

Having appropriate budgetary institutions may be a necessary condition for disciplining the aggregates, but it is not always sufficient. Aggregate fiscal outcomes can be driven off target by exogenous factors that are weakly controlled by the government, if at all, or by endogenous factors such as opportunistic behavior by politicians and other budget makers. Exogenous conditions are considered in the next section; this section deals with opportunism that is stimulated by the very rules that purport to restrain politicians and others.

Opportunism is rife in budgeting, as in other economic transactions. Opportunism is self-interested behavior that undermines budgetary constraints. Politicians may want to run smaller deficits, but they also want to spend more and tax less. When rules try to prevent them from doing the latter, they opportunistically seek ways to evade or disable the rules. Without opportunism, there would be no need for strong rules; with opportunism, the rules might not yield the intended outcomes unless they are reinforced by external constraints.

Anyone who has managed public expenditure has encountered opportunistic behavior by politicians catering to voter preferences or by managers who want bigger budgets to carry out their responsibilities. The catalog of opportunistic budget tactics includes: under-estimating or hiding the costs of programs; selling assets and booking the income as current revenue; shifting payments back to the previous fiscal year or forward to the next; miscoding accounts so that money provided for one purpose is spent on another; paying liabilities with chits rather than with cash; accelerating tax collections; disregarding the liabilities of state-owned enterprises in budget statements; transferring balances in state-owned enterprises to government accounts; and labeling current expenditures as capital investments. A 1997 IMF working paper identifies 28 types of opportunistic revenue and expenditure actions that might be used by European Community countries to show compliance with the Maastricht deficit and debt rules.

When budgetary opportunism is carried out on a small scale, perhaps nothing needs to be done to stanch

it, especially if the rules strengthen aggregate discipline. Suppose, for example, that in response to constrictive rules, the government reduces the deficit, mostly by cutting pension benefits and in a small part by deferring some payments to pension funds. In this case, the rules have constrained expenditure, even though full compliance is lacking. Arguably, the government should settle for the real deficit reduction it has achieved without taking further steps to tighten the rules. On the other hand, a case can be made for tougher enforcement on the grounds that this small breach might well turn into a much larger one as opportunists become emboldened to devise bigger evasions.

Opportunists cannot be relied on to curb their self-interest. More rules, or clearer specification of their terms, might help somewhat, but as contract law demonstrates, rules alone do not put an end to opportunism. What is required is that the rules be accompanied by strong enforcement mechanisms. In some countries, the Finance Ministry plays this role, in others the supreme audit authority does. The checks and balances built into democratic political systems can dampen opportunism by enabling one branch to block the actions of the other, or to call public attention to the misbehavior. In presidential systems, an independent legislature can check executive actions; in parliamentary regimes, the legislature can have an effective watchdog role, even though it is not fully independent. In the United Kingdom, the nonpartisan Public Accounts Committee has played this role in recent decades; it has been joined by an array of standing committees which oversee and sometimes influence government actions. An independent central bank also can check budgetary opportunism, provided that it enjoys sufficient public esteem so that its voice can be heard above the din of political debate.

It is doubtful, however, that internal constraints suffice when willful opportunists seek to twist ambiguities or gaps in budget rules to their advantage. In president-centered countries the two branches often collude rather than check one another; in parliamentary systems, legislative committees often behave as sleepy watchdogs. In all countries, it is rare that the central bank challenges the actions of opportunistic politicians.

External Constraints

It may be appropriate, therefore, to supplement the internal controls with external constraints on budgetary opportunism. Constraints can be imposed by outside entities which monitor a government's performance, by financial markets which punish imprudent budget policies, or by the accounting profession which promulgates standards and polices compliance. These and other external constraints are effective only when they are underpinned by transparent budgets which provide reasonably accurate and complete information on public finances.

In the wake of the EMU's enforcement of the Maastricht norms, one can expect the role of international organizations in overseeing budgetary policies and outcomes to increase. This role has long been played by the World Bank and IMF in enforcing conditionalities on loans and other forms of assistance. In many instances, however, international enforcers have been locked in a cat-and-mouse relationship with the recipient country, in which tough conditions have generated evasive responses.

There is some evidence (presented by Campos and Pradhan) that open financial markets contribute to aggregate discipline by penalizing countries for fiscal mismanagement. Open markets allow investors to swiftly withdraw capital whenever they fear that a large deficit might generate inflation and devaluation. Moreover, investors demand higher interest rates as a premium for taking the risk of placing funds in the country. In general, Campos and Pradhan conclude, the more open its financial markets, the smaller a country's fiscal deficit will be. It may be the case that budgetary opportunists will devise means of hiding their tricks from vigilant financiers, but if they do so, the reactions that ensue when the legerdemain is revealed will punish the offending country even more.

Financial markets work well when budget documents and financial statements are transparent. But without robust accounting standards and attentive auditors and other monitors, transparency can be more of slogan than a reality. As financial markets have become more closely interlinked, and outside institutions have become more involved, significant steps have been taken to elaborate and harmonize accounting standards across countries. These steps have been spurred by

efforts to discourage various types of fiscal opportunism.

In the future, pressure will increase to impose these standards on budgetary documents, not only on financial statements. Moreover, rules will be elaborated for the assumptions that underlie budget projections and for estimating the impact of policy changes on future budgets. The budget will be a battleground between opportunistic politicians and vigilant guardians.

How Hard Are the Constraints? Entitlements, Risks, Cycles and Shocks

Aggregate fiscal discipline is predicated on the notion that governments are the masters of their budgetary fate. It assumes that they can chart a fiscal course and can enforce hard constraints regardless of the conditions under which their budgets are formulated and implemented. In reality, however, governments often have weak control over the economic and political circumstances in which they operate. If the fiscal impact is big enough, exogenous changes can dislodge even the most obdurate government from its intended fiscal course.

There are degrees of hardness in fiscal constraints, as there are in all political decisions. To say that constraints cannot be maintained in all circumstances does not mean that they can be enforced in none. One of aggregate fiscal discipline's valuable contributions to public finance may be to encourage the adoption of policies that reduce the budget's exposure to external disturbances and thereby enable governments to attain more rather than less of their fiscal objectives. Doing so depends on the capacity of governments to design policies and programs in ways that limit risk before external circumstances force their hand. Remedial action almost always is too late when it is taken at the point of crisis or when the only acceptable options are those that would breach fiscal discipline.

Government budgets face four types of "bad news" that vitiate fiscal constraint: (1) the unbudgeted, unwanted, or unaffordable costs of open-ended entitlements; (2) contingent liabilities incurred in one fiscal period that become payable in a later (sometimes much later) period; (3) cyclical weakness in the economy that imbalances the budget; and (4) big shocks that jar government from its

intended course and destabilize the budget. The four sets of conditions are sequenced from those over which government has most fiscal control to those over which it has the least. A government can opt not to establish certain entitlements and can hedge against contingent obligations, but it may be unable to avoid the adverse budgetary impact of an economic downturn or the shocks resulting from major upheavals, such as the onset of war.

The four categories are closely linked. A government that spends much of its budget on entitlements is likely to be more affected by cyclical downturns than one that does not; a government that indemnifies firms or households for fiscal risks will be more exposed to political or financial shocks than one which adopts risk-averse policies. Despite these and other interconnections, discussing each category on its own sheds light on the problems contemporary governments face in maintaining fiscal discipline.

Entitlements

It generally is more difficult to enforce constraints on entitlements than on consumption or investment expenditure. The latter usually are definite in amount and are controlled by annual appropriations; the amount provided each year determines what is available for expenditure. Entitlements, however, typically are open-ended; there is no fixed limit on the amount to be spent. Moreover, the volume of expenditure is determined by permanent law rather than by annual appropriations. For many entitlements, the budget typically accounts for the amounts to be spent; for consumption and investment programs, the budget decides the amount to be spent.

Spending on annual entitlements often is driven by exogenous factors, particularly economic and social conditions, not by explicit budget actions. The effective decisions were taken years or decades earlier when the entitlement was established (or expanded) and when eligibility criteria and payment formulas were enacted. Because of these characteristics, entitlements undermine both short-term fiscal discipline and the long-term capacity of government to stabilize its financial condition. In the short run, it may be difficult for the government to accurately estimate the amounts to be spent or to buffer the budget from unanticipated (or unwanted) swings in economic conditions. In the long run, the budgets of many countries will be

exposed to the fiscal consequences of an aging population, especially in their pension and health sectors. Even when short-term fiscal policies are affordable, they may become unsustainable as the dependent population rises and entitlements take a larger share of the budget.

Entitlements suffer from a costly variant of the "common resource pool" problem that drives total public spending upward, in many cases to unsustainable levels. In the standard common pool situation, each "taker" acts alone or logrolls with others to draw resources from the pool. The takings are individualized; what one gets, others do not. In entitlements, however, the takings are mutual; one gets because others also get. All get even if they do not logroll or actively stake a claim to the pooled resources because entitlements confer broad rights to beneficiaries. These rights are not diminished by the government's inability or unwillingness to pay, or by other claims on the budget. In the commons, when the pool is depleted, nobody takes because there is nothing left. In entitlement programs, however, beneficiaries continue to get, even when the government's revenues have been depleted. When it runs out of money, the government makes good on the beneficiaries' rights by borrowing or "printing" the needed funds.

The best time to control entitlements is before they have been established. Beyond this point, the government can exercise fiscal control only by taking away previously conferred benefits. This is in sharp contrast to the politically expedient function of the budget—to distribute benefits. Inasmuch as "taking from" is much more difficult than "giving to", when a government entitles others, it inevitably weakens fiscal self-discipline.

Developing (and some transitional) countries generally have small entitlement budgets. But as they progress and economic conditions improve, these governments tend to follow the path taken by the developed world: they introduce or enhance pension schemes, improve citizen access to health care, provide financial assistance to the disabled and unemployed, and so on. Transitional countries may face pressure for broadened entitlements early in their embrace of market-oriented democracy, as they seek to cushion households against the economic hardships caused by the end of subsides, rising prices, and the privatization or closing of state enterprises.

Ideally, developing and transitional leaders should be cautious in taking on new fiscal burdens, because the entitlements established to ease the transition or in response to real improvement in economic well-being will draw scarce funds from the public treasury for many years to come.

During the past two decades, most industrial democracies have been reluctant to create or expand entitlements. They have been wary of adding entitlements because their national budgets have been strained by chronic deficits. A few have adopted formal rules that bar new entitlements that would add to the deficit. Since 1990, for example, the United States Government has enforced a pay-as-you-go rule that has made it difficult to expand entitlements. Under the rule, legislation that increases entitlement spending must be offset by cutbacks in other entitlements or by revenue increases. The rule is enforced through a multi-year expenditure baseline that provides Congress and the President timely information on the projected costs of new entitlements.

Most formal and informal efforts to constrain entitlements have come only recently, after the costly framework of existing entitlements already was inscribed in law. Although developed countries have had few success stories in disciplining their entitlement budgets, some have tried and an increasing number can be expected to make the effort in the years ahead. Efforts along these lines are likely, for if entitlements are not effectively controlled by the time that the financial implications of an aging population impacts national budgets, supposedly hard constraints on aggregate spending will turn out to be very soft.

Table 3.1 lists some of the approaches that may be taken by governments bent on strengthening fiscal discipline. They range from options which disentitle current or future beneficiaries to those which retain the basic structure of entitlements but save money by making marginal adjustments in payments or eligibility rules. Disentitling is the boldest approach, but politically the most difficult. It can be accomplished by terminating legal rights and making payments dependent on discretionary appropriations. Alternatively, the government can convert certain entitlements into private schemes, thereby reducing its fiscal liability. For example, some countries have been influenced by Chile's social security reform to create a two-tier sys-

Table 3.1: Controlling the Costs of Entitlements

Method	*Advantages*	*Disadvantages*
Disentitlement. Terminate legal rights to payment and decide amount (if any) to be paid through annual appropriations.	Spending would be subject to budget decisions, and would depend on government's ability to pay.	Would reduce government's role in stabilizing and redistributing income, and impair its ability to protect citizens against recession, aging, illness, and other adversities.
Voluntary Opt-out. Citizens may withdraw from certain entitlements by enrolling in private insurance schemes.	Market incentives would favor most efficient plans, while reducing financial risk to government.	Risk of adverse selection, with most vulnerate persons remaining in government programs. Government would have moral (or legal) obligation if private plans failed.
Capped Entitlements. Total entitlement spending (or spending on a particular program) would be limited. Spending above the limit would require an express decision by the Government or legislature.	Entitlements would have to compete against other claims on the budget. Spending in excess of budgeted amount would not be automatic or open-ended.	Dependent populations would be adversely affected. Moreover, enforcing the caps might be impractical for political or technical reasons.
Disindexation. Payments would be fixed, adjustments for inflation would require Government or parliamentary action.	Payment increases would not be automatic and could be made in the light of the Government's budget condition.	Real value of payments would be eroded by inflation, with greatest impact likely on low-income recipients.
Targeted entitlements. Payments would be means-tested; they would no longer be universal.	Scarce resources would go to most need recipients, thereby reducing cost to government.	Public support for certain entitlements would be undermined, as would the concept of universal benefits.
Tax benefits. Payments would be universal, but would be subject to income taxation.	Effect would be similar to targeting, but might be politically easier to implement.	Marginal tax rates would be very high for some recipients, discouraging them from income-earning activity.

tem in which only a portion of pensions are financed through the public budget. One tier is a defined benefit plan in which the government guarantees a minimum payment to all participants; the other tier is a defined contribution plan in which the amount paid out depends on the performance of each participant's pension account. The shift from defined benefits to defined contributions also can occur within a wholly-public pension system.

While drastic restructuring of entitlements may be feasible in some countries, others are likely to settle for marginal reforms. One option is to trim entitlement spending by targeting payments to lower-income individuals or by reducing the real value of the benefits. Australia has taken the first path, limiting some transfer payments to low-income households; the Netherlands has taken the second path, reducing the percentage of wages replaced by unemployment benefits and other schemes. Still another approach is to trim entitlements indirectly, by taxing benefits as if they were ordinary income. This tactic has two advantages: it enables the government to retain universal benefits, which are (in some countries) a hallmark of the welfare state; and it means-tests the value of entitlements through the tax system.

In striving for aggregate fiscal discipline, some governments might limit the amount paid out each year. Entitlement programs would be cash-limited, just as running costs and other payments are in some countries. In enforcing the limits, the government might prescribe pro rata reductions in transfer payments or (in programs such as health care) in fees to providers. Alternatively, if the limit were breached, the government would be required to take an explicit decision to raise the limits or to make some other adjustments that would hold spending to the preset ceiling.

In imposing fiscal discipline on entitlement budgets, governments must be mindful of the risks entailed in weakening or disabling built-in stabilizers and in adverse impacts on dependent persons. As important as it is, fiscal discipline is not the only financial objective of governments. Many also seek to protect citizens made dependent by age, unemployment, or other economic circumstances, and they seek to counter the adverse effects of recessions and inflation. Doing these things entails income support and stabilization through entitlement programs.

Table 3.2: Issues in Managing Financial Risks

	In All Countries
1. Moral Hazard	Persons/firms take undue risks when losses are compensated by the Government.
2. Lack of Transparency	In cash budgeting, the cost to Government is not accounted for until payment is made.
3. Lack of Information	Government usually does not know the extent of its contingent liabilities and other risks, the probability of the contingency occurring or the prospective cost.
4. Lack of Budgetary Control	Funds are allocated after the contingency has occurred, too late for the government to effectively control the amount it spends.
	Developing/Transitional Countries
5. Underdeveloped Insurance Market	Government often assumes risk because the private insurance system is under-developed.
6. Efforts to Privatize Enterprises	To encourage investors (or to obtain a higher price) the Government may provide explicit or implicit guarantees to purchasers of state-owned enterprises.
7. Inadequate Regulation	During transition or development, there may be a tendency to under-regulate financial institutions (and other risk takers) either because of cozy relationships between politicians (or bureaucrats) and the institutions, or because of failure to appreciate the need for robust, arms-length regulation.
8. Risky Behavior	There may be a tendency for risky behavior during early stages of market development, encouraged by inadequate regulation and lack of instruments to assess and manage risk.
9. Concentrated Risk	Because markets are under-developed, risk may be concentrated in a small number of enterprises or risk takers, making it difficult for the government to assess or control the risks.

Although entitlements will continue to be the most prominent part of national budgets, it is highly probable that no later than the second decade of the next century, most developed countries will take significant measure to curtail transfer payments. Many of these efforts will be controversial; some will cause the downfall of governments; all will require strong political leadership.

Developing and transitional countries would do well to study the experiences of more economically advanced countries before they assume the enormous financial risks inherent in an entitlements culture. To a far greater extent than happened in the developed world, they have the opportunity to explore market-type instruments for protecting citizens against the risks of economic distress.

Contingent Fiscal Risks

The conventional tools of government budgeting have been designed to manage cash flows; they generally have not been applied to contingent liabilities and similar fiscal risks. With few exceptions, governments account for revenue when money is received and for outlays when money is paid. This form of budgetary accounting may suffice for operating expenditures as well as for most transfer payments and public investments; it is not adequate for transactions in which the government is obligated to make a future payment if certain contingencies occur. Cash-based budgeting fails to record the government's contingent risk at the time it is incurred. It does account for any subsequent payments, but at this point it is too late for the government to effectively control the expenditures it must make in fulfillment of its contingent liability. In fact, when the government charges an origination fee for providing guarantees, the cash budget records this income as revenue, but it does not show the government's potential exposure to future payments. Of course, if default (or some other contingency) were to occur the cash budget would account for any payments, but these amounts would be "uncontrollable" obligations. The government would not strengthen control of expenditure it is obligated to make in fulfillment of its contingent liability just by recording the amount paid in the budget. The appropriate time for constraining fiscal risks is when they are incurred; at that point, however, the government typically is unaware of the full cost of

Table 3.3: Controlling Contingent Liabilities and Other Fiscal Risks

Method	*Advantages/Disadvantages*
Market Solutions	
1. Government marketizes risk by selling state-owned enterprises, withdrawing guarantees from financial institutions and other entities, and refusing to indemnify losers in market transactions.	Formal exposure to risk is reduced, but government may still have moral obligation to indemnify private risk-takers, especially in developing and transitional countries where markets are fragile.
2. Government purchases re-insurance that covers all or a portion of its fiscal risk. In developing and transitional countries, reinsurance would likely be purchased from multinational insurers, not from domestic firms.	Reinsurance limits fiscal risk, and informs the government of the cost of the risk it is taking. But the cost of reinsurance is likely to be quite high, and the government may be unwilling or unable to finance it in the budget.
3. Government charges risk-based premiums which transfer the costs from taxpayers to risk-takers or beneficiaries. These charges may include origination fees or annual service charges.	These premiums would discourage some risk-takers from seeking government protection, but they may also reduce productive risk-taking needed to develop the economy.
4. Government insures last rather than first loss by having high deductibles that are risk-based or adjusted for different types of risk-takers (e.g. households, firms, types of firms, sectors, etc.).	Risk is shared by government and risk-takers. But government may be pressed to cover first loss, especially when failure to do so injures households or the economy.
Public Solutions	
5. Government budget includes estimated costs as an expenditure, in effect setting aside a reserve for future payments.	Cost of risk is transparent, but it may be difficult to make reliable estimates, especially in developing and transitional countries where experience with similar risks is limited.
6. Government records estimated risk on financial statements, such as the balance sheet or statement of contingent liabilities.	Government's financial condition reflects contingent liabilities and other risks. But few countries (even developed ones) publish comprehensive financial statements.

the liabilities to which it is exposed. Matters are made worse by the practice of booking up-front origination fees as current revenue. This makes it appear that the government is profiting from taking the risks, when, in fact, it often incurs heavy losses.

Contingent liabilities come in

many forms and just about every national government has them. Hana Polackova of the World Bank has mapped out different types of risks and the measures governments might take to control them. For the present discussion, the most relevant risks are contingent liabilities that require future payment if a certain event, such as default or natural disaster, occurs. Many contingent liabilities are explicitly recognized in law, contract or other formal commitment; others arise out of the "moral obligation" of the government to assist those who have suffered financial loss, or form the expectation that it will provide such assistance. Obviously, the government knows less about these informal risks than about explicit contingencies, yet the potential cost may be greater. In fact, the expectation that the government will act may escalate as the losses increase. For example, if a small bank fails, the government may opt to do nothing, but when a large bank fails, the government may be impelled to act in order to stabilize financial markets and restore public confidence.

The list of contingent liabilities is lengthy. It includes: indemnifying farmers against crop losses; homeowners against floods; exporters against exchange rate fluctuations; depositors against bank failures; entrepreneurs against losses; investors against default; and so on. Because of the inadequacies of cash accounting, the extent and magnitude of contingent commitments rarely are fully documented. In the United States, the General Accounting Office has estimated that by 1995, the federal government had accumulated $5 trillion in insurance commitments, an amount equal to three years budget outlays. With implicit guarantees and other types of contingent liabilities added in, the total might be considerably higher.

When government indemnifies losers, it spurs risk takers to behave in a morally hazardous manner by taking risks they would avoid if they had to bear the full cost of their actions. Moral hazard is widespread in government-insured programs: depositors seeking the higher yields offered by weak financial institutions; homeowners building in flood-prone areas; bankers lending to high-risk borrowers; exporters not hedging against currency rate fluctuations; and much more. The common element in moral hazard is that risk takers need be concerned only about the adequacy of the government's commitment, not about

the riskiness of their actions. As a consequence, risks escalate, along with the cost to government.

Developing and transitional economies are especially prone to shifting risk to government. Table 3.2 itemizes some of the reasons why government in these countries expose themselves to costly contingencies. One of the main reasons is that private insurance usually is unavailable or inadequate during the early stages of transition or development, leaving investors, entrepreneurs, lenders, and other with little recourse but to seek risk protection from government.

In many instances, the government is the insurer of last resort. If it fails to accept the risk, economic development would be retarded. Moreover, in privatizing state enterprises, the government may be impelled to guarantee minimum financial results, either to obtain a higher sales price or to enable the enterprise to continue as a going concern. The government's exposure to risk may also increase because of the tendency during the early stages of development to under-regulate financial institutions; in transitional countries because the new democratic regimes have dismantled the regulatory systems imposed during communist rule and do not yet appreciate how sound regulation contributes to economic development; in less developed countries because weak or poor governments lack the will or resources to regulate powerful interests, or because cozy relationships with these interests deter them from doing so.

Contingent liabilities can best be managed when there are many risk takers, each of whom takes a small risk. The classic case is of homeowners who obtain mortgages insured by the government. Because there are many borrowers, the risk is pooled, government can charge each homeowner a risk-based premium, so that when some borrowers default, premium revenue covers all or part of the cost. In transitional and developing countries, however, risk tends to be concentrated: a small number of big risk-takers (financial institutions, conglomerates, etc.) take a very large part of the risk. When this occurs, it is hard to estimate the risk faced by government and harder yet to charge risk-based premiums. Matters are further complicated when cozy relations and deficient accounting practices spur financial institutions to extend credit to failing enterprises.

To maintain fiscal discipline, governments must control their contin-

gent liabilities. Table 3.3 divides control mechanisms into those that rely on market decisions and those dependent on government action. Market-based solutions withdraw government from indemnifying losers or require risk-takers to pay the cost of government-provided insurance. Market solutions generally are favored in developed countries, for despite the extensive government exposure most economic risk is insured by private institutions. Although this approach might not yet be appropriate for developing or transitional countries that have inadequate private insurance systems, it would be sensible for governments in these countries to avoid policies that would retard the development of private insurance. As long as government is the insurer of first resort, the market for private insurance will remain underdeveloped, and risk-takers will behave in morally-hazardous ways that overburden government finance.

Another market-based solution would be for government to purchase reinsurance when it enters into a contingent commitment. A big advantage of this approach is that the total cost would be transparent, the government would not have to rely on estimates of future liability, nor would it have to wait until contingencies occur before paying the cost. Reinsurance would be priced by the market, and would be expensed at the time it was purchased. Up front costing would likely dampen the willingness of government to assume the risk, and might induce it to require risk-takers to share a portion of the cost. Another approach to sharing risk is to impose high deductibles on government-insured transactions.

Government-based remedies would have the government undertake contingent liabilities, but these would be itemized in the budget or in financial statements. Future costs would be estimated, using accounting principles devised for this purpose. This approach has been adopted by New Zealand which lists all quantifiable and non-quantifiable contingent liabilities in its consolidated financial statements. Notes to the statements estimate future pension liabilities, risk in managing debt and foreign currency, and certain other liabilities. The United States has taken a different approach. It expenses the net discounted cost of all estimated future cash flows (inflows and outflows) of each guaranteed loan program in the budget. Although the same methodology can be applied to other contingent lia-

bilities, thus far the U.S. Government has used it only for loan guarantees.

Economic Cycles

A government is most likely to be exposed to the costs of contingent liabilities when the economy is weak, financial institutions are in trouble, and its currency is losing value. During these periods, the government may have to prop up or take over insolvent banks, make good on exchange rate guarantees, assist failing enterprises, and take other actions that add significantly to public expenditure. This is not the most propitious time for contingent liabilities to come due, because it also is a period during which revenues are declining (or not growing as robustly as hoped for) and the budget deficit is rising.

Can a government maintain fiscal discipline under these adverse conditions? Judging from experience in developed countries over the past two decades, the answer is yes and no. Yes, in terms of discretionary fiscal stimulus; no, in terms of the impact of built-in stabilizers on key budget aggregates. Prior to the oil shocks and lower growth in the 1970s and early 1980s, many developed countries intervened to stimulate recovery by taking actions (tax cuts or spending increases) that enlarged the budget deficit. It was fashionable at the time to distinguish between cyclical and structural deficits, and to assume that cyclical imbalances would fade away once growth resumed and government revenues rose. Various fiscal measures were devised to distinguish between the two types of deficits and to calculate the appropriate size of the deficit.

Few developed countries actively manage the economy this way anymore. Most have found that the added costs (such as higher interest payments due to increased spending on public works or income support) approved when the economy is weak continue to burden the budget when the economy recovers. This concern has been heightened by lower growth rates during the past two decades than were experienced during the postwar boom years. Further, fiscal policy also has been influenced by changes in economic theory, such as the rational expectations argument that because government intervention during periods of weakness is expected, it fails to produce the intended effects.

But if discretionary action is out of style, built-in stabilizers still do their work. An automatic drop in revenue or

rise in transfer payments can produce large, unplanned deficits. A government can try to stay on its fiscal course by raising taxes or curtailing benefits, but it generally is inopportune to do so when the economy is stagnant. Countries that tighten fiscal discipline in these circumstances may unwittingly prolong and deepen the recession without achieving their budget targets. Japan may be a contemporary case in point. During a protracted slump, it ended temporary income tax relief, boosted consumption taxes, and curtailed supplemental public works programs. It acted in this manner because policy elites were more concerned about the long-run unsustainability of fiscal imbalances in the face of a rapidly aging population than about short-term economic distress.

Developing and transitional countries also face unstable budgets during economic difficulty. But they also risk capital flight, a run on their currency, illiquid financial institutions, and political instability. These countries may be compelled to adopt stringent budget policies as a condition of receiving international assistance or to restore investor confidence. To the extent they are dependent on capital inflows to stabilize or develop their economies, these countries may have to constrain public spending in the hope that fiscal discipline will be rewarded by long-term improvement in economic conditions.

Shocks

These disturbances are far more destabilizing than those caused by a cyclical downturn; they jar a government off its fiscal course and force structural changes in public policy. The primary cause might be the onset of war or the collapse of political order, but the budget is deeply affected. The unification of Germany began as a bold political decision, but has left a legacy of unplanned deficits and rising public debt. In developing countries, a severe drop in commodity prices or a sudden capital outflow can make it impossible for the government to abide by agreed fiscal policy. In transitional countries, the collapse or inefficient enterprises and difficulty in implementing a new tax system can have enormous impacts on the budget.

In dealing with shocks, as with cyclical downturns, it is important to distinguish between fiscal balance and fiscal discipline. Losing the former may be unavoidable; but the latter can be maintained even under stressful

conditions. Obviously, a government will be compelled to alter its fiscal targets when shocks register on its budget accounts. But this does not mean that fiscal discipline also is abandoned. It is when things seem to be falling apart that a disciplined approach to public spending may be most urgent. Constraining expenditures will not produce fiscal balance, nor will it enable the government to achieve pre-shock targets. But it will moderate and shorten the after effects of shocks on political or economic order.

Germany's response to unification illustrates how fiscal discipline can be maintained in the face of severe budgetary shocks. To rebuild the Eastern sector, the government far exceeded expenditure plans, but it did raise taxes to finance a significant portion of the added cost and it did constrain other portions of the budget. Despite these moves, the government failed to achieve revised fiscal targets because it underestimated the cost of unification and faced a shortfall in economic performance. When shocks occur, it may be impossible to foresee the full cost at the outset or to make all appropriate adjustments in government policy. But the fact that Germany made the effort has left it in sturdier condition than if it had not tried.

Summing Up: the Basic Elements of Aggregate Fiscal Discipline

Maintaining aggregate fiscal discipline requires changes in budgetary institutions to establish and enforce spending constraints. The following are prominent elements of systems used in various countries.

- **Targets should reflect political commitments made by political leaders**

Selecting the appropriate fiscal constraints is a key political responsibility of government. Developing appropriate targets must engage major political actors—the head of government, Cabinet, in some cases party leaders, and, (in coalition governments) an agreement among the governing parties. If politicians are not involved in agreeing the targets, they cannot be expected to take steps necessary to implement them. Even when the targets are externally imposed, as in the case of the European Monetary Union and IMF conditionalities, achieving them depends on political commitment and action in the affected country.

- **Targets must be realistic and achievable**

If they are not, the targets will either be ignored or induce politicians to dissemble and conceal the true condition of the budget. In the mid-1980s, both the United States and Australia established aggregate fiscal targets, the former through a statutory limit on the size of the deficit, the latter through a trilogy policy that prescribed reductions in taxes, spending, and the deficit. The American targets were breached in every year (1986-90) that they were in effect; Australia, by contrast, had significant (though not lasting) success in constraining the aggregates. Australia's targets were achievable, the American targets were not.

However, achievable, does not mean without constraint. Fiscal norms must be constrictive, for if they merely accommodate demands on the budget, there would be no gain in having them. Targets must discipline the fiscal aggregates, that is, they must result in lower deficits and less spending than would otherwise occur.

- **A medium-term framework for setting and enforcing the budget aggregates**

The medium-term is appropriate for several reasons. First, constraining total spending or the deficit typically requires implementing action over several years. A multi-year framework can establish milestones along the way toward full implementation. Second, it is easy to evade fiscal discipline when the targets pertain only to the current or the next financial year. Spending or revenue actions can be accelerated or delayed, depending on the year for which the budget outcome has to be made to seem more favorable than it actually is. Assets can be sold, new spending can be scheduled to take effect in the future, nonrecurring revenue sources can be exploited. Evasion also is possible in a medium-term framework, but the incentive and opportunity to manipulate the numbers is lessened.

The typical framework includes projections of future budget aggregates and the main subaggregates, a baseline that reflects authorized spending and revenue for the medium-term, procedures for estimating the fiscal impact of policy changes, accounting rules for enforcing fiscal discipline, and a process for establishing budget constraints. Developing and operating this medium-term framework becomes the major responsibility of the central budget office. As aggregate fiscal disci-

pline matures, annual budgets are formulated in the context of multi-year constraints. The annual budget becomes one year's installment in the multi-year fiscal strategy.

Even with a multi-year framework, governments periodically find it necessary to retarget fiscal policy. Doing so in a medium-term context enables them to assess the impacts of cyclical swings or policy shocks on the fiscal aggregates.

- AGGREGATE NORMS SHOULD BE SUPPORTED BY SUBTARGETS

Fiscal norms are not likely to hold in the face of spending pressures if only the totals are targeted. Ideally, spending constraints should extend to major subcomponents. These may include limits on running costs, discretionary spending limits, or limits on particular budget sectors, functions, or portfolios. When these sublimits are agreed, the aggregate constraints are sturdier because they reflect prior agreement on how total resources are to be parceled out. The totals are not merely pie-in-the-sky numbers, but commitments on future spending plans.

Yet it also is important that early agreement be confined to major subtotals. If decisions also were made on the various spending items, advance determination of the fiscal aggregates would be unduly influenced by particularistic claims on the budget.

- THE CONSTRAINTS SHOULD COVER MOST KEY AGGREGATES, NOT JUST TOTAL SPENDING OR THE DEFICIT

If only the deficit were targeted, aggregate discipline might be weakened by paying for spending increases with tax increases. If, however, only spending were constrained, politicians might cut taxes and allow the deficit to rise. The constraints do not have to cover all fiscal aggregates, but there may be considerable value in extending them to the public debt. A few countries have begun to constrain contingent liabilities, but most lack sufficient information to set effective limits on these fiscal risks.

- AGGREGATE CONSTRAINTS SHOULD COVER MANDATORY SPENDING

Constraints that permit an open checkbook for entitlements or other mandated costs weaken aggregate fiscal discipline. Although it is unlikely that democratic governments will disentitle major benefit programs or disable the budget's built-in cyclical stabilizers, it is highly probable

that they will act to trim entitlement spending at the margins, slow the spending growth in this area of the budget, and impose barriers to the establishment of new entitlements. As the fiscal burdens of demographic change draw nearer, more governments will be impelled to make hard choices about mandatory programs and to take politically unpopular actions. If they do not, aggregate fiscal discipline will resemble a poorly designed dam that cannot hold back the pent-up pressure building up against it.

- AGGREGATE TARGETS SHOULD INCLUDE ENFORCEMENT MECHANISM, INCLUDING IN-YEAR MONITORING AND OUT-YEAR PROJECTIONS

Targets are not self-implementing; enforcement never is automatic. Effective constraints must include ongoing review during the year to assess whether the fiscal trends is in line with forecasts, as well as actions to be taken when the aggregates veer off target.

- HARD CONSTRAINTS RARELY ARE AS HARD AS FISCAL POLICYMAKERS INTEND THEM TO BE

The literature on aggregate fiscal discipline suggests that hard constraints are needed for controlling spending totals and the deficit. Hardness is a matter of degree, however. Absolute prohibition against breaching the totals may be too rigid to withstand political pressure or economic necessity. As aggregate fiscal discipline gains prominence as an objective of expenditure management, democratic governments may find supple arrangements which allow a safety valve for political and economic pressures more lasting and effective than unyielding targets. ❧

Chapter 4
Allocative Efficiency

Every budget system rations resources by allocating money for some uses and withholding it from others. The effectiveness of government programs depends on these allocations, but governments face numerous impediments to making truly efficient allocations. One of the key tasks of modern public expenditure management is to create the conditions that foster allocative efficiency.

Allocative efficiency refers to the capacity of government to distribute resources on the basis of the effectiveness of public programs in meeting its strategic objectives. It entails the capacity to shift resources from old priorities to new ones, and from less to more effective programs. Allocative efficiency requires that the government establish and prioritize objectives and that it assess the actual or expected contribution of public expenditures to those objectives. To allocate efficiently, government must be strategic and evaluative; it must both look ahead and define what it wants to accomplish and look back to examine the results.

The linkage of strategic planning and program evaluation to ongoing budget procedures has been a perennial issue in public expenditure management. Forging a tight link has been a recurring theme in budget reform during the past half century. Many governments have tried, few have succeeded. The failure rate has been high because striving for allocative efficiency increases informational burdens, transaction costs, and political conflict. Informational needs are higher because of the demand for additional data on program impacts; political conflict escalates because of efforts to redistrib-

ute budgetary resources. The task of contemporary public expenditure management is to improve allocative efficiency without overstraining the capacity of government to process information and cope with conflict. Unless information demands and budgetary conflict are manageable, governments may prefer suboptimal allocations that enable them to muddle through the annual budget exercises.

This chapter considers the conditions (institutional arrangements, including informational flows and behavioral implications) that promote allocative efficiency in the context of efforts to strengthen aggregate fiscal discipline.

The Pursuit of Allocative Efficiency

Ideally, governments should seek allocative efficiency under all fiscal conditions, when the budget is growing and when it is shrinking, when incremental resources are available to finance additional spending and when they are not, in poor countries and in affluent ones, during boom times and when the economy is in distress. In all cases, government should spend its limited resources on programs that yield the greatest social return. In fact, however, financial conditions can make a big difference in whether and how governments seek allocative efficiency through the budget.

In developed countries, during the long postwar expansion, budgeting was oriented to allocating incremental resources. Budget bids were made and reviewed as claims for additional resources, and relatively little attention was paid to the base of previously authorized expenditure. Incremental budgeting enabled the government to respond to fresh demands without taking resources away from existing budget holders. Budgeting was a distributive, not a redistributive process. Intragovernmental conflict was low because explicit tradeoffs generally were avoided; winners gained by claiming incremental resources, not by taking from those who already had shares in the budget. Relative priorities were rearranged by awarding different growth rates to the various parts of the budget. The central budget office accrued power by serving as the hub of this incremental process; by allocating the increments, it influenced the future direction of government.

Budgeting paid lip service to allocative efficiency by insisting that there be a nominal review of all expenditure claims

each year. Spending departments submitted detailed justifications of all items of expenditure, not just of the increments. Formally the process was highly adversarial; the budget office had authority to review and challenge any items and to seek the cutback or elimination of those it considered unproductive or of lesser value. In fact, however, the process was relatively calm and accommodating. Conflict was mitigated by the tendency to continue most ongoing programs. Although all of the budget was nominally reviewed, almost all escaped serious review. Few changes were made, except those financed by additional resources.

Incremental budgeting suited the times, but it is a flawed means of allocating public money. It encourages allocative inefficiency and the creeping enlargement in the relative size of the public sector. *It weakens aggregate fiscal discipline by presuming that spending will be higher next year making the totals accommodate the parts.* Spending departments generally have few constraints on proposing program initiatives, but these typically are bids for more money, not trade-offs within fixed budgets.

Incremental behavior calls into question due process assumptions. Classical budgeting seeks allocative efficiency by requiring that the budget be comprehensive and that all claims compete against one another in a global competition for public funds. It assumes that if all claims are standardized as to form and are submitted according to a prescribed schedule, the allocations deriving from the budget competition will be correct. But as budgeting hardened into incremental patterns, structural impediments to the optimal allocation of government money became apparent. One is the "stickiness" of public expenditure; another is the short time frame of annual budgeting; and a third is a lack of adequate information on program effectiveness. Stickiness refers to the difficulty of taking funds from existing programs and agencies. Budgets are sticky because recipients mobilize and logroll to protect their shares and because there is no market mechanism to drive out inefficient performers. Moreover, within the framework of annual budgeting, it often is difficult to make reallocations that unfold over several years or whose program impacts lie in the future. Finally, by allocating inputs conventional budgeting does not sufficiently consider

whether funded programs are achieving governmental objectives.

Recognition that due process in budgeting often produces inefficient outcomes led to a series of abortive efforts to reform government budgeting. One popular vein of reform ideas was centered around PPBS (planning-programming-budgeting systems) and similar arrangements in many developed countries; another was zero-based budgeting (ZBB) and its variations. PPBS sought to give budgeting a longer time horizon and to upgrade its analytic capacity; zero-based budgeting sought to redistribute resources within the base of existing programs and expenditures. Although they differed procedurally, both PPBS and ZBB sought to intensify competition for budget resources, the former by providing information on the cost effectiveness of alternative means of achieving government objectives, the latter by having each spending unit prepare alternative budgets (each with incremental resources and outputs). With the prospect of greater competition, however, came increased informational burdens and conflict, along with often successful political-bureaucratic tactics to disable the new budgetary mechanisms. Variations of both approaches were exported by bands of consultants (often encouraged or financed by international institutions) to many developing countries. The reforms were even less fruitful in poor countries than they had been in rich ones, for they overtaxed the capacity of governments to generate policy analysis and budget alternatives.

This is not the place for reviewing the many reasons why efforts to reform budget allocation systems have failed, but it is important to distinguish contemporary PEM from PPBS and ZBB-type innovations. The earlier reforms were confined to budgeting; they tinkered with the informational content and procedures of the annual budget process. PEM, by contrast, views budgeting as a critical part of the larger institutional environment in which it is embedded. PEM connotes a Copernican shift in the relationship of budgeting and institutions: rather than budgeting being the driver of political and managerial actions, it is the behavior of politicians and managers that drives budgeting. To change budget allocations requires, therefore, changes in the incentives provided those who decide the budget, including the institutional arrangements in which they work and the information supplied to or by them.

The test of the allocative strength of any budget systems lies not in its procedures but in the allocations themselves. Due process in budgeting does not suffice. It is possible to have a well-run budget process that allocates inefficiently because of the stickiness of expenditures and the refusal of politicians and managers to reallocate. Budget stakeholders need incentives to cooperate and the rules that matter the most are that they operate under constraints that impel them to reallocate and that they have a large say in the reallocations that are made. Anything less will blunt allocative efficiency.

Allocating Under Fiscal Constraints

In terms of allocative efficiency, enforcing fiscal discipline can be a mixed blessing. Although it stabilizes the budget totals and makes them congruent with government economic objectives, a fiscal norm that constraints total spending risks freezing old programs into the budget and new ones out. This outcome is highly likely because it is politically safer to continue old programs than to terminate them in order to make room in the budget for spending initiatives. Consequently, a government whose fiscal norms compel decremental budgeting might seek to meet aggregate constraints by eliminating program initiatives rather than by stringently reviewing the effectiveness of existing expenditures. The more austere the spending norm and the longer it is maintained, the greater the risk that budget priorities will rigidify. The risk is greatest when economic growth is weak and fiscal increments are inadequate to finance normal year-to-year increases in spending. In this circumstance, a strong case can be made for reallocative initiatives that transfer resources from current budget holders to new spenders. Paradoxically, however, while striving for allocative improvement is most needed when the budget is tight, this may be the condition under which it is most difficult to achieve. To keep the budget fresh and supple when there is little or no money to expand programs requires that the government have the strategic capacity to reallocate resources in accord with its priorities.

Both rich and poor countries suffer from allocative inefficiency, but the cost may be significantly higher and more apparent in the latter. When they fund ineffective programs, developed countries obtain suboptimal returns on public expenditure. Per capita income is somewhat lower, citizens are deprived of social benefits they might otherwise receive, and government is not sufficiently

responsive to emerging problems. Depending on the pattern of inefficiency, there may be distortions in private investment and consumption as well as in the distribution of income. Poor countries face all of these costs, but relative to the country's wealth, the price paid may be far higher. When a poor country tolerates serious inefficiencies in the allocation of public resources, it may underspend on critical needs (such as public health and education) and overspend on other areas (such as military forces); facilities and other capital investments acquired through international assistance may fall into disrepair because they are inadequately maintained; money may be wasted on showcase projects that offer meager social returns. When poor countries misallocate resources, development is retarded and poverty persists. It is especially urgent, therefore, that countries striving to lift themselves out of impoverishment improve allocative efficiency in public expenditure.

The Institutional Framework for Reallocation: Rules, Roles, Information

The procedural elements of a public expenditure reallocation system are similar to the elements of PPBS and other failed budget reforms. Both PPBS and the public expenditure model seek to enhance allocative efficiency by establishing a multi-year budget framework, generating data on program performance, and allocating resources to more productive uses. One difference is in their fiscal context: PPBS-type reforms were introduced during a period of rising expectations about economic well-being and the affordability of program expansions. The logic of PPBS-type systems was that through multi-year planning and program analysis, governments would be more efficient in allocating the dividends of a growing economy. Although governments gave lip service to reallocation, the prevailing mood was that planning and analysis would lead to improved allocations of new money.

Contemporary public expenditure is being managed in a different environment. Austerity is the order of the day, promoted by efforts to curtail the legacy of past deficits, weaker economic growth than was enjoyed in the past, and taxpayer unwillingness to pay more to finance government programs. In this environment, most program initiatives have to be financed by reallocation, not by new money. The dif-

ference in fiscal condition and government ambitions has affected the institutional context, informational resources, and behavioral patterns in public expenditure management.

Rationing Public Expenditure

The key change in rules is that budget allocations are made pursuant to explicit constraints on the amounts that can be spent. These constraints need to be set before departments bid for resources, and they must be centrally set for each sector and portfolio in accord with government objectives. In contrast to conventional bottom-up budgeting which permits open ended bids for resources, PEM requires that department requests be within the resource envelope provided them. Moreover, in contrast to PPBS and other "rational allocation" systems which base budget decisions on net benefit considerations, PEM requires beneficial programs to compete for constrained resources: just because a program yields net benefits does not necessarily mean it will be funded.

Rationing public expenditures mitigates the common resource pool problem of public finance, but can worsen the principal-agent problem. Inasmuch as the amount that can be drawn from the pool is rationed, self-interested spenders cannot opportunistically take more than is permitted. Enforcing this rule requires a vigilant, powerful central office that reviews spending demands and assesses adherence to budget constraints. But no enforcement mechanism is perfect, and wily ministers and managers can maneuver to spend more resources than are in their envelope. As long as the excess is marginal, it will not do much damage to the fiscal constraints; but if spenders succeed in breaking the constraints, preset limits will have little impact on budget outcomes.

Organizational Roles: The Center Versus Ministers and Managers

Reallocation is difficult because it stirs up political conflict, spurs those threatened with a loss of resources to take counter-measures to protect their budgets, and requires an enriched flow of information on program objectives and results. Nevertheless, governments can facilitate reallocation by building their capacity to specify strategic objectives and reprioritize programs within medium-term expenditure constraints.

Seen in this light, reallocation is a function of strategic capacity, that is, the ability of a government to anticipate and plan for future changes in its environment, to recast its objectives and programs on the basis of planned change, to define future desired outcomes and to reallocate resources to achieve them, to measure progress in achieving the planned outcomes, and to assess the effectiveness of programs. Having all these capabilities promotes use of the budget as an instrument of change, but doing all these places significant demands on the analytic and conflict-resolving capacities of government. Few governments make serious efforts along these lines; those that do generate more reallocation than those that do not.

The strategic capacities set forth above must be concentrated at the center of government where responsibility for national priorities and inter-sectoral allocations is lodged. Moreover, strategic decision-making should be linked to allocative decisions; if they are not, the plans made by government will not be effectively implemented.

Allocating resources is the stock in trade of the central budget organization; reallocating resources may require a more sensitive division of labor in which central budget makers are responsible for strategic decisions and major priorities, while ministers and managers are responsible for sub-allocations in their respective fields of responsibility.

Top-down Versus Bottom-up Budgeting

In classical budgeting, the production of information proceeds in a bottom-up sequence, while decisions flow in a top-down sequence. Spending agencies are permitted to ask for as much as they want, with little or no guidance from the center. In bidding for resources, agencies submit vast amounts of information on their activities and expenditures. This information and the associated bids are reviewed by central authorities who decide the amounts provided to each agency or activity in the government budget. Invariably, the total demanded by agencies exceeds available resources. The fact that not all demands can be satisfied gives the central budget office the lead role in allocating budget resources. The greater the excess of bids over resources, the greater the center's influence in dictating where the money goes.

This arrangement puts spending agencies and central budget makers on a collision course. Much of the increase sought by agencies is denied

by budget guardians. But friction typically is eased by weak aggregate fiscal discipline (the total can be raised as spending pressures intensify), the inclination of central officials to give agencies at least as much as they were allocated for the previous year, the availability of spending increments, and avoidance of explicit reallocation. When austerity removes these favorable conditions, central controllers no longer regard bottom-up, open-ended requests as useful. Such requests enable spenders to avoid hard priority choices and explicit reallocation. When central controllers want significant reallocation, they cannot rely on spending departments to voluntarily surrender resources in the normal course of compiling their budgets. Central controllers have to intervene early and effectively by providing substantive guidance on the government's preferences and strategic interests.

Changing Government Priorities

What does the center do when it is bent on reallocating resources? The short answer is that it changes government priorities. Reallocation entails changing what government does with public money. In contrast to allocation which is driven by the opportunity to obtain a bigger budget, reallocation depends on government decisions that certain objectives should be accorded priority in the competition for public funds. Reprioritizing can be an explicit decision that A is more important than B, or an implicit choice that is revealed only by the outcome—A gets more money and B gets less. Either way, reallocation requires capacity at the center of government to change. In contrast to allocation which often proceeds in a fragmented manner, reallocation requires a high degree of central coordination. Not much reprogramming of public funds occurs when spending departments logroll to divide the budget among themselves.

There is no standard process for reconsidering and changing government objectives and priorities. Some governments are guided by party platforms, others by the views of strong leaders. In some multi-party governments, coalition agreements map out the policy initiatives that will be taken, including changes in the use of public funds. In some countries, the Cabinet meets months before the annual budget is prepared to specify medium-term priorities and to decide the fiscal envelope for each sector or department. In recent years, a few countries have

announced the strategic areas that are to be favored in budget allocations. In these countries, ministers and managers must demonstrate that the resources they are bidding for would contribute to the government's strategic objectives.

All of these processes can be used to reallocate, but they are more likely to be used for allocative purposes, that is, to claim larger budgets. Strategic planning potentially is oriented to reallocation, though it is not always applied to this end. In business, strategic planning is used to decide which markets to enter or exit; in government, it typically is used to decide which programs to expand. When used to its full capacity, strategic planning questions the role and objectives of government entities and considers how they might be transformed by terminating some activities and starting others.

The common element in the various approaches is that they provide an opportunity for the government to rethink its strategic goals and to shift resources to new or underfunded priorities. Governments operating in a constrained environment are likely to find that they can respond to new priorities only when they cut funding on some existing activities.

Medium-term Expenditure Constraints

Because strategic changes typically unfold over an extended period and have greater impact on future budgets than on the one immediately ahead, a second element of reallocative capacity is for the government to set medium-term fiscal targets, including the margin (if any) available for spending initiatives or the net savings required to meet the preset targets. The margins and savings usually are calculated on a net basis: new spending minus savings from program cutbacks. Net budgeting encourages reallocation by protecting spenders against a loss of resources when they shift funds in response to changes in the government's strategic priorities.

The medium-term constraints should be consistent with the government's fiscal objectives, and they should not be so accommodating as to enable the government to avoid reallocation. It is also the case, however, that (as discussed in the previous chapter) the constraints have to be attainable. If they aren't, the government might be impelled to resort to accounting maneuvers that understate the true amount of public expenditure.

Medium-term spending constraints are not self-enforcing. In fact,

the drive to reallocate can open the door to efforts by spending departments to substitute more expensive programs for the ones they are replacing. A familiar ploy is to overstate the savings from program cutbacks and to understate the spending on new programs. To forestall these tactics, it is important that the government maintain a baseline that projects the spending impacts of authorized programs over the next 3-5 years, and enables it to estimate the future budgetary impact of proposed policy changes. As will be discussed below, scorekeeping is one of the important functions of the central budget office.

Inter-sectoral Decisions

Reallocations across sectors are not likely to emerge from bottom-up bids by departments for resources. Decisions to take money from one sector and assign them to another must be made at the top, or they will not be made at all. Accordingly, reallocation requires that the government specify a resource envelope for each sector or major spending unit before ministers and departments compile their budget estimates. In the course of setting these envelopes, the government may decide that some sectors should be permitted increases above the baseline and that others should have decreases. In parliamentary regimes, these decisions usually are made by the Cabinet, often pursuant to recommendations from the Prime Minister or the Finance Minister. In a presidential system, the chief executive usually sets the constraints.

Reallocation can be made at any stage of budgeting, but there is a clear advantage to doing it early, before spenders stake their claims for resources. If the government were to defer these decisions to the give-and-take of budget formulation, the outcome might be very little reallocation and pressure to accommodate spending demands by raising the totals. Moreover, when sectoral decisions are a byproduct of unguided departmental bids for resources followed by bilateral negotiations between them and the Finance Ministry, there is a good chance that the budget will not be aligned with the government's objectives and priorities.

Intra-sectoral Spending Decisions

The contemporary drive for fiscal discipline may tempt the government to maintain a tight grip by making detailed budget allocations within sectors or departments. Central control of

spending details might seem to be a logical response to the current budget situation in many countries. If spenders are reluctant to trade off within their areas of responsibility, it may make sense for central authorities to do the job for them. There are a number of strong reasons for centralizing intra-sectoral allocations in the Cabinet or Ministry of Finance: (1) The center can reallocate more broadly than can a line minister or department; (2) The central organs have a more comprehensive and strategic view of the government's interests and priorities than a single department which is beholden to sectoral pressures and perspectives; (3) Central authorities can promote reallocation based on evidence of program effectiveness, evaluative findings, and objective analysis; (4) Central involvement is essential for establishing rules and procedures that enforce fiscal discipline and ensure that the cost of program proposals is accurately reflected in the budget; (5) Without strong pressure from the center, departments may protect existing programs rather than reallocate resources; (6) Departments have incentives to launch programs at low cost and to underestimate the full impact on future budgets. If not counteracted by the center, this behavior would undermine both aggregate fiscal discipline and the government's capacity to establish program priorities. In sum, if spending agencies will not (or cannot be trusted to) make the tradeoffs, central budget authorities should do the job for them. But despite these arguments for centralized intra-sectoral reallocation, the current condition of government finance in many countries—fiscal constraints, inadequate increments, and pressure to make room in the budget for program initiatives—may justify a decentralized approach for budgeting within sectors and departments. Arguably, more reallocation will occur if spending ministers and managers have an active role in generating policy changes. Trying to do the job centrally may result in much conflict and little reallocation. The threat of losing resources and coveted programs may impel departments to resist the tradeoffs and savings demanded of them. Although they are not at the center of power, departments have formidable weapons at their disposal. They can withhold information needed to make cost-effective tradeoffs; they can enter into logrolling coalitions with other spenders to protect their budgets

against cutbacks and reallocations; they can mobilize support among affected interests and within government. Judging from the past, it is by no means assured that central authorities will win the battle for reallocation; instead, they may end up with status quo budgets.

Central organs operate at a disadvantage vis-à-vis spending departments when they aggressively seek to reallocate resources. They may lack sufficient information on program and political impacts of proposed policy changes, and (despite their central perch) sufficient political support to accomplish the task. Departments know a lot more about their programs—what works and what does not—than do the ministry of Finance, Cabinet and other central authorities. They may also have a better appreciation of the political risks of changing policies and programs. This asymmetry is due to the high cost of obtaining program and political information, as well as to the understandable reluctance of departments to provide information that may cast their programs in an unfavorable light or lead to loss of resources. In other words, central organs are beholden to (or captured by) spending departments for much of the information needed to make effective reallocations. Central authorities can seek to develop independent sources of information by installing a performance measurement system or by developing a comprehensive evaluation capability. But even if they take these steps, central allocators inevitably depend on spending departments for much of the raw data that goes into evaluation and measurement.

To gain the cooperation of spending departments, it may be sensible to give them a prominent voice in the reallocation process. A devolved arrangement would free up the Cabinet (or other central decision-making organs) to focus on major policy changes rather than on the details of expenditure. When the government dictates the myriad spending items, its attention to the details often drives out consideration of strategic issues.

When intra-sectoral matters are entrusted to ministers and their departments, the government allocates a spending margin or savings target to each sector minister in accord with its budget priorities. In Australia, for example, the forward estimates (described in Box 3.1) give each minister an approved spending baseline for his/her portfolio. The forward estimates may be set at a

level that accommodates spending increases, in which case the minister would be able to propose program expansions consistent with the government's priorities; or they may be set at a level that requires cutbacks, in which case the minister would have to propose savings. These targets serve both as constraints on spending requests and as the starting point for compiling and reviewing the budget. Within the assigned target, a minister may propose increased spending on some activities to be financed by savings derived from other activities in the same sector or portfolio. In this devolved institutional arrangement, ministers would have authority to approve relatively minor spending changes below a preset threshold on their own; proposed reallocations above the threshold would be reviewed by the government to ascertain whether the policy change would contribute to its priorities and to estimate the impact on future budgets. Australia has a AUS$5 million threshold below which departments can act unilaterally. This threshold clears the government's agenda for major policy issues.

Shifting much of the initiative and responsibility for intra-sectoral allocations downward to the affected spending entities entails a fundamental reorientation in the role of central budgeting organs and their relationship with spending departments. In seeking allocative efficiency, they would act more as referees of the reallocation system than as close reviewers of department budgets. They are likely to have a lead role (shared with the Cabinet or some other policy coordinating organ) in managing the trade-off system and in ensuring that program changes and budget reallocations are consistent with the government's fiscal norms and policy objectives. In this arrangement, the budget office would be responsible for guidelines and procedures for proposing and implementing program changes. It would maintain baselines and data bases for assessing the budgetary impact of program initiatives and reallocations; it advises ministers and the Cabinet on the financial and program impacts of proposals; and it conducts or promotes the ongoing evaluation of programs and reporting on performance. As it emphasizes these allocative tasks, the budget office would likely withdraw from (or curtail its involvement in) some traditional controls. It would no longer decide or monitor detailed items of expenditure; if it continued to do so, spending departments

would have little incentive to cooperate in reallocation schemes. Instead, departments would be permitted to manage their operating budgets within guidelines and financial limits set by the government. This devolution would free the central budget process to concentrate on strategic objectives and policy decisions (and contribute to operational efficiency—to be discussed in the next chapter).

A devolved reallocation scheme may require more political support and earlier involvement of politicians than one in which central authorities try to shift resources. In conventional budgeting, reallocation decisions are made late in the process, if at all. The process generally revolves around bilateral negotiations between the finance ministry and the affected spending departments. These "bilaterals" begin with middle managers who strive to resolve issues in their competence, then move to senior managerial levels. Ministerial discussions take place at the end of the process and consider only those matters not resolved at official level. After bilaterals between the finance minister and the affected spending minister, remaining issues may be taken to Cabinet. In a public expenditure system bent on significant reallocation, however, ministers must get involved earlier to set the "fiscal envelope" within which sectoral decisions are made and to establish baselines and/or reallocation targets for the various ministers or portfolios. If politicians do not play these roles, the central budget office will lack sufficient leverage to compel departments to reallocate.

The institutional rearrangements discussed here aim to make spending departments allies in reallocating public resources. But even when a cooperative relationship is established, the interests of spending departments may not perfectly align with those of central authorities. Reallocation engenders tension and conflict between those who want to hold on to or increase their resources and those who want to shift money to other uses. Decentralizing some decisions and giving departments a greater say in budget outcomes can diminish friction, but it cannot ensure that the allocations will be optimal and free of conflict.

To promote more effective reallocation, it would be appropriate for the government to insist that ministers first look to their own portfolios for savings before approaching it for additional resources.

Information

Allocative efficiency depends not only on institutional arrangements that facilitate reallocation, but also on information concerning the effectiveness of programs. The drive to reallocate can add significantly to information demands on spending departments. In addition to detailed operating data, they have to supply information on multi-year impacts and program results. In seeking broader reallocation, budgeting risks information overload, as occurred when PPBS and other reforms were introduced. Overload is common because departments have limited capacity to produce the demanded data and central authorities have limited time to review the material within the confines of annual budget routines.

Decentralizing the reallocation process and entrusting spending departments with most operational decisions can ease the informational burden by reducing the volume of operational detail produced by departments for central review, and by delegating much of the analysis and evaluation to spending units. But these informational savings are offset by the vast increase in program evaluation and performance data. It is costly to produce these data, especially when, as is often the case, the program's outcomes are outside the direct control of the affected department. In a reallocative budget process, departments have to make special efforts to build evaluations into their work. They must design appropriate methodologies, gather and interpret the data, and apply the findings in allocating resources.

The cost of evaluation is not only in the money expended in searching for and analyzing data, but also in the threat to departments that coveted programs will be found wanting. Departments undertake programs because they "know" the activity is worthwhile, and because they know this, they want to continue ongoing activities. Turning an evaluation spotlight onto a program calls it into question. It is the rare program that passes every major evaluation test and is therefore judged worthy of being continued without change. Not surprisingly, therefore, departments often protect their program interests by giving little more than nominal support to the idea of evaluation. Where evaluation is conducted, it is typically on a hit or miss basis, as is the application of evaluative findings to resource decisions.

Developing a systematic approach to evaluation requires a substantial commitment of money and political support. To influence the allocation of public finds, this commitment must be strong and continuing, and it must be manifested in the use of evaluative findings in allocating resources and making other program decisions. Without follow through to allocation, evaluation withers.

In establishing an evaluation process, the government must strike a balance between leaving the task to line departments and entrusting it to a central agency. If the finance ministry or some other central unit conducts the evaluations, spending departments may be unwilling to act on the results. When departments lack a vested interest in the evaluation, they can refuse to cooperate with evaluators, withhold data, or refrain from using the findings in making budget and program decisions. But turning responsibility over to the departments, without strong central guidance and commitment, will likely mean that little genuine evaluation is done. Yet, as important as it is for departments to have a say in the process, most have a quite limited capacity for self-evaluation. To undertake thorough and objective assessments of programs, it is necessary for government to prod departments to take the process seriously.

The government also has to strike a balance between organizing program evaluation as a free-standing process without any formal tie-in to the budget cycle, or feeding it directly into resource decisions. A tight linkage might discourage departments from cooperating, for fear that the data they produce will be used against them at budget time; but without a formal linkup, there is a strong possibility that data on performance will not be used in allocating resources. There is no perfect or permanent solution to this problem, but a sensible middle ground might be to establish evaluation as an independent process, while prodding departments to apply the findings in reallocating resources.

Australia's ambitious evaluation strategy has been designed to influence budget allocations. Each portfolio must publish evaluation plans that describe the studies to be conducted over the next three years. In addition to the periodic review of ongoing programs, Cabinet rules require that each program proposal submitted to it indicate how the initiative will be evaluated if it is approved. The Department

of Finance monitors the evaluation process, participates on many of the working groups that oversee the studies, advises on appropriate methodologies and best practices, reviews portfolio evaluation plans, and maintains a roster of completed evaluations. It also reports on the extent to which evaluations are used in allocating resources. Despite this substantial investment, many budget allocations are made without regard to the evaluations. In Australia, as in other countries, there often is a big gap between doing and using evaluation.

Australia and a few over governments have sought to link evaluation and allocation through performance measurement systems that report on program results and social outcomes. In their most advanced forms, these systems seek to feed data derived from ex post evaluations and other research into annual budget decisions. Systematic reporting on performance can influence budget allocations in several ways: (1) performance trends can be tracked over an extended period and related to program and spending trends; (2) performance results can be compared to ex ante targets and variances can be analyzed; and (3) increments in resources can be explicitly linked to increments in performance at the time budget decisions are made.

Despite these seeming advantages, no government has yet devised a performance-oriented budget system that directly links program outcomes and budget allocations, though several (Australia, New Zealand, Sweden, and others) have made significant progress. One reason for this difficulty is that outcome measures are costly to develop and difficult to apply. In contrast to evaluation which probes deeply into program operations and results, outcome measures express key aspects of a program's contribution to public objectives in relatively few (usually quantitative) indicators. It is rarely easy to distill a complex program with multiple and sometimes conflicting objectives into a few measures, or to devise measures that fairly account for the various factors (some of which may be beyond the government's control) that contribute to the observed outcomes.

In countries that emphasize outcome measures, departments that start down this path often end up with output measures instead. The tighter the formal linkage of performance measures and budget allocations, the greater the likelihood that the data will pertain to outputs, and the greater the incentive

for spending units to select easy rather than challenging performance targets. When budgeting and performance reporting are tightly linked, so that measurable results become the basis for allocating marginal resources affected departments may have little choice but to report on outputs because only these can be directly correlated with the level of expenditure. Inasmuch as outcome data are much more relevant to allocative efficiency, it may be sensible for the government to loosen the connection between performance measures and budget decisions.

Even when circumstances are favorable, measuring and reporting on outcomes is difficult and costly. It takes special effort to gather appropriate outcome data. Major outcomes typically result from a confluence of factors, including government policy, private behavior, and social conditions. Attributing outcomes to specific budget allocations does not enhance allocative efficiency when the cause-effect nexus is problematic. Nevertheless, policy makers must be mindful of outcomes when they make budget and program decisions. After all, the objective of government actions and expenditures is to improve the condition of those affected by its programs. It would be logical to regard outcome measures as directional signals, as stimulants to policy review and change. When used properly, they should spur policy makers to review existing programs and explore opportunities to do better. They indicate whether conditions are getting better or worse, whether the government is closer to achieving stated objectives or further away, whether existing programs should be continued or retargeted. Even when particular programs do not by themselves cause the measured social conditions, ministers and officials should be mindful of whether established policies are working.

These considerations dictate a loose coupling of outcome measures and budget choices. Government should use outcome data in establishing strategic priorities and in evaluating results. But strategic planning and program evaluation need not be conducted solely within the prescribed routines of the annual budget process. To promote allocative efficiency, budgeting should be viewed as only one of the government's policy tools. If it is the only one, there may be less reallocation, not more.

Summing Up: The Path to Allocative Efficiency

The incentive to reallocate is inherently weak in public organizations. In contrast to markets which are non-stop reallocation mechanisms, in which resources are continuously rearranged in response to changing consumer preferences and other signals, the public sector faces strong pressure to maintain the status quo. Program evaluation and performance information can prod departments to adjust their program mix, but there is no self-enforcing mechanism to ensure that resources are shifted to more effective use.

In reallocation, the behavioral objective is to turn potential adversaries into active allies. This is not easy to do because the interests of those at the center of government are not the same as those of ministers and managers in departments. At the least, however, it is essential that politicians and officials not be penalized for reallocating resources; they should not be any worse off than they would be if they had refused to cooperate. As much as ministers and managers may want to do public good, they will not aggressively seek to reallocate if in proposing to shift resources their budgets are cut.

This reasoning justifies a division of labor in reallocation, in which central authorities establish national objectives and strategic priorities and manage the budget process but the affected departments or portfolios have considerable latitude in proposing and implementing program changes within their respective sectors. There is a risk that entrusting so much power to those who would be most affected by change will lead to little or no reallocation. Yet central authorities need not be helpless when faced with departmental intransigence. Their job is to push for reallocations by giving strategic direction to government, demanding that departments adhere to the strategy, insisting on robust evaluations and performance reports, and adjusting the baseline to encourage cooperation.

The logic of this division of labor in reallocation is that the center cannot do the job by itself, but neither can it leave the task solely to the affected departments. The center must manipulate incentives to promote cooperation, even though it will not always get the cooperation it seeks. If it doesn't, stronger direction from the center may be necessary, but the first choice should be to induce cooperation, not to compel it.

Basic elements of a public expenditure system oriented to reallocation include the following:

- The government establishes strategic objectives and priorities before departments bid for budget resources. These can be global objectives (for society or the public sector) or sectoral (for particular areas of government activity).
- The government establishes medium-term (3–5 years) fiscal objectives, including the margin (if any) for spending initiatives or the net savings required to meet the fiscal target. The margin and savings usually are calculated on a net basis: new spending minus savings from program cutbacks. The net margin is the amount of unallocated money (incremental resources plus savings from existing programs) available for new spending in a sector or portfolio; net savings are the amount by which spending in a sector or portfolio must be reduced to meet the government's expenditure target.
- Spending margins or savings targets are allocated among ministries in accord with the government's strategic priorities. Within a target, a minister may increase the resources available for program enhancements by taking resources from other programs within his/her portfolio. The extent to which ministers can reallocate on their own without obtaining approval from government will depend on the size of the reallocation and the structure of government. The scope for reallocation is greater when there are relatively few portfolios.
- The government maintains a baseline for projecting future budget conditions, establishing targets, and measuring the fiscal impact of policy changes. The baseline covers three or more years and is rolled forward with each annual budget.
- The government encourages reallocations that promote program effectiveness by requiring departments to systematically evaluate their activities and expenditures and to report on outcomes and performance.
- Cabinet review of the budget concentrates on policy changes,

not on discrete items of expenditure. Authorized policy changes (both expansions and cutbacks) are incorporated into the baseline which becomes the starting point for the next round of budget allocations.

As Box 3.1 indicates, most of the elements of a strategic reallocation process have been implemented by Australia since the mid-1980s. Annual budget decisions are made in reference to medium-term forward estimates which project spending (and other fiscal aggregates) for the budget year and the three following years. The forward estimates specify the amounts that will be provided in future budgets unless policy changes are made or underlying economic or program conditions (such as prices or program participation rates) are reestimated. By definition, a policy change is a revision to the forward estimates. Proposed policy changes are considered in a prescribed sequence that includes identification of options; consideration of policy proposals by the Cabinet's Expenditure Review Committee; Cabinet decision on allocations to portfolios; the costing of policy changes proposed by portfolio ministers; trilateral negotiations between the Treasurer, Minister for Finance, and the relevant portfolio minister; and preparation of the budget. Moreover, resource allocations are supported by an ambitious evaluation strategy that requires ministers to systematically review ongoing programs and approved policy initiatives. ❧

Chapter 5
Operational Efficiency

Operational efficiency is the ratio of the resources expended by government agencies to the outputs produced or purchased by them. The resources can be measured in money terms or in terms of other inputs, such as work hours or years. Output is conventionally measured in volume terms, but qualitative dimensions can also be measured. These include the accuracy of payments (or of other transactions), the timeliness of services, the courtesy with which they are provided, and the satisfaction of recipients. In measuring operational efficiency, these qualitative indicators can be correlated with the volume of resources or other inputs.

Operational efficiency generally refers to government consumption expenditure in the national income accounts, in contrast to allocative efficiency which covers investment expenditure and transfer payments as well. For example, operational efficiency is concerned with the cost of processing pension claims, but not with the amount paid out in benefits. The distinction is not always clear-cut, however, because operational efficiency often affects program allocations. In unemployment compensation for instance, the volume of benefits paid varies with the efficiency (accuracy, timeliness, etc.) with which claims are serviced. Nevertheless, it is useful to distinguish the cost of producing outputs from the cost of providing a particular level of benefits. The distinction parallels the one commonly drawn between outputs and outcomes.

Operational efficiency spans much more than the running costs of government agencies, though this is the

part of the budget that has been most impacted by recent efforts to enhance efficiency. In some developed countries, running costs add up to only about 10 percent of the central government's budget, but this low percentage typically excludes significant operating expenses, such as the cost of repairing and maintaining roads, feeding prison inmates and hospital patients, and teaching schoolchildren. Even with an expanded definition, operating costs have declined as a share of national expenditures in developed countries, though they still are a significant part of the budget. In these countries, the bulk of the central government's budget is spent in transfers to households and to subnational governments. In developing countries, transfer payments tend to be less prominent and operating costs dominate the national budget. In some of these countries, operating costs are very high because public employment rolls are bloated and productivity is low. Regardless of the composition of the budget, operational efficiency is important because it affects the availability of resources for social development, citizen attitudes toward government, the relative prices of government and market-provided goods and services, the integrity of government, the allocation of resources between the public and private sectors, and the reliability of information on public finances and programs. Operational efficiency is particularly important in poor countries. When government is inefficient, public sector wages tend to be low, much public expenditure is absorbed by deadweight administrative costs, and the government is robbed of resources needed for critical social development.

During the past two decades, significant advances in management theory and practice have generated new interest in improving operational efficiency. With concepts and applications liberally adapted from institutional economics and business organizations, the new public management (or managerialism, as it is sometimes called) has led in some countries to expanded operating discretion for public managers, new forms of contracting within government and between public entities and private providers, greater attention to results and accountability for performance, and the modernization of information systems. Some countries have sought to improve operational efficiency through the ex ante specification of output targets and the ex post review of results. Efficiency

gains have been very high in countries (such as the United Kingdom and New Zealand) that have separated service delivery from policy advice and the purchase of services from the provision of services, leading other countries to consider a similar restructuring of their own operations.

Following the structure of previous chapters, this chapter discusses the evolution of operational efficiency, its key elements, and institutional, informational and incentive prerequisites of reform.

Evolving Concepts of Operational Efficiency

Operational efficiency deals with the relationship of budget inputs and program outputs. Over the years, many governments have sought to enhance operational efficiency by controlling the inputs; recently, a few have shifted to control of outputs.

Modern budgeting began in 19th Century Europe as a process for controlling the volume of inputs—both total expenditure and the individual items. But while spending control always has been an essential feature of budgeting, the manner in which it is exercised has changed over the years. Budget control has gone through three stages: external control of spending items by central agencies; internal control on inputs by spending departments; and managerial discretion and accountability for producing outputs. In the formative years of their budget systems, all governments seek to establish external control. Some have persisted with external control even when their budget system was highly developed; others have moved to internal control systems. Thus far only a few have shifted to managerial accountability for outputs. *This sequence indicates that a government must establish the rudiments of external control before it can safely switch to internal control, and it must have robust internal controls before it can entrust managers with broad flexibility and accountability for resources and outputs*. Some developing and transitional countries seeking rapid improvement in public administration have tried to leap from inadequate internal control systems to managerial accountability, but (as discussed below) there may be substantial risk in ceding broad discretion to managers before internal controls are highly developed.

The form of budget control affects operational efficiency in several ways. First, the various approaches differ in

their informational requirements and procedures, and, therefore, in the operating costs they impose on government departments. Second, the controls differ in the incentives they give managers to be efficient in spending public money. To anticipate the argument made later, devolving control to managers reduces information and compliance costs while giving managers incentives to improve efficiency. But these gains come with the risk that if internal control is not effective and accountability is not strictly enforced, spending control might break down, and there would be a loss in efficiency. Table 5.1 compares the three types of control system.

External Control

This form of control has three basic characteristics: spending actions and control of operating funds are entrusted to two distinct entities; control is exercised exclusively over inputs; and control is imposed before any action entailing the expenditure of funds is taken.

External control means that line managers must obtain authorization from central controllers before they spend public money, even if funds were budgeted and appropriated for the purpose. The outside authority usually is the finance ministry, the civil service agency, or an agency responsible for overseeing the government's purchase of supplies and equipment. In some governments approval has to be obtained for each discrete transaction; in others, blanket authorization is provided for a group of expenditures. For generations, external control was practiced through Treasury control in the United Kingdom and other Westminster countries; by inspectors or controllers of finance in France, Germany, and many other countries; and through line item budget and accounting systems.

Looking back at the evolution of public expenditure management in developed countries, one can understand why strict external controls once were regarded as a signal advance in public administration. At one time—a century ago in many countries, only a few decades ago in others—government was small, its program objectives modest, and needed administrative skills were in short supply and concentrated in central agencies. Civil service systems and rules were in their infancy, procurement was not well regulated, and public accounting practices were not standardized.

Table 5.1: Types of Expenditure Control

Type of control	*Exerised by*	*What is controlled*	*Mode of acountability*
External Control	Central Agencies	Inputs: specific items of expenditure	Compliance with Itemized Budget and Government-wide rules Preaudit of transactions
Internal Control	Spending Departments	Inputs: classes of expenditure	Department Systems comply with Government-wide standards Postaudit of transactions
Managerial Accountability	Spending Managers	Outputs and total running costs	Accountability for outputs Ex ante specification of outputs Ex post audit of results

External control was an appropriate response to this unsatisfactory state of affairs, for it inculcated the habits and ethic of compliance with rules in government organizations. Because control was centralized, operating managers had to hone the skills of preparing and implementing detailed budgets, employing and supervising staff under civil service rules, and purchasing supplies in accord with government regulations. They also had to provide central authorities with periodic reports on their activities.

To the extent these conditions still persist, as they certainly do in many developing countries, it would be appropriate for management reforms to concentrate on strengthening external controls, so as to reduce corruption, build up managerial capacity in central agencies and spending departments, and prepare the way for shifting to internal controls.

External control is exercised on the input side of the budget; outputs are not explicitly considered and data on them are not systematically compiled.

Despite its limited scope, input control can be effective because it is activated before spending occurs, it can be applied uniformly throughout government, it economizes on public expenditures, it separates those who decide on the legality and propriety of expenditure from those who actually spend the money, and it can be pinpointed to specific transactions. But adverse effects on operational efficiency are ignored because these controls pertain only to inputs.

Although external controls may have worked reasonably well in developed countries when government was small, as public expenditure increased, the individual items receded in importance. Moreover, operating agencies now had their own administrative competence, and central agencies such as the ministry of finance became more interested in program and economic issues than in operating detailed input controls. Within departments, corps of line managers were trained to operate modern personnel, budgeting, and procurement systems. It became prudent, therefore, to entrust them with some measure of managerial discretion.

As a government grows, the cost of managing on the basis of external control escalates. These controls are costly because they are enforced by burdensome procedures, and require extensive monitoring. They breed both a compliance mentality—it is more important to follow the rules than to operate efficiently—and evasion of the rules. In countries which enforce external controls, managers learn how to "game" the civil service pay and classification system, how to spend on coveted items even when budgeted funds are not available, how to rig contracts so that purchases are made from favored vendors. An informal administrative culture emerges: there are the rules, and then there are the ways things really get done. This double standard—strict rules and loose compliance—is a breeding ground for inefficiency and corruption.

Internal Control

External control still is practiced in some developed countries, but since the postwar period there has been a marked trend towards internal control. In its most basic sense, *internal control means that those who spend public funds have first-instance responsibility for ensuring the legality and propriety of their actions.* Under internal control, operating agencies must establish personnel, purchasing and other management systems that comply with government-wide stan-

dards. Control still focuses on inputs, but managers no longer have to obtain outside approval before they act. In lieu of preaudit (before the expenditure is made), the government shifts to postaudit (after the financial period has ended), and instead of reviewing all transactions, it samples a small number to ascertain whether the system in operation (and not only in design) complies with the rules.

Although internal control vests managers with greater operating discretion, uniformity still is demanded. In managing resources, they must abide by government-wide pay and classification schemes, they must make purchases following prescribed procedures, and they must comply with externally-imposed rules. The key difference is that they rather than outsiders make the determination as to whether a particular transaction would be in compliance with the rules.

Internal control improves operational efficiency by reducing compliance costs and by giving mangers some leeway in organizing work and carrying out assigned responsibilities. Nevertheless, internal control, as it has been practiced in various countries, is only a modest step forward. Managers still feel bound by external rules, they still operate with a compliance mentality, and despite the liberalization of operating rules, managers still are strictly regulated in using the funds appropriated to them.

There are three main reasons why internal control does not put managers in charge. First, the pursuit of uniformity deprives managers of operating discretion. "One size fits all" still constrains public managers. Second, managers still must receive central approval for key operating decisions. For example, a central agency typically assigns accommodation to government agencies, charging their budgets for actual or imputed rents, even though managers have little or no say about the premises they occupy. Finally, when central agencies relax their control, the controls often migrate to departmental headquarters. From the perspective of operating managers, it makes little difference whether they are restricted by the central civil service board or by their own department's personnel office. In both situations, managers cannot exercise judgment on how best to operate.

Although they do not enable managers to optimize operational efficiency, internal control systems facilitate the transition from external control to

arrangements which give managers virtually complete control of operating funds. Without the experience, information, and managerial skills developed under internal control, managers would not be prepared to take full responsibility for operations.

Managerial Accountability

This arrangement shifts the focus of control from inputs to outputs, from what managers are buying to what they are producing. It does so by giving them broad discretion to spend appropriated resources, in exchange for which it holds them accountable for performance. The two sides of the exchange are inextricably linked: without discretion, managers cannot be held accountable for results; and without being held accountable for results, managers would (or should) not be given operating discretion. Only a few countries have moved in this direction, most notably, New Zealand, the United Kingdom, Australia, and Sweden.

In countries embracing managerial accountability, managers are given wide discretion in spending operating funds. They can decide how much to spend on personnel, whom to hire, how to pay them, the premises to be occupied, whether services should be provided in-house or outsourced, and so on. The government may retain some residual controls, such as equal opportunity rules for staffing, maximum pay levels for senior civil servants, or a ceiling on the value of contracts that can be tendered without competitive bids.

Some governments have been spurred to enlarge managerial discretion by adverse budget conditions. Faced with chronic deficits and escalating transfer payments and interest charges, some have sought to cut operating costs, by means of spending freezes, across-the-board cuts, cash limits, and other methods. Britain has had cash limits on operating expenditures since the mid-1970s; Japan has enforced a sinking lid on these expenditures for approximately two decades; Australia cuts operating budgets by a percentage equal to a required efficiency dividend; Sweden has constrained operating costs for almost two decades; the United States has had a statutory limit on appropriations since 1990. The longer these constraints are in place, the more onerous they become, and the greater the risk that affected departments will adjust to the loss of resources by cutting the volume or the quality of services.

Governments can seek to avert hidden cuts by specifying the outputs that are to be produced with budgeted resources. Most of the countries mentioned above have greatly increased the volume of output data published in the budget and related documents. A few (New Zealand and the United Kingdom) routinely compare actual and targeted outputs; others (Australia and the United States) use a variety of performance measures. In these and other countries, the government has taken steps to make managers accountable for outputs through annual reports, performance measurements systems, and the auditing of performance data.

But targeting outputs is not likely to induce managers to be more efficient if they lack discretion in using appropriated funds. Being accountable for outputs requires that managers have the freedom to decide on the mix of inputs. Accordingly, a few countries have greatly increased the operational discretion of managers. Australia and the United Kingdom have running cost arrangements that give managers a lump sum operating budget. Australia and Sweden allow managers to carry over unused operating funds from one fiscal year to another and, in some circumstances, to prespend a small portion of the next year's operating funds.

New Zealand probably has gone further than any other country in reorganizing its public expenditure system to increase managerial discretion and accountability. Since the early 1990s, appropriations have been made by output classes; the budget, the supporting estimates, and appropriations do not itemize inputs. The budget, appropriations, and financial statements are on an accrual basis, showing the full cost of producing outputs. Departments are charged for the capital invested in them by the government, and they are charged for depreciation of fixed assets. Departments manage their cash balances, earning interest if the rate of spending is lower than expected and paying interest if it is higher. If departments divest assets (for example, by remitting excess cash balances to the government), they reduce the capital charge, and the savings can be applied to any other operating expenses. Accountability for outputs is maintained through a series of contract-like documents. When the government submits the budget to Parliament, each department tables a "forecast report" itemizing the major outputs to be produced pursuant to the amounts bud-

geted for it. More detailed specification of outputs is contained in purchase agreements negotiated each year between the chief executive of each department and the minister purchasing outputs on behalf of the government. In design, but not always in practice, the minister has the option of purchasing outputs from the department or from any alternative supplier. These and other features of the New Zealand model are reported to have produced substantial gains in operational efficiency. Additional information on New Zealand is provided in Box 5.1.

Managerial accountability contributes to operational efficiency in two ways. First, by targeting (and, in a few countries, contracting for) outputs, it makes managers responsible for the volume, timeliness, and quality of the services produced. Unlike control systems which define efficiency in terms of economizing on inputs, managerial efficiency expands the opportunity for efficiency by optimizing on outputs. Second, by giving managers full (or near-full) operating discretion, this arrangement enables them to apply their professional skills, judgment, and information to select the most efficient mix of inputs. For example, managers have incentive to economize on the cost of accommodation because savings can be applied to any other operating expenses.

Application to Developing and Transitional Countries

There is understandable interest in developing and transitional countries to accelerate the pace of reform by adopting the most advanced and promising innovations devised by developed countries. This interest has been whetted by the attention and acclaim given the New Zealand model, and by the hope that enormous gains can be quickly achieved in operational efficiency. Yet there are important preconditions for the successful implementation of managerial accountability, and these should not be ignored by countries striving to improve public sector management.

The typical developing or transitional country has a formal external control system, extensive evasion of the controls, and low operational efficiency. Advising these countries to go through the sequence of managerial reforms outlined earlier—first establish reliable external controls, then shift to internal control systems, and only after these systems are well

Box 5.1: New Zealand's Contractual Model

In every formal contractual relationship, five conditions must be present in order for the parties to enter into the agreement and to perform according to the terms of the contract. (1) The two sides must have an arms length relationship; (2) the purchaser must have freedom to purchase goods or services from alternative suppliers; (3) the supplier must have freedom to produce the contracted goods and services; (4) the contract must specify the cost of the goods or services; and (5) the contract must specify the performance required of the supplier.

Beginning with the enactment of the State Sector Act 1988 and the Public Finance Act 1989 and continuing into the 1990s, New Zealand has transformed public management to satisfy each of the five conditions for contracting.

(1) Arms length relationship. In most departments, the government has decoupled policy advice from service delivery, either by hiving off the latter into new organizational units or by reorganizing the department into a number of discrete business units. For example, the Ministry of Defense was restructured so that it is responsible only for providing policy advice to the minister; military operations are entrusted to a new organization, New Zealand Defense Forces which contracts with the Minister for various services.

(2) Purchaser freedom. In New Zealand, appropriations are made to the Minister who has the option of purchaser services from government departments, other public entities, or outside suppliers. In fact, most services are purchased from governmental suppliers, but many are not.

(3) Provider freedom. To enter into contract, providers must have discretion to manage their operations as they deem appropriate. In New Zealand, each department is headed by a chief executive who serves under an employment contract for a fixed term. The chief executive has full discretion to use the resources available to the department, without constraints on the amounts that can be spent on personnel, supplies, and other inputs.

(4) Specification of cost. In contracting, the purchaser and supplier must agree on the amount of money that the former will provide to the latter. This amount must reflect the full cost of producing the services. Accordingly, New Zealand accounts and budgets on an accrual basis, which shows the full cost (including depreciation charges and a charge on the use of capital) of producing the services.

(5) Specification of outputs. Finally, contracts must specify the outputs to be supplied. This requires that outputs be specified in advance and that departments compare actual outputs to targeted outputs. In New Zealand, the budget is prepared and appropriations are made by output class, not by inputs. Moreover, each department submits a "departmental forecast report" specifying the outputs for the next fiscal year, and negotiates a purchase agreement with the Minister specifying the outputs to be provided. After the year is over, each department published an annual report detailing both its financial performance and its outputs for the year.

embedded move to managerial accountability—may seem to be a prescription for failure. After all, why rely on centralized controls (civil service classification and pay schemes enforced by a central agency, budget estimates that itemize and separately control each category of inputs, and so on) when these controls breed corruption, evasion, and inefficiency? Why stretch out the process of managerial reform over decades when the opportunity is at hand to leapfrog to state of the art systems?

Notwithstanding these arguments, governments take enormous risks if they adopt a regime of managerial discretion and accountability before strong, reliable controls are in place. *There are two elements to effective controls systems: workable rules and procedures; and patterns of behavior that accept the rules and procedures as legitimate*. To say of a country that actual expenditures do not conform to the amounts shown in the budget, or that the hiring and remuneration of staff is not based on civil service rules and procedures, is to say that the time is not ripe for managerial freedom.

Rules work when they are accepted as fair and rational. It is for this reason that external control typically precedes internal control, and that internal control is a precondition of managerial accountability. External control nurtures the habits and practices of managing according to the rules. True, it takes a bite out of operational efficiency, but the cost is justified when the rule of law is implanted in the public administration.

Once this occurs, government can safely adopt systems of internal control which entrust operating managers with greater control of their inputs. In a formal sense, internal control means, as was explained earlier, that the spending agency is responsible for systems that ensure legality and efficiency in expenditure; in a behavioral sense, it means that the controls are internalized, that managers accept the rules—not because their actions are monitored by others or because they would be penalized for violating the rules—but because they regard the rules as legitimate and workable. Without this behavioral dimension, internal control would open the door to abuse, no matter what safeguards are built into the formal control systems.

This culture of compliance paves the way for managerial accountability in which managers have formal

carte blanche in purchasing inputs but are responsible for producing budgeted outputs. Managerial accountability does not mean that anything goes in spending inputs; it means rather that managers, having internalized the rules, can be trusted to spend properly and efficiently. Without this internalized behavior, managerial discretion would be risky and costly.

Although developing and transitional countries may not be ripe for avant-garde managerial systems, the process of development need not stretch over decades or longer. The process can be accelerated by (a) rationalizing external controls, removing duplicative and deadweight controls (for example, by consolidating budget items and civil service classifications); (b) tendering internal control authority to well-managed departments that can handle enlarged responsibility; (c) instilling a managerial ethic in the public service through skills-based and behavioral training; and (d) developing first-generation performance measuring systems. These steps would enhance operational efficiency and prepare the way for bolder reforms in the future.

Basic Elements of Managerial Accountability

Inasmuch as managerial accountability systems are in their infancy, their basic elements have not yet been standardized. Nevertheless, the following elements seem essential in systems that purport to give managers operating discretion in exchange for enforcing strict accountability. Some of those are discussed in Table 5.2.

- *Managers are given global operating budgets*
  Within this total, spending items are fungible; managers have incentives to be efficient because they have more to spend on some items by spending less on others.

- *Managerial control is devolved to operating levels*
  Those who provide the services (field offices, for example) are given their own operating budgets and managerial flexibility. Without devolution, managerial power would be concentrated in headquarters and operating managers would lack incentive to be efficient, or opportunity to be accountable.

Table 5.2: Instruments for Improving Managerial Accountability

Instrument	*Advantages*
Running Costs Budget	Managers are given a single allocation for all operating expenses to spend on inputs as they deem appropriate, thereby reducing compliance costs and giving manager incentive to operate efficiently.
Devolved Budgets	Line managers in field offices and other units control their own operating budgets, thereby enabling them to respond to local needs and conditions and to operate efficiently.
Efficiency Dividend	Percentage reduction in operating budgets equal to expected annual productivity gains compels managers to seek efficiency improvements.
Output Specification	Expected outputs are specified in the budget or related documents, thereby giving managers advance notice of expected performance, and enabling the government to compare targeted and actual results.
Separation of Purchasers/Providers	Reduces capture of purchasers by providers and enables purchasers to choose among alternative providers, thereby creating internal markers within government.
Market Testing	By comparing the cost of purchasing services from its own agencies versus outside suppliers, the government can select the most efficient means of obtaining services.
Performance Agreements	Contracts between the government and chief executives or their agencies specify the resources to be made available and the output to be provided, thereby establishing a basis for assessing individual or organizational performance.
Annual Reports and Audits	Agency reports on financial results and outputs are independently audited to assess reliability and relevance of performance information.

- *Costs are allocated to outputs or activities*
  If managers are to be efficient, they must be charged the full cost of producing outputs and of carrying out required activities. Some countries use cost allocation models for apportioning overhead and other indirect costs; a few have cost accounting systems in which resources are accounted for on an accrual basis. Along with allocating and accounting for costs, it is necessary that managers have discretion with respect to the costs charged their budgets. For example, if they are charged for accommodation, they should have freedom to decide where their operations will be located.

- *Expected outputs are specified in advance*
  Expected outputs are specified in advance, either in the course of compiling the budget or in contracts between managers and their superiors. Ex ante specification requires that outputs be measured or stated in a form that enables those purchasing or providing outputs to know what they are buying or selling. A few countries (most notably the United Kingdom) specify a small number of key performance targets; others (such as Australia) encourage managers to specify the full array of outputs to be produced.

- *Purchaser and provider roles are split*
  In conventional public administration, policy decisions on what the government should do are combined in the same organization along with operating decisions on how services should be provided. This functional integration was long regarded as a virtue because it facilitates the free flow of ideas and feedback between policy makers and operating managers. But in modern public expenditure management, it often is regarded as a disincentive to efficiency because (a) policy makers are captured by providers, (b) policy makers lack needed independence and information to

Table 5.3: Types of Output Targets

Type of measure	*Example*
Volume/Workload	The agency will process 562,400 claims during the fiscal year.
Timeliness	97 percent of claims will be processed within 3 days of receipt; 99 percent within 5 days.
Quality	The error rate on determination of eligibility shall not exceed 2 percent. The error rate on amount paid per claim shall not exceed 3 percent.
Service Quality	At least 60 percent of recipients are very satisfied with the service; at least 80 percent are satisfied or very satisfied with the service.
Unit Cost	The average cost per claim processed will be $4.62

enforce accountability, and (c) policy makers do not have the option of buying services from the most efficient supplier. Some countries (the United Kingdom through its Next Steps initiative, New Zealand by restructuring departments) have separated policy advice from service delivery. Separation aims to create an arms-length relationship in which purchasers have freedom to obtain services from in-house or alternative suppliers. It should be noted, however, that this decoupled model is not widely applied and some countries (such as Australia) have rejected it.

- *The government maintains a comprehensive performance reporting and auditing system*
  To maintain accountability it is important that results be systematically compared to targets, and that data on results be subject to audit. In the countries moving in this direction, it has proven much easier to audit financial performance than program outputs. Nevertheless, some countries now require that each department publish

auditable performance data in its annual report.

- *Managers are personally responsible for cost and outputs*
  Once they have operating discretion, managers can be held responsible for expected results by linking their pay and job tenure to performance. Implementing this feature of managerial accountability would compel the government to abandon conventional civil service rules concerning pay classifications, appointment, and termination. Under an accountability regime, managers would be employed under fixed-term contracts that specify pay and other working conditions as well as performance expectations.

Institutions, Information, Incentives

Adopting a managerial accountability system portends significant shifts in rules governing operational expenditure, the roles of budget controllers and spending managers, and the information produced and used in running government activities. Because managerial accountability is still in the early stages of development, practices have not been standardized yet, and significant differences have emerged in the approaches taken by the countries that have moved in this direction.

Rules

Two sets of closely linked rules are prerequisites for establishing managerial accountability. One pertains to the use of operating resources, the other to accountability for outputs and other dimensions of performance. The first without the second would give managers license to spend as they wished; the second without the first would make managers accountable for results over which they have little or no control.

The first set of rules regulates the volume and use of running or operating resources. In managerial accountability, running costs are cash limited; that is, managers are required to operate within a fixed budget with no supplementation during the year for cost overruns, except possibly for those due to demand-generated increases (over which line managers have no control) in the volume of outputs. Moreover, the cash limits are set progressively lower each year to capture expected efficiency gains. Typically, this

enforced cutback is applied across-the-board to all operating budgets, but agencies still can bid for additional resources during budget formulation. For example, if the "efficiency dividend" were set at 2 percent of operating expenses, each agency's baseline for running costs would be reduced by this percentage. However, agencies could, in the course of compiling the next year's budget, seek additional operating resources above the baseline. Once the operating budget is decided, managers have broad discretion in using resources, including authority (in some countries) to carryover some unused funds to the next fiscal year, or to prespend a small portion of the next year's running costs. Line managers—not controllers in central agencies or departmental headquarters—decide on the amounts spent on personnel, supplies, equipment, and other puts. This managerial discretion might be hedged by limits on pay and certain other expenditure items.

The second set of rules pertains to accountability for performance. Ideally, expected performance would be specified in advance so that the budget would be an explicit or implied contract on the services to be produced in exchange for the resources provided. Table 5.3 provides examples of types of output measures that may be specified in the budget or related documents. As illustrated in this table, performance measures are not limited to the volume of outputs; quality, cost, and customer attitudes also can be measured.

Once outputs have been specified, it should be possible to hold managers accountable for results. The results can be presented in annual reports or other documents and formatted in ways that facilitate comparison of projected and actual outputs. Ideally, to maintain accountability, performance measures should be reviewed by independent auditors empowered to note deficiencies in the data and to recommend remedial actions.

Roles

External control concentrates decisions on expenditures at the center of government and operating responsibility at the bottom; internal control keeps operational responsibility at the bottom but shifts spending control to the center of departments; managerial accountability devolves both control of resources and responsibility for results to operating units within departments. These units can be field offices which directly deliver services, regional

Box 5.2: Performance Targets in the United Kingdom

Published performance targets are a central feature of management reform in the United Kingdom. These targets have been developed pursuant to two initiatives which have transformed central government: the Next Step program launched in 1988 and the Citizen's Charter started in 1991. Although they were launched by Conservative Governments, both initiatives have been so successful that they have been continued by the Labor Government elected in 1997.

Next Step refers to a process by which responsibility for service delivery has been transferred from central departments to agencies which have been granted operational independence. As of 1996, there were 129 such agencies, comprising approximately three quarters of the civil service. Each agency operates within a discrete area of responsibility. It is thought more efficient to have a large number of agencies, each with specific targets than a small number of agencies with multiple responsibilities. The Government publishes an annual report that compares actual performance against targets for the previous year and specifies targets for the next year.

The citizen's Charter aims to improve the quality of services by publishing standards which users can expect for each service they receive from Government, and entitling users to an explanation (and in some cases compensation) if the standards are not met. In addition to certain Government-wide standards (for example, that officials or employees will meet with citizens no later than 10 minutes beyond the time for which an appointment was made), each department and agency has its own service standards.

The following performance targets and results pertaining to social security (published in the 1996 Next Step Reports) illustrate the types of performance information used to improve service operations.

	'93-'94	'94'-95	'95-'96	'96-'97
Income Support Claims Cleared in 5 days				
Target	71%	71%	63%	63%
Outturn	74%	69%	67%	
Accuracy of Payments				
Target	92%	92%	87%	87%
Outturn	91%	87%	78%	
Customer Satisfaction				
Target	85%	85%	85%	
Outturn	84%	83%		
Overpayment Recovery (millions of pounds)				
Target	54	75	110	92
Outturn	80	117	122	

offices which oversee operations within a defined area, headquarters units which provide overhead services, or any other organizational area with specified resources and responsibilities.

In the countries that have embraced managerial accountability, several models have been developed. (1) Sweden has a long-standing separation going back to the 19th century, between small ministries which have political and policy-making functions and a large number of independent agencies which carry out government programs. Managerial accountability has spurred the government to clarify the relationship between the two types of entities and to strengthen accountability mechanisms. (2) Since the late 1980s, the United Kingdom has established more than 130 executive agencies (popularly referred to as "Next Steps" agencies), each headed by an appointed chief executive, and each operating under a framework document that delineates what the agency can do on its own accord and the matters for which it is accountable. See Box 5.2 for a description of the Next Steps initiative and sample performance targets used in it. (3) During the 1990s, New Zealand separated most service-delivery functions from policy-advising units, introduced output-based budgeting, and various contract like documents in which resources and outputs are specified. (4) In contrast to other countries, Australia has retained consolidated departments, but has pushed for devolution of resources and operating discretion to field units.

This organizational variety may be partly due to the different political—administrative cultures of the countries that have emphasized managerial accountability. But behind the various approaches lie two distinct strategies for encouraging managerial accountability. One is managerial, the other is contractual. Managerialism refers to systems in which managers are given broad scope to run the organization according to their judgment; contractualism refers to relationships in which agents who provide services write explicit agreements with principals who control resources on the services to be provided. Contractualism spurs government to decouple operations from policy; managerialism pushes government to combine the various responsibilities in the same organization. Managerial flexibility is precondition for internal contracts, for if managers lack discretion, they cannot be responsible parties to an agreement.

Table 5.2 describes some of the instruments devised in recent years to strengthen managerial accountability.

Information

Every form of control has distinctive informational demands. Maintaining external control requires a bottom-up informational flow, in which managers provide superiors with detailed information or their operations. Internal control allows for the consolidation of information sent by departments to central authorities, but still requires an extensive flow from operational levels to headquarters. Managerial accountability greatly reduces the volume of input information exchanged between organizational units, but also greatly increases the volume of cost and output information. Managers have to generate, compile, transmit, and analyze cost and output information; they need to specify these in advance, and to assess results against targets; they must develop new cost measurement, accounting and allocation systems, based on accrual principles; and they should have the capacity to price outputs independently of input costs. Table 5.4 presents various concepts used in measuring costs.

Compiling and processing the new types of cost and performance information is costly, especially during the early years of reform when new measurement and reporting systems must be developed. The more determined the government is in enforcing accountability, the greater these costs will be. To this writer's knowledge, no country has systematically measured the transaction costs of establishing performance targets, collecting data, monitoring performance, and assessing results. It is relatively simple for governments to estimate the costs foregone when input controls are terminated or relaxed; it is much harder for them to estimate the new costs assumed when managers are held accountable.

Managerial Behavior

Getting the incentives right is critical to the successful implementation of any managerial accountability system. This new approach is predicated on the expectation that managers will behave efficiently if given the information and opportunity to do so. But will they? Some managers may prefer to have more control if, as a consequence, they also are not held to account for failing to perform. Some managers may feel threatened by the mass of cost and performance information which they must prepare for use by others.

Table 5.4: The Definition and Measurement of Cost

Term	*Definition*
Expenditures	Amounts paid by government entities in the course of operating programs. Expenditures are recorded on a cash basis in the fiscal period during which the payment is made.
Cost (or Accrued Cost)	The resources used in producing goods and services, regardless of the entity incurring the expenditure or the fiscal period in which payment is made.
Cost Allocation	A method of charging costs to the activity/output which incurs them. Allocated costs include indirect and overhead costs, and costs paid by other entities or accounts, such as the cost of accommodation in government-owned buildings.
Activity Based Costing	A method of assigning costs to the activities (or "drivers") generating them.
Unit Cost	The cost of producing a unit of output. Unit costs are used to compare the relative efficiency of different service providers, to calculate changes in productivity over time, to allocate budget resources, and to charge users for services.
Marginal Cost	The cost of producing an additional increment of output, in contrast to the average cost of producing total output.
Variable Cost	Costs that vary with the volume of output, in contrast with fixed costs that are incurred regardless of the volume.

In real organizations, managerial accountability rarely is implemented in textbook fashion. Managers get mixed messages when they are given resources. They may be promised operating freedom but find that their budgets are hedged with all sorts of well intended restrictions (to guard against corruption or mismanagement), but the result is that they are

not really free to manage. They may be promised a certain volume of operating resources for each of the next several years, only to find that funds are cutback whenever the government is pressured to reduce the budget deficit; they may be given arbitrary budgets that are set without regard for the actual cost of producing the specified outputs; they usually are given fixed budgets that do not vary, even when the volume of outputs produced is driven up by exogenous demands.

Managerial incentives may also be weakened by the failure of government to use available performance information. It is not uncommon for managers to take special care in developing performance data only to find that the material is not used in allocating resources or in making other operating decisions. Managers who are turned on when a new performance-based system is introduced turn off when the information goes unused. There are many different ways of using performance information. Table 5.5 arrays the principal uses in a sequence from the least impact on decisions to the most. The last entry on the list—performance budgeting—indicates how far governments must go in transforming public expenditure management to optimize operations. A true performance budget is a variable budget. Introducing variable budgets in the public sector is a challenging task because (a) appropriations are legally fixed limits on expenditure, (b) few governments have reliable accounting systems for apportioning costs and for distinguishing between fixed and variable costs, and (c) managers rarely have sufficient operating authority to control costs as the volume of outputs varies. In government, the near-universal practice is to authorize fixed budgets that do not vary with changes in the volume of outputs. The major exception occurs when organizations are voted net appropriations which permit them to spend certain self-generated money, such as revenue from user charges. Efficient firms, by contrast, have variable budgets, which distinguish between fixed and variable costs.

Giving managers operating freedom would require, among other things, abandoning government-wide civil service systems and much greater use of temporary, seasonal, and part-time workers who can be hired or sacked as work levels rise or fall.

Incentives for operational efficiency also depend on advances on the accountability side of the equation.

Table 5.5: Using Performance Information to Improve Operations

Activity	*Purpose*
Performance Measurement	Provides basis for specifying expected performance and assessing managers and their organizations.
Performance Targets	Notifies managers of the specific results they are expected to achieve and establishes basis for assessing their performance.
Performance Reporting	Compares actual and targeted performance, with explanation of significant variances. Makes performance transparent and provides citizens/customers basis for judging the volume, quality, and cost of services.
Performance Auditing	Independent assessment of the reliability and relevance of performance reports.
Performance Benchmarks	(a) Provides basis for comparing performance with results achieved by other public or private producers; (b) Sets performance targets in reference to results achieved by most efficient producers.
Performance Contracting	Formal agreement between the government and internal or external providers setting forth amounts to be paid and outputs to be supplied.
Performance-Based Pay	Links all or a portion of a manager's pay to performance.
Performance Budgeting	Allocates resources on the basis of expected performance, with each increment in resources linked to a specified increment in output.
Variable Cost	Costs that vary with the volume of output, in contrast with fixed costs that are incurred regardless of the volume.

Governments must establish challenging performance targets, monitor compliance, and intervene to reward successful performance or to penalize inefficient managers. Although some progress has been made on this front, governments generally have found it much easier to divest input controls than to vigorously enforce accountability.

Summing Up: Pathways to Operational Efficiency

There are many routes to improving operational efficiency, but few shortcuts. Governments seeking rapid progress in this area of expenditure management would do well by beginning with an assessment of their current control systems. If, as often is the case in developing countries, departments are operating under the burden of externally imposed and enforced controls, the government should assess not only the compliance costs, which are likely to be substantial, but whether departments actually comply with the rules. Have departments accepted the rules as fair and workable, or do they regularly ignore or evade the rules? In managing human resources, as well as in managing public money, do departments accurately record transactions, or do they deliberately and repeatedly miscode information? Answers to these and other questions provide vital clues in gauging a government's readiness to switch from external to internal control. The efficacy of every internal control system depends on ingrained habits of abiding by rules, perhaps not in every case, but in almost all. Without these habits, internal control systems would not be reliable, and governments could not have confidence in the information supplied by their spending departments.

Internal control is the bridge between external control and managerial accountability. Moving to internal control is no small feat, for it reduces compliance costs, and bolsters the capacity of departments to manage their own affairs, without having each of their actions reviewed, and possibly vetoed, by central controllers. Once internal controls are in place, the role of central controllers is transformed from preauditing transactions to auditing systems. Each department maintains its own systems (for civil service, expenditure, procurement, information management, etc.) subject to government-wide standards. In auditing systems to ascertain compliance with these standards, central agencies typically sample a small number of transactions to determine whether the systems work according to blueprint. For the most part, however, departments manage their own operations.

Yet from the perspective of line managers, the shift from external internal control often is hardly noticed. The controls seem to be as onerous as before, and compliance as rigidly enforced. The reason for this is that in shifting to internal control, the controls previously exercised by central agencies often migrate to department headquarters. For managers hobbled by command and control public administration, it makes little difference whether the detailed rules are enforced at the center of government or at the center of their own department. In either case, compliance is the order of the day, and considerations of performance fall into neglect.

Managerial accountability liberates managers from the straitjacket of one size fits all rules and procedures. In gaining new operating freedom, however, managers are made to abide by tougher, more transparent performance requirements. Expected performance is targeted in advance, and actual results are compared to the targets. In some venues, detailed performance contracts are written and government is restructured to give it greater opportunity to purchase services through market-type competition between in-house and external suppliers.

Managerial accountability systems are still in their infancy; the oldest were established in the late 1980s or early 1990s. There is reason to believe that these systems have improved operational efficiency by reducing compliance costs and giving managers strong incentives to be more efficient. Countries that have gone down this path give no evidence of backsliding. In fact, the Labour Government elected in 1997 after 18 years of Conservative rule, has retained, and in some cases deepened, most of the managerial reforms it inherited.

Should developing countries start down this path as a means of improving public services and making operations more efficient? The answer depends not on the attractiveness of managerial accountability systems but on the robustness of current control systems. A government that has reliable internal control systems in most departments may be a suitable candidate for giving managers broad discretion. But a government that has not yet reached this stage of development would be advised to build sturdy control systems before

venturing to the difficult and risky task of managing on the basis of outputs rather than inputs. ❧