Chapter 16. BUDGETING REFORMS IN OECD MEMBER COUNTRIES

By Jim Brumby

A. INTRODUCTION

While OECD countries differ in the magnitude of their budgetary problems and the timing and comprehensiveness of their responses, there has been increased acceptance by governments that the structure of the budget process and institutions influence budgetary results. Institutional reform is now seen generally as a necessary condition for the achievement of durable budgetary conditions. This should come as no surprise as it is now well-recognized generally in economic and institutional analysis that the "rules of the game" do shape the nature of decisions taken. By managing the institutions of budgetary control and management, we shape the rules of the game and by implication, the outturn of the game. It is noteworthy that the most comprehensive budgetary reforms have been in countries that experienced serious budget deficits during the economic slowdown earlier in this decade. Those countries that moved early with reforms are reporting positive feedback, and more member countries are moving in this direction. Much of the modern reform in the nature of the budgetary systems has thus been concerned with changing "the rules of the game" to reduce the likelihood of systematic biases for poor fiscal outturns. This paper starts with a brief examination of the generic problems associated with aggregate expenditure management and the management of the public sector in OECD countries.

The chapter then moves on to survey recent developments in budgetary management in OECD countries, and then surveys recent developments in budgetary management in OECD countries. In doing so, it will focus particularly on the following major developments:

Jim Brumby heads the Budgeting and Management Division of the OECD Public Management Service. This paper is drawn in part from two member OECD sources.

- Institutional requirements for fiscal responsibility;

- The shift to a more multiyear focus;
- Top-down budgeting techniques;
- The relaxation of input controls;
- The use of output based accountability regimes; and
- The introduction of accrual accounting and budgeting systems.

The paper concludes with a discussion of earlier budgeting reforms in OECD countries and how the current reforms relate to them. Two disclaimers are very important at the outset. First, reforms in OECD countries have been designed to deal with particular problems in these countries, and are unlikely to be applicable to problems of developing countries and transitional economies. Second, even when the problems are relevant, developing countries may not have the administrative capacity or other pre-requisites needed for the effective introduction of these reforms.

B. PROBLEMS OF AGRREGATE FISCAL MANAGEMENT

There is abundant literature on how various institutional features of decision making may give rise to what could be called an excessive level of government spending. These features can reasonably be summarized as "the tragedy of the common." In this well-documented case the individual interest of the participants conspire to produce a loss to all which comes to light through time.[1] The problem is that no one gains individually by self-restraint. In expenditure management this suggests that sectoral or individual political or economic interests can be promoted with little concern for the aggregate position. Only the Finance Minister has an interest in the protection of the whole, and this may or may not be valued by the Prime Minister and the electorate, depending on their own views concerning their particular risk exposure to the aggregate budget. This creates room for opportunistic behavior.

There is some evidence to suggest that there is a kink in the way economic actors evaluate gains and losses: they dislike losing a certain amount more than they

[1] More formally, the model of "the common" relies on two noteworthy features: first, only those that use the common are affected in proportion to how much they use it; and second, the costs of using or overusing the common is in the same currency as the benefit (T. Schelling, *Micromotives and macrobehavior,* Norton, 1978, pp. 112—113).

would value a gain of the same amount. Thought of in terms of collective decision making, this suggests that there will be accretion or a bias for upward movement in the spending line, not necessarily matched by taxes. Participants will never agree to a reduction, but will always pursue an increase.[2]

The decision-making problem is not helped by some systemic features of traditional public management which also add to the likelihood of upward bias. These features include:

- Poorly developed product markets for public services, making the public sector a monopoly supplier, with tax-supported expenditure being a captive purchaser;
- Nonexistent control markets, making public-sector supply immune to market-based monitoring and pressure;
- Complex, incoherent, or unstated goals, making allocation to the highest value very hard to determine, with this difficulty often compounded by unclear accountability after the fact;
- Limited authority being passed down the line to where information is more complete; and
- Unequal access to information, placing higher decision making at a severe disadvantage relative to lower.

At various speeds, from different starting points, most OECD countries are considering introducing or have introduced large-scale reforms to deal with some or all of these problems. This has been a profound aspect of late-20th-century governance. And more and more, a transnational interest in these issues is being seen.

Global commercial liberalization and the free flow of capital are exerting new pressures on systems of public governance. Recent experience shows starkly that the quality of public institutions and the trust in which they are held by economic players

[2] In addition, expenditure increases typically benefit a specific group (significant enough to mobilize political support), while the implied tax increases are distributed imperceptibly across the whole population.

can have very demonstrable effects on the behavior of these markets. Public-sector governance systems that induce loss of market trust impose costs not only directly on their domestic economies, but more generally as they reduce global growth rates below potential.

While many of the features of the responses required to deal with the Asian crisis are outside the scope of this paper, they are operating in a way that is consistent with the direction of the changes in budgeting and management systems. These changes deal with the three tiers of efficiency associated with budgeting and management systems:

- The general call on resources made by the public sector (aggregate allocative efficiency);
- The ability to direct resources to where they will be most beneficial (allocative efficiency); and
- The technical efficiency associated with producing—or having produced on behalf of the public sector—specific goods and services (technical efficiency).

C. INSTITUTIONAL REQUIREMENTS FOR FISCAL RESPONSIBILITY

It is difficult for a government entity to commit credibly to a course of action, because it has the means to change its mind and to put this change into effect. A number of the new fiscal frameworks, whether legally based or relating to a political commitment to a rule of thumb, have been designed to increase the credibility of the commitment by government to a course of action. The basic idea here is to create rules and mechanisms that impose a cost on government for deviating—or at least, capriciously deviating—from a course of fiscal responsibility. Once the government can commit credibly, it means that it can strongly influence expectations through signaling and communication.

There have been two particularly noteworthy innovations in fiscal frameworks associated with building in credibility in commitment:

- Establishment of medium-term budget targets; and
- Requirements for transparency and timeliness in financial reporting.

The global fiscal targets incorporated in the Maastricht Treaty as convergence criteria for EMU are a clear example. These requirements have given targets both a multilateral character and a higher intensity of obligation by creating a peer group of countries with common objectives. Most EU countries now refer to the Maastricht criteria as their primary aggregate fiscal goal. It seems that these have served as a particular incentive for fiscal consolidation in countries with significantly higher deficit and debt levels than the Maastricht criteria. There can reasonably be debate about the durability of this mechanism and the aptness of the targets so far chosen. But what we have already witnessed is quite formidable. Fiscal rectitude has generally entered the objective functions of the EMU and potential EMU countries, to a degree not seen before. Especially for the smaller EMU countries, the Maastricht targets and the conditions of EMU continuation provide very compelling reasons for ongoing prudence. The common currency area brings forward the benefits of fiscal consolidation to these countries.

The U.S. has made legislative change over more than ten years in support of budget deficit reduction. The Gramm-Rudman Hollings Acts of 1985 and 1987, the Omnibus Budget Reconciliation Acts of 1990 and 1993, and the Balanced Budget Act of 1997 have been the main legislative frameworks.[3] The latest budgetary rules have proved successful in controlling discretionary spending by setting caps on government investment and consumption. If the annual appropriation bills exceed the caps, the law invokes an automatic sequestration, which means across-the-board cuts in discretionary spending. While the caps have been amended annually, real discretionary spending has fallen every year since 1991.

The Swiss government has proposed that its fiscal consolidation target be enshrined in the Constitution. The new constitutional clause would set the authorized

[3] Most observers consider the Gramm-Rudman Hollings Act ineffective. This view is supported by the vast increases in the central budget deficit until 1993, despite their existence.

deficits for coming years. Should these objectives not be achieved, a mandatory procedure would be set in train, requiring savings to be made based on financial priorities. It has still to be presented for approval by the Parliament, the cantons, and a public referendum.

New Zealand has adopted a different legal track for fiscal consolidation objectives through the Fiscal Responsibility Act of 1994. This law states principles of responsible fiscal management and transparency on key budget parameters and other aggregate fiscal reports. The important mechanism operating here is that governments have to explain the policy rationale behind five crucial fiscal indicators. The fact that they have to do this repeatedly builds in commitment. When they deviate from a policy that is consistent with the achievement of the indicators, the government is required to explain its track back to meet the objective.

The Australian Charter of Budget Honesty also aims to increase transparency in fiscal policy making and fiscal results. A notable feature it shares with the New Zealand approach is the requirement to publish a set of fiscal updates prior to all elections to prevent governments from withholding information on the true fiscal position. This produces a number of desirable features—including sharing a common economic and fiscal outlook in the election debate and preventing a newly elected government from being "shocked" at the state of finances. The U.K. has recently announced a Code for Fiscal Stability, which has a number of features that are quite similar to the New Zealand law. This code includes adherence to "the golden rule," targeted debt, and real operating expenditure levels.

The golden rule in this context specifies that over the cycle the government will borrow only to invest and not to fund current expenses (including depreciation and maintenance). The German golden rule—which is embodied in article 115 of the Constitution—states that in any year, government lending must not exceed government investment expenditure, except in circumstances of a "macroeconomic disequilibrium."[4] The United Kingdom's golden rule differs from the German one by allowing deficits to

[4] The German golden rule refers to investment in budgetary terms that differs from the national accounts definition in a nontrivial way.

exceed investment in any specific year as long as the rule is fulfilled over the course of the economic cycle. On the other hand, it is stricter by referring explicitly to net instead of gross investment. The Japanese golden rule is institutionalized by the virtual separation of government "deficit bonds" from government "construction bonds" and the aim of limiting government borrowing to construction bonds only in the medium term.[5]

The advantages of a golden rule are twofold: it puts a limit on the scope for government lending, and it does not prevent beneficial government investment from being undertaken. The underlying idea of the rule is that government investment generates a future stream of income and/or services that justifies the allocation of some of the expenditure to the future. However, a golden rule does not rule out government borrowing to finance even investment projects with low economic or social returns. In any event, the golden rule appears to have some appeal to policymakers; since 1970 both the German and U.K. versions of the golden rule seem largely to have been fulfilled for many OECD countries on a national accounts basis, and indeed also for the OECD as a whole.[6] Adherence to the golden rule, however, does not rule out fiscal stress unless governments also commit to a funding constraint—usually captured by a net or gross debt target. General government-sector capital expenditure may produce positively returns from projects from an economic perspective, but these returns are not necessarily captured by the government as a financial entity.

There can be a risk that high-profile capital and operating spending targets, and targets for deficits and debt can lead to an inappropriate recourse to nonspending interventions. There is evidence for some countries that during the 1990s parts of the social agenda have been shifted onto off-budget mandates—in particular, regulatory activities and targeted tax relief. The economic costs of such measures are often not as transparent as financial costs associated with budgetary mandates. Similarly, in the

[5] The Fiscal Structural Reform Act of 1997 states that the current budget of central and local government should balance by FY 2003 (later amended to FY 2005).

[6] This applies if borrowing were allowed to cover a broad range of capital expenditure. If based on a more narrow capital expenditure definition, i.e., government fixed investment only, net lending of most member countries would have surpassed their golden-rule level on the average during the past 25 years.

absence of a robust accounting system and method, hard targets for one sort of expenditure can lead to pressure on the classification system.

D. THE SHIFT TO A MULTIYEAR FOCUS

By their nature, the “rules of thumb” and legal frameworks referred to above include an intertemporal perspective. By bringing into play the “through-time” dimension, decision makers are forced to consider issues of sustainability, and rates of deterioration and consolidation. It also means that the policy implications for aggregate spending level have to be integrated with aggregate tax and debt planning.

It is hard to be credible when putting forward a fiscal policy that is not sustainable. This is not to say that it is not possible, just that the credibility will require very careful explanation. The medium-term focus, of itself, redresses some of the natural focus of politicians and tends to place a new test of credibility onto their reputation and functions. It brings into play today the relative harvesting or stewardship of the common referred to at the outset.

As discussed at length in chapter 4, multiyear planning and forecasting serves to increase the fiscal discipline by setting overall fiscal policy objectives, showing the minimum costs of continuing existing policies through baseline projections, and illuminating the full-year budget implications of decisions in following budgets.

As noted earlier in this book, a multiyear perspective in setting budgetary policy serves to restrain demands at the start of budget process. They serve notice to politicians, interest groups, bureaucrats, and other claimants for public funds that there are clearly set limits to the responsiveness of government to their demands. In most countries, political leadership and public support have been a critical factor in governing these global targets. To serve their intended purpose effectively, they are generally expressed in aggregated terms capturing either future fiscal trends or the direction the government plans to go. They are not detailed qualitative statements of intent. The global targets used in member countries can be grouped into three categories as follows:

- Ratios (usually expressed as a percentage of GDP). The ratio may relate to the level of the budget balance, revenue or expenditure, public debt, or government borrowing.
- Rates of change in revenue or expenditure.
- Absolute values for the target variable in nominal or real terms. These targets may be expressed as the future level of expenditure or the deficit, or as the amount of desired change from previous baseline projections.

The key tension in determining medium-term targets is to provide enough *stretch* so as to produce change, on the one hand, while being sufficiently attainable to be *credible*. Sweden applies the following four criteria in determining appropriate targets. The targets should:

- be difficult to manipulate;
- involve a political cost to deviating from them;
- be sufficiently flexible to allow the fiscal policy to deal with the cycle; and
- be easy to communicate to the public.

Yet these medium-term frameworks have also encountered a number of methodological problems, including the following:[7]

- A tendency to overestimate the growth potential of the economy. In some cases this has created the illusion that additional resources were available in the forecasting period and created an upward impetus for public expenditures.[8] "Prudent" or "conservative" economic assumptions have now become the dominant feature in a number of countries so as to avoid this problem. It can be questioned whether a precommitted bias for underforecasting growth itself can deliver the benefits sought, as decision makers would be expected to undo the bias. A more durable practice would

[7] "Multi-year budget forecast," *Budgeting for the future,* OECD, PUMA/SBO (96)3.

[8] Evidence is found in the experience of Canada, Finland, France, and the United States (see "Managing structural deficit reduction, OECD occasional paper no. 11, 1996).

involve the use of the best available or best professional forecasts, thereby separating the interests of the technicians from those of the politicians.

- Some ministries have viewed their numbers in the forecasting period as a commitment from the center to a certain level of resources. This has made changes in existing policies difficult and created a bias for their perpetuation, even in the event of a negative shock.

- The focus on medium-term fiscal objectives could contribute to postponing or undermining pressing short-term consolidation decisions. It is even possible that medium-term forecasts can give the illusion of more fiscal room when demographic conditions are expected to become more benign in the medium term prior to deterioration.[9]

For the EU countries a number of medium-term reporting requirements are embodied in the Maastricht Treaty and the Stability and Growth Pact.[10] Since 1993, EU member states have been obliged to publish medium-term convergence programs regularly, with the programs being scrutinized by the ECOFIN council. Members of the EMU are obliged to submit every year a “stability program” containing medium-term projections for government deficits and debt covering at least the following three years, their main assumptions and a description of budgetary measures being taken—or proposed—to achieve the objectives set forth. In the case of major budgetary measures, an assessment of their quantitative effects on the budget position should be provided. Finally, sensitivity analyses of how changes in the main assumptions might affect the budgetary and debt position are required. The stability programs are key elements of the “early-warning” procedure of the Stability and Growth Pact in which the Council can make recommendations for member states to take corrective actions in the event of actual or expected significant deviation from the medium-term budgetary objective or the adjustment path toward it. Member states outside the euro area will continue to submit convergence programs, which—unlike the stability programs—

[9] This was noted in the OECD’s report *Maintaining Prosperity in an Aging Society.*

[10] Some EU countries, for instance, the United Kingdom, Sweden, and Denmark, also publish medium- and long-term fiscal strategy reports on their own.

should contain medium-term monetary objectives and their relation to price and exchange rate stability.

Most countries outside the EU also publish medium-term fiscal strategy programs containing, to a varying extent, the same sort of information as the stability programs. For instance, New Zealand publishes an annual Fiscal Strategy Report, Australia a Fiscal Strategy Statement, and the United States an Economic and Budget Outlook. Some others prefer not to announce medium-term fiscal targets. In Canada, a two-year fiscal planning horizon has replaced previous medium-terms plans, as authorities there concluded that a short-term focus would be more appropriate in dealing with consolidation. They argue that a medium-term view is not necessarily helpful in achieving the goals of visibility and public support. Furthermore, most OECD countries publish an extensive amount of information related to the current and coming year's budgets (prebudget reports, financial statements at the time of the budget, fiscal updates during the year, etc.). In the Netherlands, the independent Netherlands Bureau of Economic Policy Analysis publishes a pre-election analysis of the estimated effects of economic packages proposed by the different political parties. Perhaps this is a practice that may spread.

The use of long-term budget forecasting has not been as widespread nor as uniform as the medium-term planning and forecasting. Long-term forecasts covering 30—40 years have been prepared in countries such as the United States, Australia, New Zealand, and Denmark, mainly to capture the impact of changing demography on budgets—as the aging of populations is by far the greatest single influence on the expenditure trend facing government. By their nature, long-term forecasts tend to be indicative rather than predictive, with projections for future economic activity being susceptible to wide variation.

Several countries, including the United States, Norway, and New Zealand, have also prepared generational accounts to assess the long-term implications of current policies and their effect on the distribution of cost and benefits across generations. Such accounts, however, are subject to a number of severe measurement and methodological problems which have raised some skepticism as to their informational content.

E. TOP-DOWN BUDGETING

Another important development has been to split up various components of budget decision making, and make more formal the interactions between these components. This is based on the view that separate consideration of budget aggregates from sectoral aggregates and then sectoral aggregates from program allocations can increase the hardness of the budget constraint. It means that the systematic bias for creating demands for additional spending can be constrained through cascading commitments to hard budget constraints. Again, this is essentially a commitment device, which can be used like a two- or three-level game, where the goals of coordinated action are ranked more highly than individual goals.[11]

The fact that the visible costs of renegotiating any higher-level commitment are high means that they have credibility, and actors at lower levels will see this and accept the hardness of their constraints. Positive incentives for budget-reducing behavior can give this technique even more credibility—this would involve measures such as promoting bureaucrats and ministers who are seen to be budget reducers rather than budget maximizers.

Such top-down spending controls are being applied by a significant number of countries to varying degrees. They place an upper limit on the spending expectations of ministries. New expenditure demands are sometimes funded by a combination of across-the-board cuts or targeted cuts. Many countries have shown a preference for applying targeted cuts rather than across-the-board cuts. This approach should allow resources to flow from less-valued to more-valued areas and act to encourage ministries and agencies to establish their own spending priorities and seek out productivity gains. Evaluations have played a role at this level and within sectoral

[11] See, for example, Robert D. Putnam, "Diplomacy and domestic policy: the logic of two-level games," in P.B. Evans et al. *Double-edged diplomacy,* University of California, 1993, pp. 431—468.

allocations. But generally the higher-level allocations are about preference revelation and involve political signaling.

Canada, Sweden, Norway, Iceland, the Netherlands, Finland, and the U.K. have continued their top-down budgeting systems. The *frame budgeting system* in the Nordic countries, consisting of an initial policy decision by the Cabinet to lay down an expenditure frame for each ministry for the coming year, has done much to restrain demands for new expenditures and has helped to reduce the stock of existing expenditure programs to make way for new ones. France has also followed this new budgetary procedure, using a preparatory ministerial meeting for overall mandates to ministries to establish itemized budgets.

The reinvention of the budget determination process into split-level games has also involved the legislature. A number of countries involve the legislature in agreeing to the aggregates and accepting that consideration of the detailed estimates will be done on the basis of these aggregates. This makes the commitment even more credible at the executive level, and removes another potential avenue from ministries seeking increased resources.

There is a trend also for the legislature to split consideration of the budget—with the aggregates being considered by the economics/finance/budgeting committee, and the program allocation being considered by the sectoral committees. This appears to work well with the specific interests and specialties of the sectoral committees being able to challenge allocative decisions, but within the context of the hard constraint.

F. RELAXING INPUT CONTROLS

Of course, the central budget office is not all-knowing. It does not have the information available to make lower-level allocative decisions. Attempts to get the information can prove very costly. And a failure to provide managers with discretion over the use of their budget-constrained resources—while preventing some forms of opportunism—may induce higher economic costs than necessary as blockages prevent funds from flowing to where they are most valued.

Many countries are responding to these problems by giving agencies greater freedom in operational decisions. Consolidation of appropriation line items into less detailed appropriations and the devolution of resource allocation decisions to ministries and agencies have been increasingly common. Many countries including Australia, New Zealand, Sweden, and the U.K. allow almost complete discretion in spending within aggregate limits on running costs. The devolution of central control on running costs is generally accompanied by strict restrictions to keep their rate of increase below the rate of inflation. The main restrictions on the use of flexibility still in place concern the number and remuneration of senior officials. France still maintains separate controls on personnel, but these may be eased as reform progresses. There are often restrictions on transfers between programs and running costs so as to ensure that focus is kept on managing the efficiency of running costs.

Shifts between fiscal years have been liberalized by permitting ministries and agencies to carry over unused funds to the following year and, in some cases, to prespend a portion of the next year's budget. These changes have been made to reduce incentives for end-of-year spending splurges and to limit poor resource use as a result of arbitrary time-lines.

An important aspect of the incentives regime is that future indicative funding levels are not reduced by underexpenditure in a previous year. Typically, the amount that may be carried forward or prespent is limited to a certain percentage of appropriated funds, or running-cost funds. Not surprisingly, the tests to carryover to the future or draw down from the future are asymmetrical—with tougher tests being employed to control drawdowns. In several countries, incentives are also increased by allowing agencies to earn interest on funds carried forward and charging interest on prespent funds.

Another arrangement providing greater flexibility is the introduction of net appropriations which allow ministries or agencies to retain all or some revenue raised from user charges, even in tight budgetary situations. This is designed to reward successful organizational effort at revenue collection. Concerns have been raised about a weakening of spending control of the Parliament and the central budget office. In some countries, net appropriations also provide the means to give an incentive for the identification and sale of surplus assets. Agencies may be credited with all or a portion of the proceeds from asset sales, rather than these going entirely to the central budget. In such cases, it is important to be clear over which assets can be controlled fully by agencies and those over which the agency has only limited rights.

The OECD has recently commissioned a study on the relationship between increased managerial flexibility and aggregate fiscal outturn.[12] The argument here is that the more responsive the movement of resources at the line-management level, the less pressure is placed on spending caps and the more likely fiscal consolidation exercises that rely on reductions in spending will be successful.

This study investigates cases of fiscal consolidation from 1986 to 1997, across nine countries. According to a standard definition of success (broadly two successive years of deficit improvement or a debt reduction in the second year after the consolidation exercise), there were 22 successful cases and seven unsuccessful cases.

The study shows that consolidation efforts in countries with high managerial flexibility are less likely to fail than in countries with low flexibility. All stabilization efforts in countries with high managerial flexibility were persistent; seven of the 17 episodes in countries with low flexibility were short-lived. This is shown in table 1.

Table 1. Managerial Flexibility and Consolidation Success

	Low	**High**
Unsuccessful	7	0
Successful	10	11

[12] R. Strauch, *Managerial flexibility and fiscal performance,* OECD (forthcoming).

Note: The exact Fisher test allows rejecting the hypothesis of independence at a significance level $p < 0.05$

G. ACCOUNTABILITY FOR RESULTS

The quid pro quo for the relaxation of input controls and increased flexibility for managers is that they be held accountable for results. Instead of controlling inputs, the focus is now on outcomes and outputs. Most countries have put considerable emphasis on developing performance indicators, and many of their annual reports and budget documents contain an extensive range of performance information. Chapter 15 discusses these issues at length. This section presents some observations from the experience of OECD countries.

Contractual arrangements have been developed as a tool to specify expected results and to assign accountability as a way of increasing performance in the public sector. The traditional idea of the purchaser-provider contract is being broadened significantly to include budgetary agreements between the central budget office and spending ministries, and even within ministries between ministers and chief executives. The UK and New Zealand have made widespread use of contractual arrangements on performance between ministries and agencies. Australia has developed resource agreements between the Department of Finance and individual departments or agencies. Most resource agreements pertain to running costs, but some deal with program expenditures. Many agreements link resources provided including funding levels, additional money for investment, retained user charges, and outputs or outcomes.

There are two main issues to be confronted in developing performance indicators or performance orientation. These are the technical problems associated with developing indicators that are meaningful, and secondly the manner in which the performance orientation is integrated with the resource allocation process.

The mere name—"indicators"—suggests that such performance information is not seen as complete, but that it generally represents aspects of performance. It sounds partial and therefore subject to challenge. There are many illustrations of how a narrow range of measures can distort organizational behavior—a tax office that has costs per unit of tax collected may shy away from complex, costly tax evasion cases, thereby setting up a dynamic for evaders to need only to signal credibly that they have deep pockets for this purpose to scare away the tax collectors. Of course, these distortions can be expected to flow only if incentives are altered to reflect them, and this requires some degree of integration in either the resource allocation system or the personal performance management system, or both. In any event, just because such distortions may be visible does not mean they are greater than in a world with no indicators—it may be just that the previous distortions were less visible.

It is possible to become hung up on trying to develop performance measures at every step of the intervention process from the center. But the effort should concentrate on establishing information that is of use in decision making and that can assist the dynamic concern of efficient resource allocation. This means that the center should not expect to have an interest in numerous low-level or economy-type measures. Instead, it makes sense to focus on the performance of its main policy interests and allow dynamic institutional pressures to induce a cascading down of objectives and the natural alignment of lower-level performance information to these needs. For instance, contracting and costing on a competitively neutral basis, when there is a threat of changing suppliers, should induce the supplier to stay smart. Output-based performance information has the generally desirable characteristic that it relates to sets of direct personal or organizational responsibilities and resource allocation. An example is provided of the New Zealand system of output-based purchase agreements.

The ease of contractability for output performance is far from uniform. There can be a range of increasing complexity from tangible services (such as issuing licenses, passports: easy) to nontangible personal services (such as training and education: harder) to nontangible ideal services (such as policy advice: harder still).[13]

[13] See C. Pollit, *Integrating financial and performance management,* OECD (forthcoming).

But the yearning for contracts means that more thought is going into the risk characteristics of these sorts of outputs, with ensuing benefits.

As explained further in chapter 15, the trend in assessing wider organizational performance is to move to a balanced scorecard approach, picking up on dimensions of performance that are not captured in one-period output contracts, such as the ethical fabric of the workforce and the institutional capability of continuing to do the things government wishes.

Benchmarking is also being increasingly recognized as a useful tool for improving value for money by establishing performance targets in reference to the best practices identified in comparable public or private organizations.

H. ACCRUAL ACCOUNTING AND BUDGETING

The increased focus on results and outputs has led authorities to question the basis of the financial information provided about these outputs and results. More countries are seeking full cost information so that they can represent to citizens the full cost of service provision. Accrual accounting was discussed at length in Chapter 7. This section is limited to summarizing the situation in OECD member countries.

There are four broad groups of OECD country practice in relation to accounting.

- Only *four* member countries have adopted both full accrual accounting and budgeting practices, or have firm plans to do so in the very near future. Iceland and New Zealand have already done so, and Australia and the United Kingdom plan to do so.

- Another *four* member countries have adopted—or are in the process of adopting—accrual accounting principles for their whole-of-government financial reporting, but not budgeting. These countries are Canada, Finland, Sweden, and the United States.

- *Three* member countries have adopted accrual accounting standards on a pilot basis in a limited number of individual agencies: Germany, Ireland, and the Netherlands (Korea, too, has announced that it will take this path).

The rest of the membership has not yet started the journey. But some countries, such as France, are considering it very actively.

The author of this chapter believes that the general transition to accrual accounting is virtually unstoppable. The shift will be accelerated if financial markets begin rewarding countries for making the commitment to accruals. There is evidence in the U.S.A. that states using accrual information borrow more favorably than those states using solely cash accounting. We could expect a similar discipline to emerge at the national level. But it is important to remember that the shift to accruals does confront institutions and individual interests with change. It can dispossess information monopolists and unleash dynamic processes. For instance, once countries commit to agency or departmental accrual reporting, they set themselves on a journey, which logically can only stop at accrual budgeting and whole-of-government accrual reporting. This is irrespective of whether this was the goal when they set out. The U.K., Australia, and Iceland are providing evidence of this. And while New Zealand shifted in one step to accrual budgeting and reporting, the shift to whole-of-government accrual representation of the fiscal position followed later because it represented the only logical framework available. One of the surprises in New Zealand came when the financial markets happily agreed to the dumping of the traditional-format cash aggregates (the so-called "table 2 reports"). Discussions with financial market operators showed that they never had much confidence in the old cash data. While the trend to accruals may be unstoppable, the time taken to make the journey may be long in some jurisdictions. Some countries have argued that on a cost-benefit basis, that there are higher-rewarding reforms to make. But in some cases, it appears to be as much the appetite for change as an assessment of the costs of change.

I. EARLIER BUDGETING REFORMS

The paper concludes with a discussion of earlier budgeting reforms in OECD countries and how the current reforms relate to them.

The first major attempt at modern budget reform was what is interchangeably termed "program budgeting" or "performance budgeting."[14] It was fashionable in the early 1950s.

The essential elements of this reform were to describe the various activities performed by each government organization, to allocate total costs to the various activities, and to establish performance measures for the activities performed. As such, it mirrors some of the reforms being undertaken today in OECD countries.

Much was achieved in terms of annotating budget documentation with information about the activities performed. However, the reforms largely failed in regard to cost allocation and performance measurement. First, these were very novel concepts at the time and were poorly understood by the government organizations that were to implement them. Second, there were few discernible benefits from implementing the reforms. Third, the reforms involved a very serious burden on government organizations as accounting systems and performance measurement systems were quite primitive by today's standards. Although the objectives of these reforms and current reforms are largely aligned, today's reforms benefit from an increased understanding of the reforms by government organizations, outputs have replaced inputs as a control mechanism rather than being an additional control, and information technology systems have reduced the cost of the reforms.

The second large-scale budgeting reform was the Planning, Programming, Budgeting System (PPBS) that a number of OECD countries adopted in the 1960s. This was a very ambitious reform that sought to create better linkages between goals and objectives, programs and activities, and financial resources. The essential element of PPBS was to create an analytical capability to examine in-depth the objectives of government intervention and to examine competing ways of achieving those objectives.

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[14] Usually associated with the Hoover Commission "Report to the Congress on budgeting and accounting," 1949.

At the heart of PPBS was the use of cost-benefit and cost-effectiveness studies to compare the various programs and activities being considered as competing means of achieving a given objective. PPBS also sought to “ignore” organizational boundaries in the budget process and to extend the time horizon to five years rather than a single fiscal year.

PPBS proved to be difficult to implement. First, the role of politics in the budget process was not recognized. The political reality that government objectives and activities are compromises of differing value judgments was not sufficiently recognized in PPBS. Second, the usefulness and applicability of rational methods such as cost-benefit analysis and cost-effectiveness studies were exaggerated as government objectives and activities are so disparate and generally noncommercial in nature. Third, departmental boundaries, which PPBS sought to ignore, proved to be very resilient and a significant obstacle to the implementation of PPBS as originally envisaged. Fourth, PPBS required highly trained administrators to conduct the various analyses and studies, and they were in short supply.

PPBS made an important contribution to budgeting as it introduced various concepts from economics and the social sciences that had not been applied in budgeting previously. These concepts are used today, but on a case-to-case basis where applicable. PPBS was simply overambitious in trying to replace traditional budgeting with these techniques in bulk.

The last major budgeting reform prior to the current wave was Zero-Based Budgeting (ZBB), which was introduced in the late 1970s in OECD countries. ZBB required every cost item in a budget proposal to be justified and approved each year. Moreover, it required that all decisions be evaluated and ranked in order of importance based on systematic analysis.

ZBB proved to be short-lived. Many of the problems that confronted PPBS were also faced by ZBB. Moreover, annual review of all programs also proved to be too demanding. Considering the time constraint and the skills required to operate ZBB, this approach is useful for occasional expenditure reviews, but it would be impossible in practical terms to undertake a complete ZBB exercise each year for the preparation of the annual budget.

In many ways, current budgeting reforms can be seen as a continuation and adaptation of previous reforms rather than being a rejection of prior reforms. Previous reforms have generally had the same objective as current ones and have been steps along the learning curve.