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Budgeting for fiscal space and government performance beyond the great recession

by
Mario Marcel*

In the course of the prolonged economic crisis that started in 2008, fiscal space has become a scarce commodity in OECD countries. This has not only broadened the appeal of a concept originally raised by emerging countries in the early 2000s, but has also extended its meaning to recognise its intertemporal nature and to highlight its endogenous features. Current projections indicate that fiscal consolidation needs and the effect of demographic change on social security may shrink non-pension fiscal space in OECD countries by some 18% between 2011 and 2030, exceeding current consolidation plans in many countries. The response to these needs should take place increasingly through budgets rather than ad hoc consolidation packages. To this end, the quest for fiscal space needs to be mainstreamed into budgeting by developing appropriate tools and procedures; the effort needs to extend beyond the annual budget process both in timeframe and scope; and many actors need to contribute to this effort in addition to ministries of finance and budget offices. In other words, generating fiscal space at the required scale needs not only a substantial revamping of budget practices, but also revisiting the temporal and institutional framework within which budgeting takes place.

JEL classification: H50, H61, H83

Keywords: Budget practices, budget framework, economic crisis, fiscal space, fiscal consolidation, incrementalist, performance, recession

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1. Introduction

In the course of the prolonged economic crisis that started in 2008, fiscal space has become a scarce commodity in OECD countries. In response to strong external pressures, many European countries have embarked on tough austerity programmes, some of them under the surveillance of the European Commission (EC), the International Monetary Fund (IMF) and the European Central Bank (ECB). Fiscal consolidation in these countries may extend well beyond the current emergency, as debt service obligations reach new heights and the pressure of demographic change over pensions and health spending continues to build up. Elsewhere, countries that have so far postponed fiscal adjustment, like Japan and the United States, may need to address these issues if market or political tolerance to their fiscal imbalances dwindles in the future.

Fiscal consolidation may be necessary for macroeconomic and prudency reasons, but it also compromises governments' ability to respond to core public responsibilities and policy commitments. Fiscal consolidation is hard not only because it requires tough decisions, but also because it has potentially large social and political costs. Fiscal space is necessary to mitigate these risks. Fiscal space creates a buffer to respond to further consolidation needs and to safeguard funding resources for core government services and top policy commitments.

The growing need for fiscal space may explain why a concept that first emerged in developing countries in the early 2000s is now gaining so much attention in advanced countries. The notion of fiscal space was raised by emerging countries after the Asian crisis of 1997-98 to underscore the need to provide continuing funding for critical infrastructure irrespective of fiscal consolidation needs. To generate fiscal space for such investments, these countries proposed to exclude such investments from macroeconomic fiscal targets. Some international agencies, notably the UNDP, linked this discussion to the resources needed to meet the Millennium Development Goals (Roy et al., 2006).

At that time, the IMF defined fiscal space as "the room in a government's budget that allows it to provide the resources for a desired purpose without jeopardizing the sustainability of its financial position or the stability of the economy" (Heller, 2005). On this basis, it was argued that rather than manipulating fiscal aggregates, the main effort to generate fiscal space should come from countries themselves. In particular, the IMF encouraged developing countries to be proactive in generating fiscal space through tax reform and efficiency gains. In the end, while some developing countries did strengthen their tax systems, growth and higher commodity prices created sufficient fiscal space to increase public investment throughout the rest of the decade and the issue was not pursued further.[1]

Recent studies have applied the notion of fiscal space to developed countries to analyse how limited and elusive it might become as a result of worsening market conditions and demographic transition (Ostry et al., 2010; Park, 2012), concluding that these countries should develop strategies aimed at generating fiscal space. Thus, since its origins in the early 2000s, the concept of fiscal space has not only broadened its appeal to a larger set of countries, but it has also extended its meaning to recognise its inter-temporal nature and to highlight its endogenous features. This broadened notion of fiscal space may be then contrasted with the demand for the quantity and quality of public services in modern societies.

The notion that fiscal space is necessary to support priority programmes and respond to people's needs is, of course, not new to fiscal management. Fiscal space is an intuitive concept that is in the background of many dimensions of fiscal management. Fiscal space is a concern of fiscal authorities all over the world as they dedicate a substantial part of their time to assessing how much room they have available for new spending. Whenever budget officials revise cost estimates they are undoubtedly trying to generate fiscal space. However, these efforts usually take place in a rather incrementalist fashion and are integrated with spending decisions under the notion of "reallocation". The time constraints on these processes and the asymmetries of information that characterise them, however, may limit their ability to create fiscal space at the scale needed to deliver on policy commitments, especially when the latter is shrinking fast, as it may be happening in many OECD countries today.

Thus, what seems to be missing is a more systematic effort at assessing fiscal space and a set of tools to step up the efforts at generating it. As fiscal space becomes scarcer, it becomes more necessary to discuss the strategies and procedures to create it.

The fact that creating fiscal space requires some special effort in the budget process was the key message from a paper presented by Allen Schick to the Senior Budget Officials (SBO) network in the early stages of the great recession (Schick, 2009). While noting how the concern with fiscal space was bringing advanced and developing countries together, Schick argued that to address such concern, fiscal space should be enlarged incrementally and cumulatively over time. To this end, the protection and creation of fiscal space could be built into budgeting routines through a number of tests and tools. These included preventing back-loaded spending decisions, approving new spending on a pay-as-you-go basis, reviewing tax subsidies, imposing cross-cutting efficiency dividends, adding sunset clauses to spending programmes and performing across-the-board cuts, among others.

However, these mechanisms may fall short of the magnitude of the fiscal challenges that have emerged lately. This was recognised by Schick himself in a presentation to the OECD SBO meeting in 2012 (Schick, 2012), arguing on the need to move beyond business-as-usual in the annual budget.

This article is aimed at discussing how to generate more fiscal space in OECD countries while preserving a focus on results in public management. This connection between fiscal space and results seems necessary as the economic functions of the budget still need to be reconciled with its institutional and managerial functions. In fact, the inability to find the right balance between these functions in the current environment may be stressing budget practices in some countries as governments continue applying performance budgeting tools while at the same time implementing ad hoc spending cuts. The paper argues that budgeting is still the main field where fiscal space and the pursuit of results can be reconciled, but that in order to do so: i) the quest for fiscal space needs to be mainstreamed into budgeting by developing appropriate tools and procedures; ii) the effort needs to extend beyond the annual budget process both in timeframe and scope; and iii) many other actors need to contribute to this effort in addition to ministries of finance and budget offices. In other words, generating fiscal space at the required scale needs not only a substantial revamping of budget practices, but also revisiting the temporal and institutional framework within which budgeting takes place.

To this end, the next section elaborates on the factors and figures behind the quest for fiscal space in OECD countries, followed by a discussion of the tools and strategies to generate and allocate fiscal space outlined above. The final section of this article explores the analytical and institutional challenges of mainstreaming the generation of fiscal space into budgeting, followed by some general conclusions.

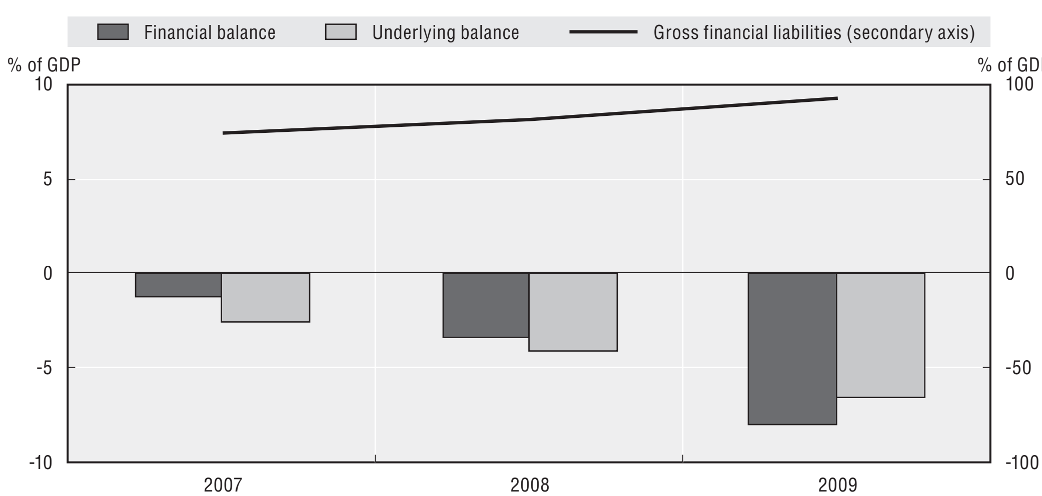
2. Desperately seeking fiscal space

2.1. Fiscal trends in OECD countries 2007-13

The economic crisis that started in late 2007 has imposed continuing and rather contradictory demands on fiscal policy in OECD countries. At the beginning of the crisis, when economic stability was under serious threat from the dislocation of financial markets, governments were called upon to implement expansionary fiscal responses. Many analysts, leaders and international organisations advocated for fiscal stimulus to cushion the impact of the financial crisis of 2007-09 on demand, output and employment. Many governments followed such directions, not only allowing automatic stabilisers to operate, but adding substantial stimulus measures. Overall, the underlying fiscal balances of OECD countries shifted from -2.6% of GDP in 2007 to -6.6% of GDP in 2009 (Figure 1). The resulting fiscal impulse of four percentage points of GDP over two years was unprecedented in its depth and simultaneity, as 25 out of 30 OECD countries reduced their underlying balances by more than 0.5% of GDP at the same time. Most of this change took place through spending increases, as a result of which the OECD average public spending to GDP ratio jumped more than 5% of GDP in the same period.

While many observers recommended a gradual unwinding of fiscal stimulus as the economy stabilised, markets started to react far earlier to fiscal imbalances and climbing public debt levels. By 2010, confidence on the sustainability of public debt began to erode,

Figure 1. **Financial balances, underlying balances and debt as a share of GDP (2007-09)**



Source: OECD (2012), OECD Economic Outlook, Vol. 2012/1, OECD Publishing, Paris, *http://dx.doi.org/10.1787/eco_outlook-v2012-1-en.*

hitting euro area countries particularly hard. Governments responded to these pressures with a turnaround in fiscal policy, reflected in fiscal consolidation plans. Pre-crisis profligacy, the stickiness of some stimulus measures, underlying fiscal pressures from demographic transition, the fiscal cost of financial rescues and the mounting financial costs from the loss of confidence in the euro, pushed consolidation plans beyond the withdrawal of previous fiscal stimuli. Between 2009 and 2013, underlying primary balances were expected to improve from -5.1% of GDP to -1.5% of GDP.

Thus, in a matter of only five years, fiscal policy has moved from a mild expansionary stance to a strong stimulus and then to tough fiscal consolidation, with primary public spending being the main tool for adjustment. In terms of fiscal space, many OECD countries used all their available fiscal space (and some went beyond it) in pursuing a countercyclical fiscal policy in 2007-09, to then shrink it under the pressure of markets. As a result, fiscal policy became persistently pro-cyclical.

2.2. The changing notion of fiscal space

Two observations are relevant to understand these overall trends; first, not all OECD countries have behaved in the same fashion in the course of the great recession and, second, the most important fiscal policy developments have taken place outside the regular budgetary process.

Differences in the trajectory of fiscal policy can be better underscored by pooling countries on the basis of their fiscal frameworks. To illustrate this we consider four groups of countries:[2]

- Group 1: Countries that experienced fiscal crises in the past, which may have led them to follow more conservative fiscal policies in the years prior to the financial crisis. This group includes Australia, Canada, Finland, Korea, New Zealand and Sweden.
- Group 2: Countries that have been under the greatest pressure from financial markets during the current crisis on the grounds of fiscal sustainability. This includes the countries that have been under IMF-EC-ECB programmes (Greece, Iceland, Ireland and Portugal) and those that are considered as candidates for support from the European Financial Stability Facility (EFSF) in Europe (Italy and Spain).
- Group 3: Other euro area countries (Austria, Belgium, Estonia, France, Germany, Luxembourg, the Netherlands and Slovenia).
- Group 4: Countries whose governments have been more isolated from sovereign debt markets on the basis of unorthodox monetary policies or by being able to tap into very long-term funding sources. This group includes Japan, Switzerland, the United Kingdom and the United States.

Table 1 shows that these groups differ not only in their standing prior to the financial crisis, but also in their behaviour throughout. In particular, we note that Group 1 (past crisis) countries started from a sounder financial position, with low levels of indebtedness and a positive fiscal stance that allowed them to pursue a countercyclical fiscal policy not only at the beginning of the crisis, but all the way to the end of it. This took place mostly through an increase in primary spending in 2007-09 that will only be completely withdrawn by 2012-13.

Group 2 countries also pursued an expansionary fiscal policy in 2007-09 – the strongest of all groups – but were unable to sustain it in the face of rocketing net debt

Table 1. **Past and expected fiscal behaviour of OECD countries by country groupings (2007-13)**

Percentage points of GDP[1]

Country groups	2007-09			2009-13e		
	Change in underlying balance[2]	Change in primary spending[3]	Change in gross debt[4]	Change in underlying balance[2]	Change in primary spending[3]	Change in gross debt[4]
Group 1	-4.08	4.17	7.78	2.37	-3.52	1.71
Group 2	-4.55	5.60	19.07	7.95	-5.14	13.41
Group 3	-1.91	5.05	14.21	2.85	-2.29	12.16
Group 4	-5.22	6.07	22.7	2.75	-2.87	24.21
Total	-4.33	5.64	18.70	3.32	-3.16	17.66

1. Group averages are weighted and refer to general government.
2. Underlying balances are adjusted for the cycle and for one-offs.
3. Primary spending refers to total disbursements, excluding net interest payments.
4. Gross debt data are not always comparable across countries due to different definitions or treatment of debt components. For more details, see *OECD Economic Outlook Sources and Methods* (*www.oecd.org/eco/sources-and-methods*). Group 1 countries include: Australia, Canada, Finland, Korea, New Zealand and Sweden. Group 2 countries include: Greece, Hungary, Iceland, Ireland, Italy, Portugal and Spain. Group 3 countries include: Austria, Belgium, Estonia, France, Germany, Luxembourg, the Netherlands, the Slovak Republic and Slovenia. Group 4 countries include: Japan, Switzerland, the United Kingdom and the United States.

Source: OECD (2012), OECD Economic Outlook, Vol. 2012/1, OECD Publishing, Paris, *http://dx.doi.org/10.1787/eco_outlook-v2012-1-en*.

levels. These governments have thus been forced to undertake the strongest and fastest spending cuts and to raise taxes, and still has not managed to stabilise debt by 2013, even after cutting spending below its 2007 levels.

The rest of the euro area countries (Group 3) adopted more cautious expansionary policies at the beginning of the crisis but have turned them into a mildly pro-cyclical policy after 2009. This may be explained by concerns of their exposure to market pressures, given gross debt levels that exceeded the European target of 60% of GDP in the five largest economies of the group.

Exposure to market pressures differentiates Group 3 countries from Group 4 countries. Group 4 countries started the crisis with relatively high levels of indebtedness (extremely high in the case of Japan) and increased it even further to execute a strong expansionary policy in 2007-09, especially in the United States. Fiscal consolidation in these countries was quite moderate to 2011 with some plans to intensify later, but without an increase in interest payments. In fact, interest rates were expected to remain very close to their 2007 level, even in 2013. The difference between these countries and those in Group 3 is illustrated by the fact that interest payments at the end of the period will be lower to the former despite a considerably higher debt to GDP ratio.

The differences in the fiscal trajectory of countries since 2007 may help understand how the notion of fiscal space has been adopted and shifted in OECD countries from its origins in developing countries in the early 2000s. While the concept of fiscal space had a rather structural and microeconomic nature when it was first proposed by emerging countries at the turn of the century, as explained above, OECD countries revived it with a more macroeconomic and long-term meaning in the course of the great recession.

In particular, fiscal space has been recently defined for developed countries as "the difference between the current level of public debt and the debt limit implied by the country's historical record of fiscal adjustment" (Ostry et al., 2010). This definition suggests some dimensions and determinants of fiscal space that were not evident in its origins. In particular, it stresses an intertemporal, medium-term perspective of fiscal space, and the notion that it may be affected by a number of factors beyond fiscal policy, including changes in current debt levels that do not respond to conventional fiscal policy, and tolerance to public debt that may change from one country to another as well as over time.

This concept may better suit the analysis of fiscal conditions in OECD countries in the last few years. In particular, it suggests that some countries undertook expansionary fiscal policies at the outset of the crisis by drawing on fiscal space that turned out to be smaller and more elusive than expected. Fiscal space was lost not only to expansionary fiscal policies, but also to governments' absorption of private liabilities through bailouts and the triggering of contingent liabilities as well as to changes in the willingness of markets to take on further public debt.

2.3. Managing fiscal space during the great recession

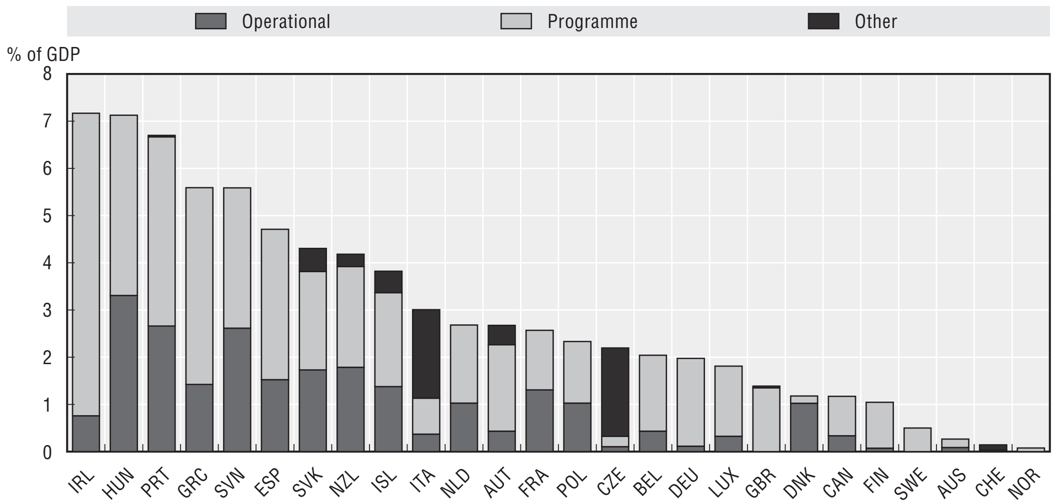
This brings us to the second feature of fiscal policy noted above, which is that since 2008 fiscal space has not been managed through the conventional mechanisms of budgeting but through the design and implementation of fiscal "packages". The latter were first conceived to stimulate the economy and later to consolidate public finances. A good example of the first is the stimulus package implemented at the beginning of the Obama administration in the United States (the American Recovery and Reinvestment Act, better known as the ARRA) that channelled nearly USD 500 billion[3] to a number of programmes selected on the basis of their ability to generate economic activity and jobs over a period of two years. Fiscal consolidation packages, on the other hand, have been frequent in countries that have sought to reassure markets through fiscal austerity. In the case of Spain, for example, three rounds of fiscal measures have been announced since the inception of the current Rajoy administration.

This is well reflected in the shape that fiscal consolidation has taken in many OECD countries. According to a recent OECD study (OECD, 2012d) at least 25 OECD countries have endorsed fiscal consolidation plans aimed at improving their underlying primary balance by 5.6% of GDP between 2009 and 2015. Of this, about half of total fiscal consolidation volume (2.8% of GDP) has already been implemented (between 2009 and 2011), with the remainder expected to be completed over the next three years. The average consolidation of the OECD area is calculated at 2.1% of GDP in 2012-13 and 0.7% in 2014-15. Most of the details of such plans have already been spelled out, with pending definitions in only 4 out of 25 countries.

About two-thirds of fiscal consolidation plans involve spending cuts, with the remaining third aimed at revenue increases. Figure 2 summarises the composition of spending measures. According to these figures, programme expenditure measures contribute to two-thirds of fiscal consolidation and operational measures one third.

In particular, most consolidation plans contemplate nominal pay freezes and a reduction in staffing levels through partial replacement of departing public employees. As for programme spending, the most-affected areas include welfare, health, pensions and infrastructure. This suggests that fiscal consolidation has been driven from the centre of government on the basis of across-the-board measures based on considerations of speed and effectiveness, rather than by a collegiate effort at rationalising spending. This may not differ substantially from the way in which stimulus packages were put together earlier on.

Figure 2. **Composition of fiscal consolidation packages through spending measures**



Notes: Expenditure measures announced by Korea, Turkey and the United States are not available. Operational measures announced by the United Kingdom are not available. Programme measures announced by Switzerland are not available. Estonia, Japan and Mexico did not apply any expenditure measures.
Source: OECD (2012), *Restoring Public Finances* 2012 Update, OECD Publishing, Paris, *http://dx.doi.org/10.1787/9789264179455-en*.

As a result of this approach, the true impact of fiscal consolidation on public service delivery will depend on the capacity of public organisations to adapt to a more constrained environment.

Additional evidence on recent changes in budgeting practices supports the idea that established public budgeting systems may have been of limited help in responding to fiscal policy needs. According to an OECD survey of 32 countries carried out in 2012, performance-based budgeting, which had been increasingly influential over the prior ten years, seems to have experienced a noticeable regression, with indicators and evaluations being less influential on central budget decisions than five years earlier (Table 2).

When focusing on how performance information is used in budget negotiations (if at all), 13 (40%) of the countries surveyed mentioned strategic planning/prioritisation, 15 (46%) setting allocations for programmes, 13 (40%) proposing new areas of spending, 12 (38%) setting allocations for line ministries/agencies and to reduce spending.[4] This represents a reduction in the use of performance indicators to influence budget decisions compared with 2007. The only issue where performance information appears to be used to a slightly greater degree is for setting allocations for line ministries/agencies (exhibiting an increase from 10 countries to 12). This seems to confirm the overall trend of concentrating the use of performance information at the line ministry and executive agency levels. A striking feature with regards to usage is that the number of countries who said they did not use line ministries' performance information in their negotiations with the central budget authorities increased from three in 2007 to nine in 2011 (Table 2).

While performance information remained relevant for management at the level of government agencies, central budget offices increasingly focused on spending reviews, presumably as guidance to savings and spending cuts. According to the same survey, 16 out of 32 countries use spending review in various forms (Table 3). Such reviews seem to be more widely used in Northern Europe and Anglo-Saxon countries than elsewhere. Of the 16

Table 2. **How is performance information generally used by line ministries in their negotiations with central budget authorities?**

	2007		2011	
For strategic planning/prioritisation	17	(57%)	13	(40%)
For setting allocations for programmes	..	..	15	(46%)
For proposing new areas of spending	14	(47%)	13	(40%)
For setting allocations for line ministries/agencies	10	(33%)	12	(38%)
To reduce spending	13	(43%)	12	(37%)
Not used	3	(10%)	10	(30%)
Number of respondents	**30**		**32**	

Source: OECD 2012 Performance Budgeting Survey.

cases, in 12 countries spending reviews cover both the purely budgetary appropriations as well as the funds appropriated in separate legislation, often in the form of social transfers. In four countries, only budgetary appropriations are examined, in ten countries the spending reviews only cover the central government and in six countries the reviews cover the central as well as the sub-national levels.

Table 3. **Countries that conduct spending reviews**

Countries	Number
Responded: Yes	16 (50%)
Australia, Canada, Denmark, Finland, France, Ireland, Italy, Korea, Mexico, Netherlands, New Zealand, Russian Federation, Spain, Sweden, Switzerland, United Kingdom.	
Responded: No	16 (50%)
Austria, Belgium, Chile, Czech Republic, Estonia, Germany, Greece, Hungary, Japan, Luxembourg, Norway, Poland, Portugal, Slovak Republic, Slovenia, Turkey.	
Lacking response	2
Iceland, United States	

Note: The Russian Federation is a partner country.
Source: OECD 2012 Performance Budgeting Survey.

These developments suggest two additional features of fiscal space in the recent experience of OECD countries. First, fiscal space is no longer sought as headroom to spend, but rather as a buffer to reduce the pain from fiscal consolidation. In this perspective, generating fiscal space may either increase the resources available for emerging needs once the current constraints start to ease, or it may help limit the damage of further cuts on priority programmes if austerity remains dominant.

Secondly, countries' responses to fiscal consolidation needs suggest that the conventional tools of budgeting have been incapable of supporting the type of swift fiscal decisions that have been needed in the last five years, either to expand or to contract public spending. This may be due to the continuing dominance of an incrementalist rationale, the procedural complexity of the regular budgeting process, the concentration of performance-based budgeting on indicators and monitoring rather than evaluation of efficiency and effectiveness, or to the fact that the fiscal year may have become too long to articulate fast policy responses.

The relevance of these features largely depends on the extent to which the current fiscal environment is expected to last. While anyone can understand that emergency situations may require exceptional responses in fiscal policy as well as in other fields, it is quite different to see the current turmoil as indicative of a more structural and lasting change in the framework to fiscal policy. If so, tools and techniques that dominated during the long economic expansion that preceded the financial crisis may need to be reformulated.

3. Emerging challenges for fiscal policy and budgeting

3.1. The continuing scarcity of fiscal space

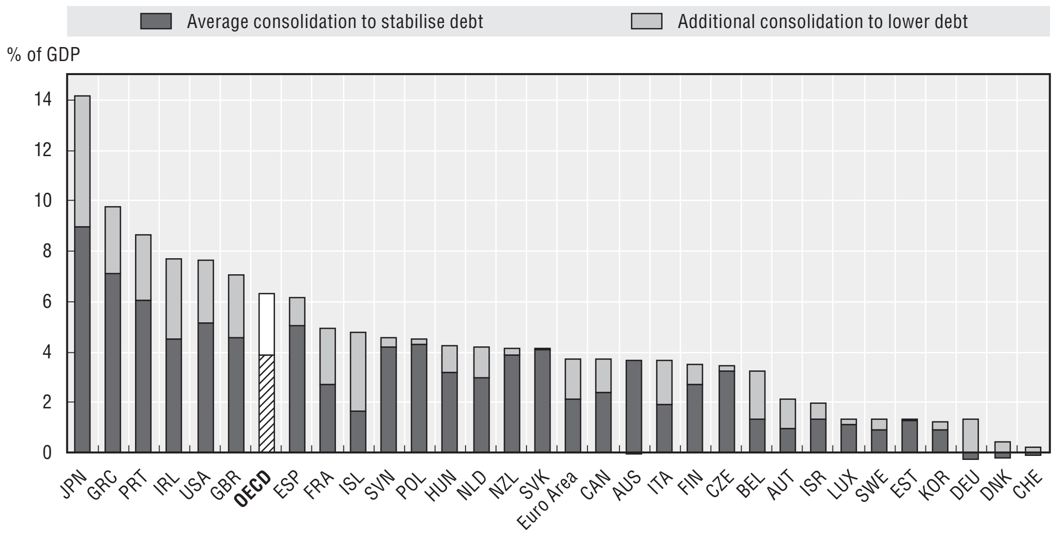
Fiscal constraints in OECD countries may not go away easily, even if consolidation plans are fully executed to 2015. In the case of the euro area, the treaty agreed in the March 2012 summit establishes a new institutional framework to enhance discipline and the co-ordination of fiscal policy in member countries, also called "fiscal compact".[5] This framework requires the budget position to be "balanced or in surplus in structural terms", be included in national law and be of "binding force and permanent character, preferably constitutional" (European Commission, 2011a, 2011b). Balance is achieved if the annual structural government deficit does not exceed 0.5% of nominal GDP. If a member country deviates from this rule, an automatic correction mechanism will be triggered. This target does not replace the Maastricht criteria that established a debt ceiling of 60% of GDP and a nominal deficit ceiling of 3% of GDP, that in the course of the crisis have been enhanced by establishing correction procedures.[6]

In the case of non-euro area countries, further action is expected from Japan and the United States, at least to move towards the stabilisation of debt ratios. In the case of the United States, an agreement to reduce the federal deficit should replace legislation mandating an across-the-board adjustment in spending in 2013 that together with the ending of transitory tax reductions amount to some 4% of GDP (the so called "fiscal cliff"). A series of deadlines for fiscal policy decisions have been sorted out by transitory agreements due to differing views on the conduct of fiscal policy. In Japan, a VAT was enacted to be introduced gradually over a three-year period, from the current 5% to 8% in April 2014 and 10% in October 2015, but this is still insufficient to stabilise the debt/GDP ratio. The new government that took over in 2013 has made fiscal consolidation one of its pillars for economic revitalisation but many concrete actions to stabilise the debt/GDP ratio still have to be taken.

Figure 3 compares the size of further consolidation needs with those already committed by OECD countries. Consolidation is estimated as the improvement in primary balances needed to deliver on two alternative benchmarks: i) stabilising debt; and ii) reducing debt to the euro area target of 60% of GDP.

As can be seen, consolidation needs to stabilise debt remain very large for most of the countries under IMF-EC-ECB programmes, as well as for Japan, Spain, the United Kingdom and the United States. In addition, there is a rather large group of countries (Australia, Czech Republic, Hungary, New Zealand, Poland, Slovak Republic, Slovenia) for which consolidation needs to stabilise debt are in the vicinity of 5% of GDP. In many of these cases (with the notable exception of New Zealand), current consolidation plans to 2015 fall short of consolidation needs. Reducing debt to GDP ratios further to 60% would involve additional consolidation efforts that are especially large (up to 5% of GDP) in the programme countries and in Japan, and between 2% and 5% of GDP in Belgium, Canada, France, Iceland, Italy, the United Kingdom and the United States. According to these figures, many countries may be expected to pursue total fiscal consolidation, both to stabilise and to lower debt, of 5-15% of GDP over the years to come.

Figure 3. **Committed consolidation needed to stabilise debt and attain a 60% debt-to-GDP ratio**



Source: OECD (2012), OECD Economic Outlook, Vol. 2012/1, OECD Publishing, Paris, *http://dx.doi.org/10.1787/eco_outlook-v2012-1-en.*

However, over the next few years fiscal space will be reduced not only by fiscal consolidation. On the one hand, the previous consolidation needs that are estimated in terms of changes in primary balances take into account the higher interest payments associated with growing debt but do not take into account further increases in interest rates due to broader sovereign spreads.[7] The impact of higher rates may be higher and faster depending on the maturity profile of government debt.[8]

On the other hand, fiscal space may also be absorbed by growing expenditure on pensions due to demographic change. According to OECD projections, public spending on pensions is expected to grow on average from 8.4% of GDP in 2010 to 10% of GDP by 2030 (OECD, 2011). This means that non-pension primary spending would need to be reduced even further to the constraints claimed by fiscal consolidation.[9]

Table 4 provides an estimate of the loss of fiscal space from 2011 to 2030 due to the combination of the fiscal consolidation needed to stabilise debt by the end of the period and growing pension outlays. In particular, the loss of fiscal space is estimated as the cumulative contraction of primary spending needed to reach debt consolidation targets and fund pension payments already committed. Measured as such, the average loss of fiscal space in OECD countries would be 18.2% of non-pension primary spending. In other words, nearly a fifth of the current level of primary spending/GDP would need to be cut in order to meet consolidation targets and deliver on pension commitments.

The projected loss of fiscal space is especially large for Japan (34.6%), Greece (34.2%), Portugal (28.6%), the United States (24.7%), Ireland (22.7%) and Spain (20.8%). These countries face especially large consolidation requirements to stabilise debt, which in turn, place the strongest pressure on the non-pension primary spending. This is why 20 of the 29 OECD countries analysed would suffer more than 10% loss of fiscal space. In contrast, Denmark, Estonia, Germany, Iceland, Sweden and Switzerland face smaller or even negative consolidation needs to stabilise their debt, relatively small consolidation requirements to reduce debt, and expect a small or even negative increase in pensions spending in the

Table 4. **Loss of fiscal space as a percent of non-pension primary spending**

Country	Non-pension primary spending[1] (% of GDP)	Contribution to stabilise debt[2] (% of GDP)	Additional consolidation to reduce debt[3] (% of GDP)	Expected increase in pension spending[4] (% of GDP(	Loss of fiscal space as a % of non-pension primary spending[5] (%)
Denmark	49.8	-0.2	0.4	0.6	1.6
Iceland	39.7	1.6	3.1	-4.0	1.9
Estonia	29.8	1.3	0.0	-0.7	1.9
Sweden	41.9	0.9	0.4	0.5	4.3
Germany	31.9	-0.3	1.3	1.2	7.0
Switzerland	26.8	-0.1	0.2	1.8	7.1
Italy	29.6	1.9	1.8	-0.8	9.5
Czech Republic	34.0	3.2	0.2	-0.2	9.6
Hungary	34.3	3.2	1.1	-0.8	9.9
Korea	25.9	0.9	0.3	1.6	10.8
Poland	29.7	4.3	0.2	-0.9	12.2
France	39.6	2.7	2.2	0.3	13.2
Austria	34.5	0.9	1.2	2.6	13.6
Australia	30.8	3.7	0.0	0.7	14.1
Netherlands	42.9	3.0	1.2	2.3	15.1
New Zealand	40.5	3.8	0.3	2.0	15.1
Canada	34.5	2.4	1.3	1.6	15.3
Finland	42.3	2.7	0.8	3.5	16.6
Slovenia	37.9	4.2	0.3	2.1	17.4
United Kingdom	39.7	4.6	2.5	0.1	17.9
Luxembourg	33.8	1.1	0.2	4.8	18.0
Belgium	39.6	1.3	1.9	4.5	19.4
Slovak Republic	28.9	4.0	0.1	1.5	19.5
Spain	31.7	5.0	1.1	0.5	20.8
Ireland	40.2	4.5	3.2	1.5	22.7
United States	32.0	5.1	2.5	0.3	24.7
Portugal	32.5	6.0	2.6	0.7	28.6
Greece	30.0	7.1	2.6	0.5	34.2
Japan[6]	40.8	8.9	5.2		34.6
Average[7]	31.1	3.8	2.0	0.5	18.2

1. Current primary spending is the 2011 general government expenditure minus the 2011 debt interest payments and 2011 public expenditures on pensions.
2. Based on the projections of public expenditure on pensions, 2007-60.
3. Consolidations to stabilise debt is the average improvement in the underlying primary balance to 2030 (or 2040 for Japan) required to stabilise the government debt-to-GDP ratio, assuming consolidation in 2012-13 is consistent with the short-term projections described in Chapters 1 and 2 of the *OECD Economic Outlook No. 91*, and thereafter amounts to half a percentage point of GDP per annum (one percentage point of GDP in Japan). Fiscal consolidation projections are the consequence of applying a stylised fiscal consolidation path and should not be interpreted as a forecast.
4. Additional consolidation to reduce debt is the average improvement in the underlying primary balance to 2030 (2040 for Japan) required to reach a target gross debt-to-GDP ratio of 60%, assuming consolidation in 2012-13 is consistent with the short-term projections described in Chapters 1 and 2 of the *OECD Economic Outlook No. 91* and thereafter amounts to 1 percentage point of GDP per annum (1.5 points in the case of Greece, Ireland, Italy, Japan, Portugal, United Kingdom and United States). Some countries have not quite achieved the 60% debt target by 2030, but with the exception of Japan, it is close enough that it is achieved within a few years after 2030 with little further consolidation. Countries with a projected debt ratio lower than 60% in 2013 are assumed to target their 2013 debt ratio. Fiscal consolidation projections are the consequence of applying stylised consolidation path and should not be interpreted as a forecast.
5. Loss of fiscal space is expressed as the percentage of the 2011 public primary spending for each country which includes three future financial obligations: the expected increase in pensions expenditure from 2010 to 2030, the consolidation measures required to stabilise debt to 2030, and the consolidation measures required reach a target gross debt-to-GDP ratio of 60% until 2030. Note that loss of fiscal space for Japan only includes consolidation measures but not its public expenditure on pensions nor its projections.
6. xxx
7. Weighting average considers all OECD countries, including those not analysed in this table.
8. For the source: *Social Expenditures Database* (2012e), (SOCX, *www.oecd.org/els/socialexpenditure*), social spending aggregates are based on detailed data for 1980-2009 and aggregate spending projections for 2010-12. Pension refer to old-age and survivors' cash benefits

Sources: OECD (2012c), *OECD Economic Outlook*, Vol. 2012/1, OECD Publishing, Paris, *http://dx.doi.org/10.1787/eco_outlook-v2012-1-en*; OECD (2012e), *OECD Expenditures Database*, *http://dx.doi.org/10.1787/socx-data-en* (accessed 25 January 2014); OECD (2012f), OECD Pensions Outlook 2012, OECD Publishing. *http://dx.doi.org/10.1787/9789264169401-en*.

upcoming years. Iceland for example expects its pension commitments to decrease by 4% of its GDP, which reduces the loss of fiscal space created by consolidation needs.

Of course, the impact of such losses is different according to the rate of growth of the economy and further demands from debt servicing. The worst case scenario in this respect is one of economic stagnation, growing borrowing costs and more challenging consolidation targets.

The challenges imposed by this scale of loss of fiscal space become particularly daunting if we consider that changes in priorities and contingencies are likely to force further reallocation of resources in many countries. In an expansionary environment, such reallocation needs may be easy to accommodate, in a contractionary one, this may force further cuts in other areas.

In sum, not only fiscal constraints will remain acute for a number of years and further losses of fiscal space may be expected in the years to come. This will strain public financial management at an unprecedented scale and length for OECD countries. In this environment, urgent fiscal decisions and regular budgeting processes will need to attain a better fit. Budgeting can do a better job at reconciling fiscal discipline with government effectiveness than consolidation packages can. However, this may require some important changes in procedures, instruments and institutions.

3.2. Can current budgeting practices deliver?

Budgeting has traditionally been the main vehicle of fiscal policy in developed countries. Despite this fact, for many years budgeting was not an extremely sophisticated process, focusing on changes in the margins of spending rather than at the core of it. In the 1970s, Wildavsky defined this practice as "incrementalist budgeting" and explained it as a rational way of making hundreds of actors agree on thousands of budget lines in a very short period of time (Wildavsky, 1975). This gave budgets stability and political sustainability over time. In fact, continuous modification of budgets in the course of the fiscal year was more associated with developing, volatile countries.[10]

Incrementalist budgeting, however, does not guarantee efficiency in the allocation of resources and generates much inertia. For this reason, since the early 1960s policy makers have been trying to develop budget techniques that could sharpen the analysis of budget appropriations and link budget decisions with government performance. This led to the development of "Programme Budgeting" (PPBS) in the 1960s (Schick, 1966; West, 2011) and "Zero-Based Budgeting" (ZBB) in the 1970s (Sarant, 1978; Lynch, 1990). As both methods disappointed practitioners on the grounds of their complexity and time requirements, these techniques gave ground to the so-called "Performance Budgeting" or "Budgeting for Results" approach in the 1990s, (Schick, 1995).

The OECD has defined performance budgeting (PB) as "the use of performance information in the budget process", where performance information includes indicators, targets, evaluations and benchmarks, among others (OECD, 2007). The OECD has provided a typology of PB modalities on the basis of the practical experience of countries, including: i) a presentational modality, where performance information is only provided to legislators and the public for information and accountability purposes, with no linkage to funding decisions; ii) a direct formula modality, whereby resource allocations are directly linked to performance results through an algorithm; and iii) a performance-informed modality, whereby performance information is expected to be considered in a rather loose or indirect way in making budget decisions.

No country has applied any of these models in their pure state and it is fair to say that progress in mainstreaming PB has been slow, uneven and with mixed results. This was already noted in an OECD assessment in 2005 that concluded that while countries had made improvements in the quantity of performance data over the previous decade, they were still struggling with issues like the quality and relevance of the data, issues of attribution and in using performance information for budget decisions (Curristine, 2005). In this last regard, the study acknowledged that countries had not completely shifted away from inputs in preparing budgets, that performance measures were rarely used to eliminate programmes or to cut expenditure, and that recommendations from evaluations were only partially followed up by the sector and central authorities.

It is thus no wonder that performance budgeting tools were of little use for budget adjustments when the crisis hit in 2008. In fact, progress in solving some of the problems encountered by the performance management system was not only slow, but it may have eroded support from ministries of finance usually pressed by urgent issues. It is not difficult to understand the reasons for this. While indicators have been the most used source of performance information, few funding decisions can be made on the basis of them, as they cannot respond to questions on the effectiveness and value for money of public programmes. Evaluations, on the other hand, were usually focused on fine-tuning spending programmes rather than finding fiscal space and were led in many countries by line ministries and agencies, and the interface with political prioritisation has been very weak.

The inability of indicators, monitoring, programme evaluations and presentational schemes to contribute to fiscal consolidation measures, in the context of a more fundamental revision of the functions of states, is already taking a toll on PB. In the United Kingdom the comprehensive public service agreements were largely abandoned as the basic steering tool and instead a more pragmatic and tailored approach is being put in place. Indeed, the major spending reductions in the United Kingdom were initiated on the basis of a comprehensive spending review that combined a technical value-for-money approach with a political prioritisation process. In the United States, the Program Assessment Rating Tool (PART) was replaced by a new system that focuses on the role of the heads of central agencies in delivering particular goals in the short and medium term. Recently the Dutch Ministry of Finance has shifted from using performance indicators towards emphasising evaluations and spending reviews. These movements mirror the OECD survey in the direct linkage between performance indicators and budget appropriations being weakened and replaced by in-depth spending reviews as a major tool for overcoming information asymmetry and obtaining knowledge about the efficiency and effectiveness of programmes.

Surely performance should still be relevant for public resource allocation and management. In a way, a focus on results is more needed now than before, as governments are expected to do more (or at least the same) with fewer resources. In fact, many innovations in public management and budgeting –most notably in New Zealand – emerged from fiscal crises in the past, as governments devolved managerial authority to government agencies in exchange for better results. It is thus important not to throw out the baby with the bathwater. If past PB instrumentalisation becomes inadequate in the current context, there may be a type of performance information and modalities of using it that respond better to the challenges from continuingly shrinking fiscal space.

3.3. Incrementalist responses

The first to identify these emerging challenges and see their implications for public budgeting was Allen Schick. In a paper submitted to the OECD SBO network at the outset of the economic crisis, Schick argued that the shrinkage of fiscal space called for budget officers to concentrate their efforts in expanding it and guarding it from backloaded spending commitments (Schick, 2008). To this end, he advocated an incrementalist approach so as to minimise conflict, political deadlock and frustration. In particular, he argued that:

> Budgeting is incremental because major reallocations are rare. At the margins, however, there are frequent shifts of resources, as new opportunities emerge and old ones recede. The shifts generally are not explicit – they do not overly pit programmes against one another in a competition for scarce funds. Nor do these shifts take money away from spending units. Instead, they are implicit, and savings are retained by the affected agency (OECD, 2009: 444).

Through this statement, Schick made evident that generating and allocating fiscal space is a substantial part of what budget officers regularly do across the world. Budget work routinely integrates generating and allocating fiscal space in a simultaneous exercise. This is reflected in the revision of cost estimates and standards, and in the challenging of sector assumptions. Rather than running against this culture, deeply rooted in budgeting procedures, ministries of finance and budget offices could intensify their scrutiny to make it more systematic in order to generate further fiscal space instead. This would devolve the responsibility for enlarging fiscal space to fiscal and budget specialists instead of simply appealing to gain more flexibility or blaming others (line ministries, executives, members of parliament) for shrinking it. This was summarised by Schick by arguing that "*the primary role of the central budget office should be as guardian and allocator of fiscal space*".

A number of alternatives are available to generate fiscal space in an incrementalist way in the regular budget process, including:

- Deindexation: Almost all government budgets are formulated on a nominal basis. This means that base spending levels are in many cases expanded according to some price inflator. Even though some spending items are subject to automatic price adjustments (indexed pensions, etc.), the decision of applying price adjustments and their size is usually discretionary. In contrast, revenues tend to be adjusted according to inflation and their bases expand according to earnings, market prices, etc. Of course, inflation adjusting below nominal price increases would mean a deterioration in the purchasing power of government resources, transfers and scaling down real activity, and this would eventually be noted by the beneficiaries of public services, but in the short run it may be a less painful way of generating fiscal space.
- Efficiency dividend: Some countries regularly impose across-the-board marginal cuts in operational spending that augment the pressure across the public sector to increase efficiency while generating fiscal savings. This is sometimes referred to as a "tax" or "haircut". Some sectors may be spared on the grounds of necessity, priority or dependency on manpower. Partial replacement of personnel or no replacement at all can be seen as a particular modality of this. Of course, not all sectors may be equally efficient and the alternative cost in terms of volume and quality of services may substantially

change from one sector to another. This is especially so in the case of partial staff replacement, as the reduction in staffing levels will not be equitable, hitting harder those sectors with workers that are older (replacement of retiring staff) or that have better market alternatives (voluntary retirement schemes).

- Sunset clauses: A way of reducing the stickiness of public spending is to set a time limit to programmes and/or legislation mandating them. Even if programmes are judged as a priority and necessary, such limit – or sunset – gives an opportunity to revisit their justification, rationale and performance against expected results. The results of such an assessment may lead to the termination of the programme, redesign or extension, depending on the findings and recommendations. The important feature of this approach is that it brings the assessment of the performance of a programme back to those that introduced it, making it easier to judge it on the basis of the reasons that justified its creation in the first place. Of course, this could generate some degree of uncertainty among administrators and beneficiaries, which can be reduced by carrying out evaluations sufficiently ahead of the sunset date.
- Pay-as-you go rules: The advocates of government programmes are usually not confronted with their opportunity costs. Pay-as-you-go rules try to correct this by conditioning the allocation of resources to new programmes to the termination or reduction of others by a similar amount. In theory, this would not only keep a sector portfolio reasonably stable but should also ensure productivity gains, as to be justified, new programmes should deliver more value for money than those that are being phased out. The main risk of this approach is political arbitrage, since government programmes are not always valued for their contribution to social well-being but by their political impact. Thus, oftentimes, ministries propose cutting a programme with the knowledge that they will be reinstated under political or legal pressure.
- Evaluations: The main advantage of evaluations over performance indicators is that evaluations can lead to some clearer judgements on the justification, effectiveness and impact of government programmes. Such judgements may provide a sounder basis for funding decisions, either to change the resources allocated to them or to condition such resources to programme adjustments. The experience of OECD countries, however, is that this connection is far from automatic. Evaluations take time and they may not be able to capture the full impact of programmes that operate under a long-term horizon; conclusions and recommendations may be too general or vague to sustain budget decisions, and the political support to take action may be limited. These problems can be minimised by better synchronising evaluations and budget decisions, by demanding concrete recommendations on resource allocation from evaluators and by making evaluations public.
- Spending reviews: Creating an effective spending review process requires a clear political mandate at the level of the chief executive. Spending reviews must be seen as a solution to a political problem rather than as a technical bureaucratic exercise. The mandate should be to identify options for reductions to baseline spending, to reallocate spending and, if relevant, to enhance revenue in order to create fiscal space for new priority spending (Table 5). With regards to revenue measures it should be noted that, in general, spending reviews should not veer into tax policy. There may be cases, however, where non-tax revenue plays an important role in financing the effort or creating incentives for particular behaviour from citizens or institutions. The options proposed should be generated on the basis of sound research but ultimately decided upon by the

Table 5. **A typology of spending reviews and performance evaluation**

	Performance evaluations (programme, policy or organisational evaluation)	Spending review 1: Efficiency reviews	Spending review 2: Strategic review
Objective	Create better programmes broadly within the existing financial parameters	Create fiscal space: reallocate and/ or reduce government expenditure for programmes or organisations	Create fiscal space: reallocate and/ or reduce government expenditure for programmes or organisations
Focus	Analysis – analyse management, structures and/or policy to improve efficiency and effectiveness	Efficiency – identify how the existing policies can be conducted with less resource	Efficiency and prioritisation – identify what the government should and should not do
Examples		Finland "Productivity Programme" (2005-15) Korea "Self-Assessment of the Budgetary Programme" (2005-)	Australia "Comprehensive expenditure reviews"; "Strategic Review" (2007) Canada "Programme Review" (1994); "Strategic Review" (2009) Netherlands "Interdepartmental Policy Review"(1982; 2009-present) United Kingdom "Spending Review" 1998-present
Fiscal Impact	Usually none	Limited except when applied widely across the public sector – e.g. the introduction of shared service centres	Large but dependent on political backing and will often encounter line ministerial and special interest group opposition

Source: Hawkesworth, I. and K. Klepsvik (2012), "Budget Tools to Foster Strategic Agility: Performance Budgeting, Spending Reviews and Productivity Cuts", *paper delivered at the annual OECD Meeting on Performance and Results*, 26-27 November, Paris.

chief executive/Cabinet or another politically delegated entity (e.g. a ministerial committee) during the budget process.

While many of the above mechanisms can be – and, indeed, have been – used by countries to generate fiscal space on an ad hoc basis, this does not add up to a strategy to expand fiscal space in the scenario described above. Instead, what is needed is to incorporate such mechanisms into a planned, structured and continuing process involving the key actors in the budget process. In other words, the creation of fiscal space through mechanisms like the above should be mainstreamed into the regular budget process with the full involvement of budget officials. This would give this approach the cumulative force underlying Schick's advocacy for incrementalist fiscal spacing.

This approach would mean, for instance, applying partial indexation and an efficiency tax on a regular, yet realistic, fashion, as is done in a number of Nordic countries, Australia, New Zealand (see Annex A). This may also involve applying sunset clauses and/or a pay-as-you-go rule to all new programmes as the United States did. The now-expired US *ex ante* spending rule used dollar denominated caps on annually appropriated spending, with pay-as-you-go (PAYGO) restrictions on the aggregation of spending mandated by permanent appropriations (mostly for programmes with important automatic stabilisation implications) and taxes.[11]

Similarly, evaluations should be organised in an annual evaluation programme, analysing a portfolio of programmes every year with a battery of evaluation methods appropriately co-ordinated, very much like Mexico and Chile have been doing for the past 6 and 12 years, respectively. An evaluation programme like this can aim at covering all government programmes over a certain number of years – conveying a message of fairness – and can adapt evaluations to the features and needs under each programme.

Table 6 summarises the main features, implementation mechanisms and potential effects on fiscal space of the five mechanisms outlined above if structured as part of the budget process. It also includes also an indication of the key actors that each mechanism needs to engage and how they can be linked to the different stages of the budget process.

Table 6. **Mechanisms to create budget space in the budget framework**

Mechanism	Focus	Key actors	Link to budget process	Fiscal Space potential
Deindexation	Spending not automatically indexed by legislation or contract	Central Budget Office, Ministry of Finance	Formulation (normalisation of budget)	Limited and declining
Efficiency dividend	Overhead, general services, operational spending	Central Budget Office, line ministries, executive agencies	Formulation (budget envelopes, ceilings)	Limited
Sunset clauses	New programmes	Central Budget Office, Centres of Government, line ministries	Programming, formulation (budget bidding)	Depends on pipeline of innovations
Pay-as-you-go rule	New programmes or expansion of existing one	Central Budget Office, line ministries	Programming	Depends on pipeline of innovations and size of sector portfolio
Evaluations and reviews	Programme spending	Central Budget Office, evaluation office, line ministries	Evaluation, programming	Larger and medium-term

As can be seen in Table 6, the actual operation of these mechanisms should indeed involve the central budget office (CBO), but in many cases it would need the co-operation or support of other actors. Particularly in the case of an efficiency dividend, sunset clauses, PAYGO, and evaluations and reviews, co-operation or outright initiative of the line ministries is essential for the effectiveness of such mechanisms. This makes it necessary to address the issue of incentives, since pure reallocation from the CBO is likely to be strongly resisted.

One way of aligning incentives could be to link fiscal space generation with its allocation. In particular, fiscal space mechanisms should not be seen as a threat to the integrity of sector budgets, but as an opportunity to regain or even increase funding when the effectiveness of traditional programmes is eroding. In other words, line ministries and programme stakeholders should be given the opportunity to tap into the gained fiscal space.

As for the connection to the budget process, Table 6 identifies concrete stages of the budget process where the proposed mechanisms could provide inputs to budget decision making. These include the conventional five stages of budgeting (programming, formulation, approval, execution and evaluation) with some further distinction of specific operations performed in the formulation stage (setting the budget envelope, bidding for additional resources, integration and indexation).

But even a structured and continuing programme like this may not provide an effective response to current and prospective fiscal space needs in many OECD countries. By acting upon public budgets in the limited timeframe of the annual budget discussion, the basis for efficiency gains, savings and reallocation may be too limited. This is largely due to the fact that most budget decisions that can be taken in this framework relate to a fraction of public resources, namely, that that is not mandated by permanent legislation or pre-existing contractual agreements.

This fraction may change from one country to another depending on definitions and the structure of public spending. In the United States, for instance, "discretionary spending" is in fact the only subject of annual budget discussions, covering only 37% of total federal outlays in 2011, or 9% of GDP. The US definition, however, includes a number of programmes and items that can only be adjusted at the margin, like the salaries of federal employees.

This suggests that incremental adjustments to discretionary spending may cover only a fraction of fiscal spacing needs, even if they accumulate over time as suggested by Schick. For instance, if through the different mechanisms outlined above governments could generate a 5% annual savings on discretionary spending amounting to 20% of total government spending, after 10 years, the average OECD government would have accumulated 4.5% of GDP.[12] This is less than half the fiscal consolidation needed over the period 2009-30 for countries like Greece, Ireland, Japan, Portugal, Spain, the United Kingdom and the United States. If we assume that some of these tools may be exposed to declining returns as the search for savings start to cut into the bone of public administration, and that line ministries may learn how to game the system, such estimate may be even judged too optimistic.

4. Fiscal space beyond conventional expenditure management

4.1. Expanding the scope of fiscal space generation

The examples given above suggest that to rise up to the current fiscal challenges, countries may need to go beyond conventional budgeting in their search for fiscal space. This means not only regularly repeating the use of the proposed tools over several years (with the chance of declining returns suggested), but going beyond that.

Fiscal space can indeed be sought in a number of ways that involve expanding beyond the scope and the timeframe of annual budgets. Among others, this may include applying regular expenditure management frameworks to tax expenditures; better scrutinising public-private partnerships to limit fiscal commitments and contingent liabilities; applying zero-based budgeting techniques to programmes in whole areas of government action in a time span exceeding the annual budget; implementing medium-term cost-containment programmes in key areas; and structuring a rigorous and open fiscal scrutiny of permanent legislation committing public resources in the future.

Tax expenditures

Tax expenditures are defined as exceptions to general tax rules that benefit certain taxpayers, transactions or revenues.[13] Such exceptions – commonly referred as tax breaks or tax exemptions – are usually established with some microeconomic purpose, expecting to promote some merit goods or to modify the behaviour of taxpayers in some economically or socially beneficial way. Of course, such objectives are very similar to those of many spending programmes; however, unlike outright public spending that is normally packed into programmes (sometimes even with time limits) and scrutinised in the budget process, tax expenditures are usually adopted through permanent legislation, written into tax codes, deducted from tax revenues and rarely assessed against their intended benefits.

Tax expenditures have been created for a long list of purposes including promoting private investment; investing in clean technologies and research and development; fostering social responsibility and donations to charities; incentivising education and a healthy lifestyle; taking businesses to lagging and remote regions; reading more books and newspapers, and so on. The list gets especially long in countries that are more supportive of private initiative and those that have enjoyed revenue windfalls from natural resources or other events. In many countries, tax expenditures have accumulated over time and it is sometimes difficult to recall the objective that led to their introduction in the first place. Still, they are difficult to terminate, as they create influential interest groups that defend view them as an entitlement.

The evident asymmetry in the transparency and scrutiny of tax expenditures has led fiscal experts and international bodies to advocate for some changes aimed at levelling the playing field with conventional spending. In particular, the IMF *Code of Fiscal Transparency* has proposed that "statements describing the nature and fiscal significance of central government tax expenditures […] should be part of the budget documentation" (IMF, 2007). In turn, the "OECD Best Practices for Budget Transparency" proposes that "tax expenditures should be disclosed as supplementary information in the budget" (OECD, 2002). Some countries have partly followed this advice. Austria, Belgium, France, Germany, the Netherlands and the United States include information on the expenditures as annexes to the annual budget, while Australia, Canada, Italy and the United Kingdom include some information and analysis in reports and documents separated from the budget. Still, many countries do not report on tax expenditures in a regular and rigorous way. And even in the most advanced countries, the use of such information in fiscal decisions still depends largely on political will, well behind the discipline and statutory procedures of annual budgets.

So, time may be ripe to make tax expenditures subject to the same approval and review mechanisms as conventional spending. This would mean separating them as line items or programmes in the budget; spelling out or reconstructing the logical framework supporting them; applying sunset clauses and pay-as-you-go rules; identifying measures to monitor their performance over time, and evaluating their impact, among others. These mechanisms should be applied on a regular basis, perhaps aiming at approving them separately in the budget from regular revenue which, also following the advice of international organisations, should be reported on a gross rather than a net basis.

Potential gains from a more rigorous scrutiny of tax expenditures may have a non-negligible impact on fiscal space, as tax expenditures represent more than 4% of GDP[14] in countries like Canada, Spain, the United Kingdom and the United States (OECD, 2010a, 2010b).

Public-private partnerships (PPPs)

Since their beginnings in the early 1990s, PPPs have become an increasingly popular way to mobilise private resources and expertise to provide public infrastructure to the community. In particular, PPPs have been defined as ways of delivering and funding public services using a capital asset, where project risks are shared over the long term between the public and private sector (OECD, 2008).[15] OECD countries like Australia, Chile Korea, Mexico, Portugal, Spain and the United Kingdom have made very intensive use of PPPs in the last 15 years, utilising this scheme to fund infrastructure investment and service provision in transport (roads and railways), utilities (energy, water), social services (health, education and prisons), and even in ITC services. PPPs have been especially popular with developing countries, and both the World Bank and the United Nations have created special units to provide technical advice in setting up the institutional and operational bases of PPP programmes.

PPPs have been promoted by governments for a number of reasons, some wrong, some right. In economic terms, PPPs should be used when they deliver higher value for money for the government than conventional public provision. This happens if the private provider can operate infrastructure at a lower cost and higher efficiency than the public sector, if it can absorb costs from the government and/or if it can recover costs better through tolls, tariffs or user charges. However, many countries have used PPPs as a way to sidestep spending controls. Such accounting and/or regulatory benefits, however, may take place at the expense of fiscal prudence. This is so because governments sometimes commit payments and fees or guarantees to make a PPP project viable that may escape the usual scrutiny of budgets. The latter are particularly serious as they become contingent liabilities for the government that may be correlated with economic activity and government revenue. This is, for instance, the case when the government issues minimum traffic or revenue guarantees for roads on the basis of traffic estimates that may become unrealistic in an economic recession.

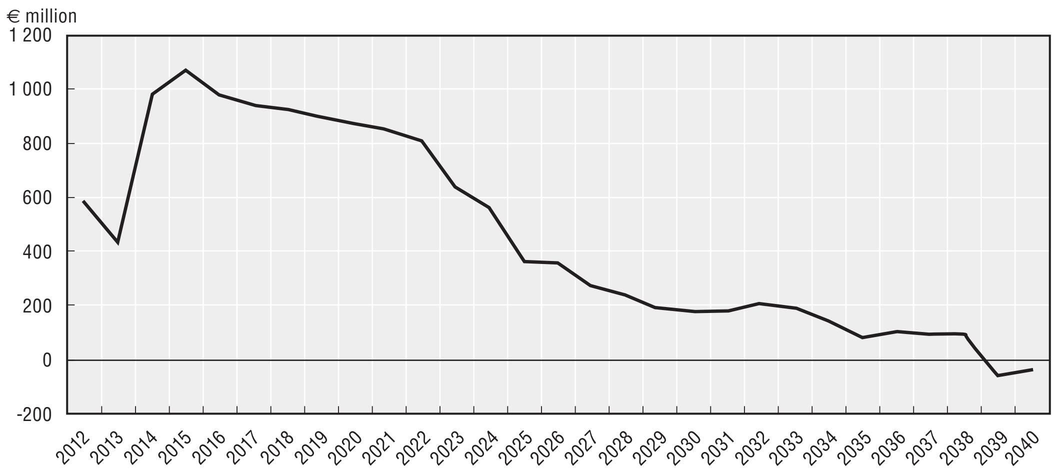
To minimise these risks and to promote an institutional structure that promotes affordability and value for money and safeguards the public interest, the OECD has issued a recommendation on the public governance of public-private partnerships. The OECD PPP recommendation provides a good basis for generating fiscal space with PPPs. In particular, PPP spending commitments and contingent liabilities should be publicised, and when they reach the point of significantly eroding value for money they should be substantially revised. In the case of the formulation phase of a programme, this may mean executing the project through conventional public procurement or not executing it at all.

There are two key elements to PPPs with regards to the fiscal space discussion. First, the overall investment envelope must be affordable, regardless of whether the infrastructure service is delivered through a PPP or through a traditional public works contract. This, in turn, requires taking medium- to long-term economic and fiscal projections into account when the overall investment plan is decided upon at the political level. Second, the procurement option that represents the most value for money must be chosen. This requires that key technical skills are available in the public sector and that the Ministry of Finance plays a key role as a gate keeper making sure that the proper value-for-money tests have been conducted. In the case of services under operation, continued vigilance is necessary to ensure that value for money is maintained. One key element in implementing these mechanisms would be to include a PPP annex in the budget documentation and to perform a general review of the fiscal commitments from the PPP portfolio every three to five years.

Potential fiscal gains from a more rigorous scrutiny of PPPs may be substantial on the grounds of potential savings and controlling contingent liabilities. Potential savings may primarily be obtained on commitments on future government payments or fees to private operators. Such commitments are made in projects where cost recovery from users is not feasible, which means that efficiency and risk management gains from private management need to be substantial in order to compensate for the financial return that the private operator would require and its potentially higher funding costs. Government payments to private operators may become rather large for countries that have made a more intensive and systematic use of PPPs after a few years. This is the case, for instance, of Portugal, where PPPs signed between 2000 and 2008 were worth EUR 9.4 billion, or 5.4% of GDP. The 2011 Portuguese PPP report shows net road charges to government rising to

EUR 1 272 million in 2011, then falling in 2012 and 2013 before rising again to around EUR 1 billion (Figure 4).

Figure 4. **Net charges to road PPP concessionaires in Portugal**



Source: Data provided by the Ministry of Finance of Portugal, August 2011 PPP Report.

But perhaps, the largest potential gains from a stricter management of PPPs come from contingent liabilities. These may be explicit, as indicated above, or implicit, as the infrastructure and services delivered through a PPP contract may become too politically visible to be allowed to fail. This gives private operators the strength to pressure the government to renegotiate contracts, which may substantially increase the fiscal commitments to a project. There are numerous examples of cases where renegotiation of contracts in the operational or even construction phase have weakened value for money, and by implication the affordability of PPPs. Guasch (2004) found that out of more than 1 000 concessions granted in Latin America and the Caribbean from 1985-2000, renegotiation of the initial contract took place in 55% of transport concessions, an average of three years after their reward. The majority of these renegotiations were initiated by the private side and involved an increase in tariffs in 62% of the cases, delays in investment obligations in 69% of the cases and reduced fees paid by the private side to the public sector in 31% of the cases (Guasch, 2004; Meany and Hope, 2012). There is little reason to assume that the situation in most OECD countries is very different.[16]

Zero-based budgeting (ZBB)

ZBB emerged in the 1970s as a more rigorous alternative to PPBS, which could better respond to the fiscal pressures that emerged with the oil crises. ZBB involves discussing funding for ongoing programmes as if they were being created, asking fundamental questions on their justification, and key design and operational choices. This should create the basis for comparisons across programmes and more drastic funding decisions, including termination and reallocation of resources.

While ZBB was technically appealing, it did not fit well with a budget process framed by political priorities and time constraints. In other words, there was not enough time to apply this kind of analysis to all government programmes within the time scope of budget preparation and when it did happen, conclusions were not feasible either on the grounds of sunk costs or due to a lack of political support. This led governments to abandon or to replace it by simpler versions. Still, ZBB survived in the private sector and many companies, especially from industries experiencing abrupt transformations, have applied it to our days.

For those companies, the ZBB approach allows top-level strategic goals to be built into the budgeting process by tying them to specific functional areas of the organisation, where costs are first grouped then measured against previous results and current expectations. This process gives top management the opportunity to judge the performance of managers and teams, creating the possibility of radically redesigning their cost structures, cutting spending on support functions while boosting efficiency and competitiveness. ZBB starts by re-envisioning the business and asks what activities and resources are needed to compete under current and future market conditions (Cichocki et al., 2012).

As ZBB takes a considerable amount of time, some companies have solved this problem by operating on the basis of a rolling annual budget with zero-based budget exercises performed every three to five years, or when a major change occurs within the operation. This allows an organisation to benefit from the advantages of zero-based budgeting without the excessive amount of work associated with conventional annual budgeting.

From this it may distil that ZBB may still be feasible if performed outside the regular budget process, with appropriate time for analysis and implementation, very much like in the private sector. One concrete way of doing this would be applying ZBB as a series of overlapping two- to three-year exercises targeted at larger programmes or to a set of programmes aimed at the same objective. The screening process should include a clear identification of the programme(s) to be analysed, addressing the classical set of questions of ZBB on the justification and alternatives to a programme, agreeing on a set of concrete actions – including funding – and their implementation in a multi-year framework. Overlapping this work means that at every point in time there would be exercises in different sectors at different stages of development.

To be coherent and effective, a scheme like this has to clarify two issues: i) what differentiates it from conventional evaluations; and ii) how would it connect with the regular budget process. On the first point, ZBB differs from evaluations on the grounds of its explicit funding focus and on its organisation around specific programme objectives. The key questions that ZBB asks is whether government should be pursuing a certain objective and whether it would be carried out in the same way if the programme(s) to attain it were just being created. On the connection with the regular budget process, it should be evident that this type of exercise – including evaluations, reviews and the cost-containment programmes depicted below – require a further formalisation of the evaluation and programming phase of the budget cycle, perhaps even requiring restructuring of existing institutions. These issues are developed further in the next section.

It is difficult to assess the potential gains from an overlapping ZBB scheme, as its advantages come more from the methodological side, covering more or less the same pool of spending that can be analysed through programme evaluations. It would appear that there are clear synergies to be harvested by combining the approaches of ZBB with the strategic spending reviews. Indeed, their objectives, and to a great extent methods, appear to be overlapping. The key element of the strategic review is the political mandate to deliver concrete proposals for saving. Combining such a mandate with ZBB rigour may fit well; arguably this approach has been applied in a number spending reviews as noted above.

Cost-containment programmes

Spending on some government programmes is not driven by priorities or objectives, but by costs. This is particularly true of sectors that strongly rely on powerful providers, be it professionals/specialists, contractors or private suppliers. In these cases, industrial organisation may play strongly against the public interest, extracting considerable resources through creeping cost pressures. In those cases, governments may need to design strategies to prevent such pressures or to put themselves in a better bargaining position.

A good example of this is health in the United States. The cost of health has been a highly visible topic of discussion for many years. Healthcare spending has been rising as a share of national income for decades and is projected to continue rising, from 10% in 1985 to 17% in 2010 to nearly 25% in 2037.

In recent years, a variety of health policy innovations and experiments have been put into place in the United States to improve quality, control cost and expand coverage. The Patient Protection and Affordable Care Act signed into law in March 2010 aims primarily at expanding *health insurance* coverage to more than 30 million uninsured US citizens without increasing the deficit, and it makes an important start on reining in the rapid growth of healthcare costs. Both government and private insurers have instituted cost-containment measures designed to limit payments made to providers of healthcare services.

A cost-containment strategy should take a medium-term perspective, be prepared to persist and to adapt over time. It requires reviewing areas that were previously considered "off limits" or "out of scope". In the case of private companies, the CEO and the board of directors expect fast cost reduction results without disrupting the company's operations, so cost-containment initiatives require extreme collaboration among the functional groups.

Potential savings from well-designed cost-containment strategies may be substantial. If we consider only the health sector, OECD projections estimate that heath spending will increase rapidly over the next 50 years. In a *cost-pressure* scenario, which assumes no stepped-up policy action, health spending could reach 14% of GDP in 2060; in a cost-containment scenario, however, it is projected to reach 9.5% in 2060 (de la Maisonneuve and Oliveira Martins, 2013).

Permanent legislation

In all OECD countries, the largest portion of public spending is not mandated by discretionary budget decisions but by permanent legislation. This is the case for most of social protection, which takes up about one third of general government spending, and for substantial parts of education, health, and public order and safety, which account for another third. These expenditures remain mostly untouched by budgets on the grounds that the latter have only an annual scope; even if some dimension of spending is modified in the annual budget, the modification is temporary compared to the permanent regulations written into legislation.

Permanent legislation limits legislatures' ability to review and change spending priorities in a number of ways. Although it is always possible for new legislation to alter current law, in practice, the many steps needed to pass new legislation, and potential opposition from parties in society who may be negatively affected by changes to legislation, render change difficult to achieve. Legislation that creates a permanent appropriation allows the recipient to spend money without further action by the legislature. Even when permanent legislation provides for funding to be carried out through the annual appropriations process, it may effectively mandate the appropriation so that the legislature can make little or no changes to the amount of funding. This is the case, for example, for Medicaid spending in the United States.

Given the size of these entitlements, some legislatures have sought greater control over their growth through the budget process. In Sweden, for example, the expenditure ceilings set by the *Riksdag* have been extended to cover existing entitlements, including the old-age pension system which is not part of the central government budget. Should spending on existing entitlements exceed these ceilings, the government is required to submit supplementary budgets to the *Riksdag* for approval. The Italian legislature must also approve spending overruns for entitlement programmes. These legislatures may have little choice but to approve supplementary spending, but they at least have the opportunity to express their own policy concerns in the process.

Budget officials regularly complain about the limited flexibility that budgets have due to the weight of permanent legislation. The latter, however, is part of the political game and a choice of society, as many functions of the state are defined as permanent and some benefits are established as a right. Whether budget officials like it or not, such decisions take priority over their authority to shift resources in the budget exercise. The real problem comes when the fiscal implications of permanent legislation are not properly weighted at the time of drafting it. In fact, despite its fiscal importance, permanent legislation is usually not subject to the same scrutiny as annual budget appropriations. This problem increases when the pattern of spending mandated by permanent legislation is not evenly distributed over time. It is not uncommon to see legislative proposals that involve little spending in the immediate future but create huge commitments in the longer run. This makes the risk of time inconsistency of fiscal decisions considerably larger.

There are a number of tools and procedural rules that can make the fiscal examination of permanent legislation more rigorous. Legislative proposals that have a fiscal impact tend to be formally approved or endorsed by the Ministry of Finance and analysed separately by parliamentary finance committees; in some countries, members of parliament can only vote up or down but not comment on the proposals from the executive that have a fiscal impact; legislative proposals may be preceded by white papers that analyse their fiscal impact; draft legislation may be informed by memoranda on their fiscal implications; independent fiscal institutions (e.g. the United States' Congressional Budget Office – CBO, Canadian Parliamentary Budget Officer – PBO, the Korean National Assembly Budget Office – NABO, the Netherlands' Bureau for Economic Policy Analysis – CPB, Sweden's Fiscal Policy Council, and the United Kingdom's Office for Budget Responsibility among others) may be called upon to provide independent estimates of the fiscal implications of proposed legislation; implementation of legislation may be conditional on the availability of resources with the possibility of the government postponing it if there is not appropriate funding, or legislation may include provisions to adjust key parameters to ensure fiscal sustainability.

The key to an effective management of fiscal commitments through permanent legislation does not stop at having one or more of these mechanisms in place, but extends to articulating them to ensure the appropriate checks and balances, to consider alternative scenarios for the obligations undertaken by a programme, and to have some safety valves in case things go wrong. The growing fiscal pressures from demographic change have fostered some progress in this direction. Nowadays, pension decisions are regularly informed by actuarial studies, usually carried out by independent specialists or international organisations, which include alternatives to baseline scenarios. In addition, a number of countries are following the example set by Sweden in creating a mechanism to automatically adjust the key parameters of the system to guarantee its actuarial balance in the presence of demographic change.

Beyond these examples of good practice, however, there is still a lot to share and learn among countries, as the study of the institutions that shape fiscal decisions embodied into permanent legislation is far less developed than the analysis of budgets.

Table 7 depicts some features of the five mechanisms outlined above. The table reaffirms the idea that these mechanisms can increase the chances of generating fiscal space, but that this may vary significantly from one country to another, as tax expenditures, PPPs and cost-push programmes may vary significantly in their weight, due to the choices of governments in policy design and delivery. ZBB exercises and fiscal assessments of permanent legislation may have a more universal impact.

Table 7. **Mechanisms to create budget space *beyond* the annual budget framework**

Mechanism	Focus	Key actors	Fiscal space potential	Risks/challenges
Rationalisation of tax expenditures	Tax expenditures	Central budget office, tax administration, legislature	Large in some countries (Mexico, United States)	Co-operation from legislature, resistance from pressure groups
PPP portfolio reviews	Fiscal commitments and contingent liabilities from PPPs	Ministry of Finance, central budget office, PPP unit	Large in some countries (Chile, Mexico, Portugal, Spain, United Kingdom)	Contract inflexibility, sunk costs
Overlapping zero-based budgeting exercises	Large programmes, Set of programmes aimed at the same objective	Ministry of Finance, central budget office, Centre of Government, line ministries, evaluation office	Larger and medium-term, potentially overlaps with evaluations and reviews	Resistance from pressure groups, co-operation from line ministries
Cost-containment programmes	Cost-push in supply-driven areas	Central budget office, line ministries, procurement authority, competition authority	Large in some sectors (health, defense)	Resistance from pressure groups, co-operation from line ministries
Fiscal sustainability of new legislation	Permanent legislation with fiscal implications	Ministry of Finance, central budget office, legislature, independent fiscal institutions	Large	Co-operation from legislature, autonomous expertise

Table 7 suggests that in order to realise this fiscal spacing potential, however, some further effort is necessary to involve actors beyond the CBO and to respond to implementation challenges. Comparison with Table 6 should make it clear that more actors are needed to seek fiscal space beyond the regular budget process. These include some existing government bodies, like the tax administration, procurement and competition authorities as well as some bodies that may need to be created, like a PPP unit,[17] an evaluation office or an independent fiscal institution (IFI).[18] Some of these mechanisms would also require co-operation from the legislature, which may make it necessary to involve the political authorities in the area of public finance. Beyond the willingness of legislators to co-operate, this may also require building the procedures and the bodies to do so, as in many countries parliamentary budget committees are convened only for the annual budget discussion.

Table 7 also identifies some risks and challenges involved in these mechanisms that require an additional effort in setting them up. Most of such risks originate in the special interests nurtured by some fiscal benefits, especially those that are less visible, like tax expenditures and cost pressure from providers of essential services. In the case of PPPs, providers may gain considerable power once projects gain political priority and sunk costs make a turnaround economically costly and politically embarrassing. To face these challenges and rationalise spending, it may be necessary to have the support of political authorities and legislators. Public disclosure of reviews, assessments and audits may help in this regard. However, the specialised, independent and technical expertise may not be easily available, and undertaking a fiscal spacing programme like this may require addressing institutional needs from the start.

4.2. Analytical and institutional challenges

The mechanisms outlined above should not be seen as an alternative to performance budgeting but as an elaboration on this concept. Creating fiscal space should not be an objective in itself but a way of safeguarding and mobilising scarce public resources to priority objectives. In fact, the existing tools of PB, the incremental mechanisms of the previous section and the expanded mechanisms proposed in this section should be seen as part of the same toolbox, aimed at optimising public policy results within a hard budget constraint.

Still, if one of the limitations of the experience with PB in OECD countries has been the ability to feed into concrete budget decisions, such risk may be also relevant to an expanded toolbox. It is not enough that the proposed additional mechanisms have a greater potential to generate fiscal space to be considered by the actors of the budget process, especially if they operate outside the budget process; additional analytical, operational and institutional support may be needed for evidence and decision making to definitely connect.

Analytical challenges

On the analytical side, the main effort to be made is to strengthen the link between annual budgets and medium-term fiscal scenarios. If fiscal space is defined in a medium-term horizon, it refers not only to today's fiscal space, but also to tomorrow's.

Many OECD countries have been developing medium-term fiscal scenarios for some time. Medium-term frameworks typically cover a period of three to five years and aim to improve fiscal consolidation by combining a prescriptive yearly ceiling with descriptive forward estimates. Estimates are calculations on how expenditure, revenue and the aggregate fiscal position will turn out under certain assumptions. Ceilings are targets set by the government regarding aggregate or policy area spending annually over the medium term.

Many OECD countries have introduced multi-year forward estimates (baselines) into the annual budget preparation process since the late 1970s and early 1980s. Today they are presented to the legislature in 32 OECD countries. In preparing forward estimates, about one third (12) of OECD countries present forward estimates at an aggregate level to the legislature, five prepare them at a ministry level and eight at a line-item level. In other cases, Iceland's forward estimates are prepared at a functional level within each ministry, while in Portugal they are prepared along programme lines. Medium-term expenditure estimates may be prepared at a greater level of detail than those presented to the legislature as part of the budget approval process. In Finland, for example, medium-term expenditure estimates are prepared for three years at line-item level but the information is only presented to the legislature in summary form.

However, this same set of data reveals differences in the approach that different countries take to these scenarios. Some countries have tended to develop them as multi-year budgeting scenarios, involving both the Ministry of Finance and/or CBO and line ministries, while others see medium-term scenarios as simulation exercises, including the financial impact of key sector policy choices. A third group of countries have developed medium-term expenditure frameworks, confronting existing commitments with the government's overall fiscal constraint. The last type of exercise seems to be more appropriate for a multi-year analysis of fiscal space.

With the development of the great recession, the attention of many analysts and policy makers has turned to matters of fiscal sustainability. The latter is commonly defined as a situation in which a borrower is expected to be able to continue servicing its debt without an unrealistically large future correction to the balance of income and expenditure (IMF, 2002). As illustrated above, this is very much the time span taken by OECD projections of fiscal consolidation needs, from which our conclusions on the need of fiscal space have emerged.

Fiscal sustainability analysis requires longer term projections than conventional three- to five-year medium-term frameworks. Usually fiscal sustainability is analysed over 10-20-year horizons, matching the maturities of government bonds. Such long-term projections can capture patterns of spending that change gradually and cumulatively over time, like spending on pensions, health and education, reflecting not only government policy but also demographic trends. In the case of pensions and health, many countries have performed even longer term analysis to capture the full extent of the impact of demographic transition, sometimes built into actuarial studies. These may provide good guidance for fiscal commitments and entitlements enacted through permanent legislation that press fiscal space.

The longer the horizon of fiscal analysis, the more sensitive it becomes to projection assumptions and methodologies. For this reason, many such projections include a range of scenarios around a central or baseline projection. Such scenarios may take into account policy decisions, external parameters and the medium- to long-term behaviour of government revenues. From a fiscal space perspective, alternative scenarios may provide a feeling of its vulnerability.

The central problem with multi-year budgeting exercises is the definition of spending limits, as they require assuming fiscal policy choices. The existence of fiscal policy rules may help solve this problem. Many countries have been adopting such rules in recent years, the most prominent of which is the adoption of a fiscal rule structure under the "Fiscal Compact" agreed by leaders of European countries in early 2012. Some fiscal rules can, in addition, be linked to long-term sustainability objectives.

Fiscal rules have special significance for fiscal space analysis and generation since they give more certainty at least on one side of the equation – spending ceilings – allowing work to concentrate on the commitments toward such limits.

Operational adjustments

On the operational side, the main concern is how to ensure that the evidence from the expanded fiscal spacing mechanisms is actually used to support budget decisions. This may require revisiting the budget cycle to identify when, how and by whom are those critical decisions adopted and what changes could be made to ensure that: i) information is both timely and pertinent; and ii) that procedures allow proper consideration to be given to it in the budget decision-making process.

This should include, first, enriching and giving proper attention to the evaluation phase of the budget cycle. Evaluation is routinely depicted as a phase of the budget, but in many countries it is not given the necessary timing, inputs and attention it deserves. Some countries, like Chile, the Netherlands and the United Kingdom have acknowledged this and adjusted the programme of work in the executive branch and legislature to pay due attention to it prior to the submission of the next budget. As the experience of these countries indicates, this may require building a proper agenda for the evaluation phase of the budget, establishing how the evidence will be analysed and how the conclusions from that analysis will be extracted and transmitted to the next phases of the budget cycle.

But the main adjustment that may be needed is to give proper and specific attention to fiscal spacing prior to the allocation of resources. We have already noted that the most common practice in CBOs today is to examine, challenge and negotiate cost estimates as part of the preparation of the budget. Yet this is done at the sector level, in an integrated exercise with resource allocation. In such a setting, if cost revisions generate some savings, these are easily absorbed by higher levels of activity or to solve funding needs in other programmes of the same sector. This simultaneity compromises both the generation of fiscal space and the improvement of results, as many decisions are made as "internal deals" with little room for evidence and analysis. One possible improvement to the budget process could be to: i) further separate fiscal space generation from allocation; and ii) to use this space to allocate resources in a more competitive way across sectors and ministries.

In particular, the evaluation phase of the budget should be seen as an exercise to identify sources of fiscal space, using evidence from the toolbox proposed here. Once such sources are identified, sector budgets could be reduced to minimum statutory levels, deducting efficiency dividends and the resource allocation to programmes and services where opportunities for rationalisation have been identified through evaluations, expenditure reviews and ZBB exercises. The difference between the global expenditure ceiling, determined by fiscal policy, and this minimum level of expenditure would provide the fiscal space to be allocated in a second step.

To allocate fiscal space, instead of defining sector spending ceilings, bids from ministries and agencies could be brought to a more open and competitive process. This process can be regulated to increase the evidence and commitments behind proposals. For instance, budget bids may be required to include a technical justification and tracking to key government objectives to provide evidence for decisions. *Ex ante* evaluation may be reinforced in this process, including a rigorous analysis of the benefits and costs of direct service delivery, contracting out to the private sector and inducing change through regulation.

Programmes that reduce their funding in the first phase should not be prevented from bidding to recover their funding in the second phase – which may reduce resistance to fiscal spacing – but in order to do so they would have to make a better case and clear commitments for improvement.

Institutional rebalancing

Adjustments to the budget formulation process should take into account the need to balance between top-down fiscal discipline and bottom-up optimisation of resource allocation. Such balance also impinges on the roles of different actors in the budget process. In this regard, it should be noted that efforts to increase fiscal space are not about centralising power at the level of the CBO or the Ministry of Finance. On the contrary, they assume that these bodies cannot resolve fiscal policy and government effectiveness objectives on their own. The true root of fiscal discipline is that austerity and government efficiency are owned by a critical mass of stakeholders that influence the budget process.

This point has been recently emphasised by Schick: "The lesson from disciplined countries is that each country must summon the will to make and live by rules, to be fiscally prudent, to strive for results, and to pay attention to program[me] effectiveness in spending public money. Outsiders can guide and prod, but the most important quality is that government leaders, program[me] managers, and citizens yearn to do the right thing" (Schick, 2012). This means that fiscal discipline should be valued by a critical mass of budget stakeholders, who may be essential to developing the type of fiscal spacing mechanisms outlined above.

In addition to aligning incentives in the ways suggested above, special attention should be paid to the enforcement of budget commitments and agreements. The counterpart to the contribution of fiscal spacing to the ability to comply with fiscal policy targets is to reduce the uncertainty of line ministries and agencies on the future funding of key programmes and services. In this regard, the commitment of the latter to deliver on performance standards should be mirrored by a commitment of the budget authority to provide the agreed levels of funding, especially when both are backed by an evaluation, an expenditure review or a ZBB exercise.

Openness and reciprocity may contribute to giving fiscal spacing mechanisms the legitimacy they need to persist over time, if they are to operate beyond the immediate emergency. One further element that may contribute to this end is fairness in the treatment of different policy areas.

One problem that has been observed in the current practice of many countries is that performance indicators and evaluations tend to concentrate disproportionately on certain policy areas. For example, based on the results of the OECD 2005 questionnaire on performance information, Curristine (2005) found that there are notable concentrations of performance measures and evaluations in health and education, followed by finance/ budget and justice, while it is considerably less in areas like security, defence and foreign affairs. In this regard, opening up the range of instruments and mechanisms for fiscal spacing in the way proposed in this article should substantially broaden and balance the examination of different sectors and policy areas.

Fairness and legitimacy may be further enhanced by ensuring objectivity in the way evidence is raised and analysed. In this regard, there is a distinctive trend in OECD countries towards the creation of specialised, independent bodies that provide key inputs to fiscal assessments, either at the macro or micro level. These include independent fiscal institutions (mentioned earlier) which are expected to provide a technical non-partisan oversight and analysis of, and/or advice on, fiscal policy and performance. By acting as a watchdog on fiscal targets, IFIs can give the different actors of the budget process a clear notion of the limits within which commitments have to be delivered and fiscal space should be created and allocated.

At the micro level, some countries have created specialised bodies in charge of policy, programmes and/or project evaluations. This is, for instance, the case of Spain that created a State Agency for the Evaluation of Public Policies in 2006 and of Mexico with its National

Council of Evaluation (2004). Similarly, in 2005 the Korean government introduced the "Self-Assessment of the Budgetary Programme" (SABP) to review programmes. Of course, in some OECD countries, supreme audit institutions have been developing a growing capacity to assess government programmes in terms of value for money. This is the case of Australia and Ireland, where their line ministries, the finance ministry or the PPP unit conduct *ex post* value-for-money assessments of projects (Burger and Hawkesworth, 2011). Institutions like these may guarantee a fair judgement on the performance of their programmes and the efficiency in the use of resources. While such a judgement may not be aimed at fostering funding decisions, conclusions and recommendations of their assessments can be used as inputs in fiscal spacing exercises, like spending reviews, as argued above.

5. Conclusions

In the past, major changes in the economic environment have prompted new developments in public budgeting systems. Programme budgeting emerged as a technique to rationalise public spending in a phase of sustained growth and expansion of government functions and resources; zero-based budgeting responded to the end of such expansion with the oil crises of the 1970s; performance-based budgeting was part of a broader response to the crisis of the bureaucratic state. This is because budgeting, no matter how technical, bureaucratic or arid it may be, cannot operate in isolation from economic and political developments. Against this backdrop, it would be odd if an economic crisis of the magnitude and length of the one that has affected many advanced countries since 2008 had no effect on budgeting.

The analysis in this article indicates in this respect, that: i) the extent of fiscal restraint in advanced countries may last considerably longer than expected; ii) that in many affected countries conventional budgeting practices have not adapted enough to support fiscal consolidation in a longer timeframe; and iii) that there are a number of practices emerging across OECD countries that, if appropriately organised, can add up to a system that combines the generation of fiscal space and the allocation and use of the limited public resources for better policy results.

OECD countries cannot afford an uneasy fit between fiscal consolidation and budgeting. This risks both taking an unnecessary toll on government results and service delivery and also eroding the credibility of budgeting institutions. After all, budgeting is not only about implementing macro fiscal policy, but also about mobilising public resources to attain public policy objectives and deliver on government commitments with society.

This article has attempted to demonstrate that a lot more can be done to generate fiscal space and deliver on government results by upgrading current budgeting practices. Such upgrading may start with a more systematic search for fiscal space in the incrementalist tradition, but it may need to continue with a more ambitious agenda that expands the technical toolbox and the scope of analysis beyond the conventional annual budget cycle. This includes an examination of tax expenditures and public-private partnerships, applying zero-based budgeting techniques and cost-containment strategies in a medium-term scenario, and upgrading the fiscal examination and revision of permanent legislation.

This is an agenda that cannot be developed under a restricted institutional setting. It requires technical capacities, authority and legitimacy that exceed those of budget offices in most countries. Legitimacy and trust are key for these efforts to persist and succeed, so fiscal authorities should partner with other actors at the Centre of Government and generate the appropriate incentives for line ministries and agencies to co-operate in – or at least not resist – this effort. The challenge for budget offices continues to be to develop the skills to use performance and cost information for budgeting decisions and to adapt budget procedures to inform funding decisions, but such information may originate in deeper and more specialised work performed elsewhere. This complementarity is especially relevant with analyses and assessments that extend beyond the annual budget cycle.

Generating fiscal space through an enhanced budgeting system should not be seen as replacing political decisions, fiscal consolidation from the revenue side or performance-based budgeting. Politicians have, indeed, the final say in the allocation of fiscal space or at least in establishing the priorities that guide it. Authorities and legislators should be informed and have a say on the findings of evaluations, benchmarking exercises, performance assessments, cost-push forces and containment needs and zero-based budgeting analyses. Indeed, as many political leaders are currently setting fiscal policy commitments, they need to be aware of what they mean for public service delivery and how social costs can be mitigated.

One key political decision is, in fact, how to combine revenue enhancements with spending cuts in fiscal consolidation strategies. However, all these decisions may be facilitated by having more fiscal space than by lacking it. If the authorities decide to concentrate their consolidation efforts in raising revenue, fiscal space will grow to move faster and be bolder in implementing priority spending or investment programmes. Also, a rigorous examination of spending may be the best argument to support tax increases.

As for performance-based budgeting, many of the tools proposed in this article may be seen as enhancing rather than displacing it. In particular, subjecting tax expenditures, public-private partnerships and permanent legislation to a stricter analysis of its full costs and benefits can be seen as extending the principles of performance-based budgeting to areas that have been relatively isolated from it when working exclusively with performance indicators and programme evaluations. Zero-based budgeting and cost-containment strategies, on the other hand, are complementary approaches to promote value for money in the public sector with a longer term focus than some programme evaluations.

Building the systems and developing the tools to budget for fiscal space at a deeper and broader scale, of course, is not an easy job. It requires methodological developments, professional capacities, institutional and operational arrangements that are way beyond business-as-usual. This is a good reason to start as soon as possible. For many countries, timing to drive change in an autonomous way may be limited and there is indeed a serious risk of self-indulgence once there is a perception that the worst of the emergency is over. To respond to this urgency, there is a wealth of good practices in OECD and non-OECD countries that can, and should, be shared, a small sample of which has been collected in this article.

Notes

1. In addition, some countries that did not depend so much on the IMF for support made their own accounting adjustments to gain some degree of freedom in the implementation of their fiscal policy. This was typically the case of Brazil.
2. Some OECD member countries – Chile, the Czech Republic, Denmark, Hungary, Israel, Mexico, Norway, Poland, the Slovak Republic and Turkey – are not included in these groups due mostly to the lack of comparable fiscal data in the period under analysis.

3. The whole stimulus package was worth USD 787 billion over two years, of which USD 501 billion was channelled as increased spending and USD 285 billion through tax cuts.
4. Comparing the 2011 responses to those from 2007 it appears that performance information is used less with regards to strategic planning/prioritisation (dropped from 17/57% to 13/40% respondents), proposing new areas of spending (14/47% to 13/40% respondents), and to reduce spending (13/43% to 12/37% respondents).
5. The fiscal compact (formally, the Treaty on Stability, Co-ordination and Governance in the Economic and Monetary Union) was signed on 2 March 2012 by 25 members of the European Council as an intergovernmental treaty aimed to ensure fiscal sustainability in the region.
6. Five new EU regulations and one EU directive (the so-called "six-pack") took effect in December 2011 as legislative measures that upgrade the Stability and Growth Pact. Also, a number of additional changes have been undertaken for the euro area: the draft Regulation for Enhanced Monitoring of Budgetary Policies and the draft Regulation for Enhanced Surveillance for Member States with Financial Difficulties (the "two-pack"), which introduce detailed procedures for persuading member countries to amend their national budgets in line with Commission recommendations.
7. Policy rates are estimated on the basis of the Central Bank's stated policy objectives. Concretely, a Taylor rule consistent with the Central Bank's policy directives is used. Regarding sovereign spreads, for some countries in the euro area, projections are made assuming that countries pursue their stated fiscal and structural policy objectives. For other countries, the term premium, inflation risk, sovereign risk and safe haven effects, if any, are taken into account.
8. In this regard, it should be noted that primary balances are projected based on the budget (if available) or other announcements or medium-term fiscal plans. Next, a projection is made for the ten-year bond yields and three-month interest rates, consistent with the monetary policy assumptions, inflation expectations and the term premium, among other considerations. Then, based on the maturity structure of the government debt, the effective bond yield and the interest expenditure on government debt are computed.
9. It should be noted that pension payment commitments over the next 17 years will only be marginally affected by parametric reforms to social security adopted by several countries in the last few years. In particular, most of the reforms that modify pension calculations and the retirement age will be only gradually phased in to new generations of retirees that cannot claim legal entitlements.
10. Caiden and Wildavsky (1974) coined the term "repetitive budgeting" to refer to this practice.
11. It was in effect an *ex ante* rule rather than *ex post* rule as law makers had to keep within the caps for their were legislating. The enforcement of the spending caps constrained appropriations as they were enacted, and the enforcement of the PAYGO rule constrained the estimated future effects of changes in tax policy and in mandatory spending programmes. The US system used across-the-board spending cuts ("sequesters") to remedy policy overages shortly after they were enacted. The US expenditure rule was enacted at the start of fiscal year 1991 to replace the prior deficit-based rule. It continued in force, having been re-enacted twice, through to the end of fiscal year 2002, when it expired. It was, however, overridden by statute numerous times in the last three years of its life, after helping the budget to leave fiscal deficit and enter surplus in the late 1990s (Anderson and Minarik, 2006).
12. Considering an average in spending-to-GDP ratio of 45%.
13. Tax expenditures are "provisions of tax law, regulation or practices that reduce or postpone revenue for a comparatively narrow population of taxpayers relative to a benchmark tax" (Anderson, 2008). For government, tax expenditure is a loss in revenue; for a taxpayer, it is a reduction in tax liability. Tax expenditures are better known in many OECD countries as tax reliefs, tax subsidies and tax aids (Schick, 2007a).
14. Tax expenditure estimates are significantly limited for several reasons: tax expenditure definitions differ across countries due to differences in the definition of their benchmark tax systems, as many tax provisions are formulated as deductions, the value of tax expenditures typically depends on the level of the marginal tax rates. While some countries report estimates for all levels of governments, others only report those related to central government; countries vary in the coverage and detail of estimates that were reported to the OECD.
15. According to the OECD (2012a), PPPs are "long-term contractual arrangements between the government and a private partner whereby the latter delivers and funds public services using a capital asset, sharing the associated risks". According to the IMF (2006, 2004), PPPs "refer to arrangements where the private sector supplies infrastructure assets and services that

traditionally have been provided by the government" while, according to the European Investment Bank (2004), PPPs are "relationships formed between the private sector and public bodies often with the aim of introducing private sector resources and/or expertise in order to help provide and deliver public sector assets and services."

16. One famous case of renegotiation that was handled well is the Sydney Cross City Tunnel. Demand risk had been transferred to the consortium but user demand proved weaker than expected. The government subsequently came under strong pressure to bail out the consortium (i.e. assume the demand risk). In the end, the project did not receive a bailout and the PPP was reconfigured on a sustainable scale (Graham, 2010). Importantly, the same terms applied (the contract stayed in place, there was no change in risk allocation, no change in pricing formula and all private sector obligations were transferred to the new owners).

17. Given the complexity of PPPs and their somewhat infrequent use, critical skills to ensure value for money may need to be concentrated in a PPP unit that is made available to the relevant authorities. A PPP unit's function can be pursued by a number of complementary units. The PPP unit can fill gaps in terms of specific skills, a lack of co-ordination or high transaction costs. Institutional shortcomings should be addressed taking the country's needs and current institutional context into account. The PPP unit should enable authorities (e.g. line ministries) to create, manage and evaluate a PPP efficiently and effectively (OECD, 2012a).

18. Independent fiscal institutions (IFI) are a growing phenomenon in OECD member countries. Particularly in the wake of the financial crisis, governments (as well as regional and international bodies and academic circles) are looking to IFIs as a way to enhance fiscal discipline and promote greater transparency and accountability. In the past decade alone, a diverse group of IFIs have sprung up in Korea (2003); Sweden (2007); Canada (2008); Hungary (2009, but effectively abolished as of 2011); Slovenia (2010); the United Kingdom (2010); and Australia, Ireland, Portugal and the Slovak Republic (2011-12) (OECD, 2012c).

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ANNEX A

Countries use of automatic productivity cuts

	Terminology	Size	Coverage
Australia	Efficiency dividend	Applied at the rate of 1.25% per annum (varying over time 1.0-1.5%). Applied an additional one-off efficiency dividend of 2.5% in 2012-13 to departmental appropriations.	Applied to the operational expenses of all agencies in the general government, unless they are specifically exempted, and to the total net departmental appropriations, excluding some specific receipts. It does not apply to administered expenses, such as grants, subsidies and benefit payments.
Denmark	Re-prioritisation contribution	A uniform 2% cut in the budget baseline; the actual outcome of the budget process may be different.	Applied to the operating expenditure of central government. Institutions and programmes subject to special political agreements are exempted from the cut (approximately one third of central government operating expenditure).
Finland	Programme for Effectiveness and Productivity	Since 2011, an increased focus is put on the effectiveness of government functions, the availability and quality of services, and human resources management. Currently, there is no absolute target but the financial impact is to be achieved in line with the previous staff-cutting target of 8 414 by the year 2011 and a further 5 034 in 2012-15. In 2007-11, only half of the savings from personnel costs were cut from the appropriations of administrative branches. In 2012-15, 25% of the savings will be cut.	Quantitative top-down targets were decided for ministries and agencies, based on ministerial productivity plans. Measures to achieve this were proposed by ministries and negotiated between the Ministry of Finance and line ministries, approved by the Cabinet.
New Zealand	Fixed nominal baselines and additional efficiency savings as of July 2012	New Zealand uses fixed nominal current operational expenditures as a baseline in the annual budget cycle. This means that inflation has to be absorbed. Given that the inflation rate has recently been around 2.5%, ministries had to achieve at least a similar productivity gain in order to maintain their existing level of output. In addition, the efficiency savings will be added t o the savings caused by the fixed nominal baselines. The size of the required savings is 3% for small agencies and 6% for larger ones.	Fixed nominal baselines for operational expenditures are applied on the entire central government budget, without exception. The efficiency savings introduced by 1 July 2012 apply to core government administration as defined by the full-time equivalent (FTE) cap.
Sweden	Deduction in productivity growth (DPG)	It is assumed that agencies can produce a constant output with decreased wage resources because of the corresponding increase in the productivity of labour. The model assumes that productivity development in the public sector is the same as in that in the private sector. The DPG is calculated as the average productivity growth in the public sector during the last ten years. Since its introduction, the DPG has kept within the range of 1-2%, and is applied to the wage index part of the Price and Wage Adjustment (PWA) index.	The PWA applies to *ca.* 28% of the total state budget (FY2012). The DPG applies to *ca.* 16% of the total budget (the percentage represents the base amount subject to the DPG, not the actual deduction resulting from the application of the DPG). Cuts are applied to the multi-annual estimates of agencies' operational costs, as an integral part of the budget process. These estimates are put up in real terms but annually converted into nominal terms by an aggregated wage and price index.

ANNEX B

Calculating loss of fiscal space

Table 4 shows the loss of fiscal space calculation for 29 OECD countries. Defined as the unavoidable budgetary restriction that governments will face in the medium term due to already set financial commitments, loss of fiscal space is expressed as the percentage that three financial obligations represent over the 2011 non-pension primary spending in each of the analysed countries. Except for the final result of loss of fiscal space, all the data shown in Table 2 are expressed as a percent of GDP.

The non-pension primary spending has been calculated as the 2011 general government expenditure (available in the OECD Annual Projections of the *Economic Outlook No. 91 Dataset*) minus the 2011 debt interest payments and 2011 public expenditure on pensions (available in the *Economic Outlook No. 91 Dataset* and the *OECD Social Expenditure Database*, respectively) in order to have an accurate measure of the actual resources that governments have for their programme financing and delivery of services.

The three financial obligations affecting the current level of non-pension primary spending are: the expected increase in pensions expenditure from 2010 to 2030, the consolidation measures required to stabilise debt to 2030, and the additional consolidation measures required to reach a target gross debt-to-GDP ratio of 60% by 2030.

The estimated increase in pensions spending is based on the OECD projections of public expenditure on pensions for 2007-60, available in the *OECD Pensions Outlook 2012*.

The consolidation to stabilise debt is the average improvement in the underlying primary balance to 2030 (or 2040 for Japan) required to stabilise the gross government debt-to-GDP ratio, assuming consolidation in 2012-13 is consistent with the short-term projections described in Chapters 1 and 2 of the *OECD Economic Outlook* (OECD, 2012c), and thereafter amounts to half a percentage point of GDP per annum (1 percentage point of GDP in Japan). Fiscal consolidation projections are the consequence of applying a stylised fiscal consolidation path and should not be interpreted as a forecast. Data on consolidation to stabilise debt has been taken from the *OECD Economic Outlook No. 91 Dataset*.

The additional consolidation to reduce debt is defined as the complementary average improvement in the underlying primary balance to 2030 (2040 for Japan) required to reach a target gross debt-to-GDP ratio of 60%, assuming consolidation in 2012-13 is consistent with the short-term projections described in Chapters 1 and 2 of the *OECD Economic Outlook* (OECD, 2012c) and thereafter amounts to 1 percentage point of GDP per annum (1.5 percentage points in the case of Greece, Ireland, Italy, Japan, Portugal, the United Kingdom and the United States). Some countries have not quite achieved the 60%

debt target by 2030, but with the exception of Japan, it is close enough that it is achieved within a few years after 2030 with little further consolidation. Countries with a projected debt ratio lower than 60% in 2013 are assumed to target their 2013 debt ratio. Data on consolidation to lower debt has also been taken from the *OECD Economic Outlook No. 91 Dataset*. It should be noted that these fiscal consolidation projections to stabilise and lower debt are the consequence of applying a stylised fiscal consolidation path and should not be interpreted as a forecast.

These three financial obligations have been added in order to calculate the portion they represent over the non-pension primary spending in each country. The final result, called loss of fiscal space, is then expressed as the percentage of the 2011 non-pension primary spending for each of the 29 analysed OECD countries.

Averages shown at the bottom of Table 2 are GDP-weighted averages and their calculation considered all OECD countries, including those not analysed in the table.

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The metamorphoses of performance budgeting

by
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Performance budgeting (PB) emerged more than 60 years ago as a key driver of budgetary innovation in the United States. Due to its often lofty goals, PB initiatives were rarely successful, but have instead reappeared, in different forms and with new labels.

This article focuses on contemporary PB transformations, explains their rationale and objectives, and assesses their prospects in eight sections. Due to the fact that PB defies standardisation and countries differ in their approaches, the versions discussed here do not fit all venues, nor would all observers agree that they are sufficiently distinguishable from one another to warrant distinctive labels. PB, however, has some basic features that cut across all its mutations, though the way they are framed or applied may differ among the various approaches.

JEL classification: H60, H61, H68

Keywords: Budget allocation, budget framework, expenditures, implementation, line items, performance budgeting

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1. Introduction

Performance budgeting (PB) has had a charmed existence since it emerged as a key driver of budgetary innovation in the United States more than 60 years ago. Often tried but rarely successful (in terms of their lofty objectives), PB initiatives typically have had an elevated mortality rate, though they have often reappeared, sometimes in a different form and with a new label. Despite its well-documented provenance and chequered past, PB still invokes wonder, as if it were a novel, experimental approach that must be designed anew and explained every time a government attempts to focus budgeting on results. PB has had many lives, sufficiently dissimilar from one another to excite the imagination that this time will be different, that the latest iteration will be truly transformative.

Its various forms in the metamorphoses of performance budgeting give this paper its title and embolden governments to ignore (and occasionally disown) previous innovations, and to confidently claim they are breaking new ground in orienting public expenditures to results. This paper focuses on contemporary PB transformations, explains their rationale and objectives, and assesses their prospects. Because PB defies standardisation and countries differ in their approaches, the versions discussed here do not fit all venues, nor would all observers agree that they are sufficiently distinguishable from one another to warrant distinctive labels. Some basic features, such as the emphasis on measurable results, cut across all mutations of PB, though the way they are framed or applied may differ among the various approaches.

The following thumbnail descriptions of six variants show enormous range in PB's purpose and application. The variants may be regarded either as substitutes for one another or as complements that can be combined in a system that integrates performance management and budgeting, feeds evaluations and reviews into resource allocations, requires suitable measures of results, and opens the process to citizen participation and oversight. It is nevertheless useful to separately identify salient PB variants and to assess their distinctive contributions to government performance. Each of the variants sketched here is discussed more fully in later sections of the paper.

This paper classifies the innovations into three categories: *i)* core PB reforms that aim to change the way budgets are prepared and implemented; *ii)* extenders that are outside the cyclical procedures of budgeting, but seek to influence programme and budget decisions; and *iii)* offshoots whose principal objectives are outside the budget framework.

1.1. Core PB

- Two models of PB are vying for pre-eminence in the contemporary study and practice of performance budgeting. One strives for budget allocations firmly based on actual or expected results, the other aims for budgets informed by data on results. The former finds fullest expression in formula-based allocations, the latter inserts relevant information on outcomes, outputs or other variables into key budget statements. Proponents of performance informed budgeting regard it as the optimal approach, not as a second-best concession to budgetary realities. Those who favour performance-driven budgets regard this as essential to compel governments to give primacy to results in spending public money.

1.2. Extenders

- PB has become an elastic label that is stretched to encompass a wide range of processes that purport to expand fiscal space, improve public services and administrative efficiency, review government programmes, and spur reallocation of budgeted funds. This approach aims to integrate discrete innovations under the performance budgeting umbrella, and to thereby harmonise the separate reforms and their data requirements. PB-extenders include programme evaluation, spending reviews, and other initiatives that appear in the next several paragraphs.
- PB is increasingly viewed as a subset of performance management rather than simply as a process for spending public money. In contrast to earlier approaches that carved out budgeting as a separate process, it is now widely understood that governments cannot budget for results unless they manage for results. This expansion in its scope complicates the task of implementing PB, but enhances its potential to improve government programmes and operations. It also subordinates PB to other management reforms.

1.3. Offshoots

- PB is often moulded into a policy monitoring instrument that bolsters the capacity of top policymakers to track socioeconomic trends and other vital signs, as well as progress in achieving pre-set objectives and targets. When used to adjust policies and allocate resources, monitoring has the potential to transform PB from a technical exercise into a process that engages the attention of political leaders and fluidly feeds updated information on results into policy and budget actions.
- Contemporary PB systems strive to use information on policy results and socioeconomic outcomes to hold political leaders and programme managers accountable for spending decisions and other policies. The shift to *ex post* accountability depends on the availability of timely and reliable performance information, as well as on fundamental changes in the orientation and capacity of audit or other oversight agencies.
- PB has been linked by some (mostly subnational) governments to forms of participatory budgeting that empower citizens (or groups) to make or recommend spending decisions. The expectation is that armed with information on actual or prospective results, citizens will more likely act in the public interest rather than on the basis of parochial influences. This version of PB has strong political implications that go beyond issues concerning the efficiency or effectiveness of public expenditure.
- Evidently, PB has multiple forms, not all of which tie directly to budget work. This is not a new condition; even during its early years, observers noted that PB has many versions and that the term means different things to different governments. Of course, performance and results are PB's universal markers, but how they are defined and measured varies among governments. What is notable are efforts to extend its reach to fundamental policy, managerial and political processes.

PB's transformations are in sharp contrast to the near-permanence of basic routines for preparing and implementing the budget that continue year after year with little or no change. The fact that PB is frequently reinvented indicates that it has not been incorporated into the core processes of budgeting. Except in countries where it is prescribed by legislation, the installation PB is often provisional and subject to frequent adjustments. Even when its arrival is accompanied by political fanfare and self-congratulatory acclaim, PB appears to be perennially on trial and uncertain of its staying power. Whether because a new government is seated or new reforms become more fashionable, PB is likely to be replaced in due course by a later version. Rather than acknowledging its debt to previous performance-oriented initiatives, new PB initiatives stake claim to be breaking virgin ground.

Why have PB reforms been so fragile, and why is one round of reform frequently followed by another, with little recognition of previous performance-oriented innovations? The short answer to the first part of the question is that PB is hard work; one year's success doesn't assure the next year's and one year's costly investment in data collection and analysis does not obviate the need for additional investments the next year. The short answer to the second part is that spending money on the basis of performance is such a compelling idea that neither failure nor disappointment deter reform-minded politicians and managers from pursuing it. Failure or disappointment embolden a new cadre of politicians or managers to try again.

The metamorphoses of performance budgeting are a compound of two conflicting perspectives: the widely-held, self-evident, belief that spending decisions are more rational and efficient when they are based on results; and a conviction that current or previous performance-based reforms have fallen short of the mark. Together, these sentiments propel governments to devise new versions of performance budgeting. This is something almost Sisyphean in the dogged determination to try to make PB work better next time. However, the succession of PB-type innovations is not just a random walk. Each version of PB outlined at the start of this paper bears the imprint of its time, and each has been shaped by changing ideas and experiences concerning the relationship between budgeting and other political or managerial processes.

This paper discusses and assesses each version of PB in the light of the circumstances that gave rise to it. The first variant – performance-informed budgeting (PIB) – challenges the notion that the budget should explicitly link increments in resources to increments in results. Although it is feasible for a country to have performance-driven budgets for some programmes and performance-informed budgets for others, governments that seek to implement PB must decide how tightly decisions on resources should be tethered to evidence on results. There are, to be sure, many variants between budgets in which results are determinative and those in which results are merely indicative. Nevertheless, the fact that PIB advocates view it as superior to results-driven budgets suggests that the two versions rest on conflicting views of how governments should organise budgeting to optimise the allocation of its financial resources. Because the outcome of this clash will influence the future evolution of PB, this paper gives it closer scrutiny than is accorded to the other versions. Two critical questions shape the discussion: with respect to resources-results linked budgeting, is it workable in the political environment within which spending decisions are made? And with respect to performance-informed budgeting, can it have a significant impact on how public funds are allocated?

The other versions are extenders or offshoots and can be grafted onto either performance-determined or performance-informed budgets. For example, extending the drive for performance to other management processes or subjecting performance measurements and evaluations to independent audit potentially enhances achievement of basic PB objectives. These ancillary versions give rise to a different set of questions: How can they be implemented, and do they make PB a more useful instrument for policymakers, managers or civil society?

Before addressing these questions, this paper reconstructs the primordial concept of performance budgeting: the simple ideas and expectations that gave rise to the label when it first emerged in the United States more than 60 years ago. Section 2 probes what preceded PB, what did it try to replace, was it successful, and, if not, why did it fall short? The answers to these questions may startle or disappoint those new to the PB movement, but they may comfort those who sense that governments do not require formal PB arrangements to perform public responsibilities well. Section 3 plunges into the ongoing clash between results-linked and performance-informed budgeting. It should come as no surprise that underlying this debate are conflicting views of how contemporary democracies should operate in allocating public resources. Section 4 discusses performance-enhancing processes such as programme evaluation and fundamental spending reviews. A key issue is whether these processes contribute more to performance when they are carried out independently or when they are hard-wired to the budget. Section 5 makes the once-neglected, but now widely-accepted point that budgeting cannot be split off from other management processes and that realising PB's ambitions may depend on a broad overhaul of managerial culture and practices. Section 6 discusses the policy monitoring variant of PB, and Sections 7 and 8 consider the final two variants: Accountability and citizen empowerment. These are two sides of the same objective – to make government more open and responsive in spending public money and creating public value. The concluding section reflects on why PB has given rise to multiple extenders and offshoots. The performance concept might fade away for a while, but it will not disappear. The lure of performance has become the Holy Grail of budgeting.

2. Why Performance budgeting arrived and why it has not succeeded

The original aim of PB, in the United States, as well as in other countries that adopted this innovation, was to purge budgeting of its line-item focus on the cost of inputs and to base spending decisions on the work to be performed. It bears remembering that most OECD countries once had highly itemised budgets, with expenditures structured into detailed classifications of personnel, supplies, travel, equipment and other goods and services purchased by governments. In some countries, national budgets were long shopping lists, bereft of explanations of what the items would be used for; in others, the budget had narrative descriptions of government activities, but little explanation of what they were expected to accomplish.

PB proponents argued that line item budgeting impedes government performance by: *i)* basing allocations on the cost of inputs rather than on the work being performed; and *ii)* by compelling government agencies to comply with burdensome spending rules that constrict managerial discretion. As logical as this argument sounds, there are often less differences between input-based and performance-based budgets than appears on paper. It is rarely feasible for governments to prepare or implement administrative budgets without due consideration of the cost of inputs. A few countries have tried, most notably New Zealand which has had output-class budgets since the early l990s and Australia which tried an "accrual output budgeting" system in the late l990s. New Zealand still has its output based system, Australia does not. But even when inputs are removed from the budget document, they still hover over expenditure decisions. Purging the budget of all input information is risky because it is difficult, sometimes impossible, to determine whether the amounts budgeted by governments are optimal when it lacks market prices or data on the cost of inputs. In the pursuit of performance, spending units need input information to carry out assigned activities and accomplish planned results. Line items detail does not occupy centre stage, but it does not disappear from budget discussions.

Detailed line items lost their grip on budget allocations, not because of the spread of PB but because of the vast post-war expansion in the scale of public expenditure. As public spending escalated, individual line items receded in importance and were no longer useful instruments of expenditure control. Over time, OECD countries consolidated line items into a few broad categories, for example, by collapsing various types of supplies or job titles into a single line. However, they still pay attention to the wage bill and to other major expenditure categories in deciding how much to allocate to administrative units. The line items have not vanished from budgeting. Instead, they have retreated to the internal accounts of operating agencies, which prepare and implement their budgets with a vigilant eye on the funds required to cover the cost of inputs, most of which are fixed in the salaries of public employees and other legal or political commitments.

While the persistence of input-based budgeting runs counter to the rationale of PB, it has not impeded the spread of a performance culture in government. Efforts to take account of results took hold in many OECD countries long before the formal advent of PB, as evidenced by their astounding progress in universalising public education, controlling infectious diseases, building modern roads, establishing basic income supports, and creating prosperous societies during the decades before the first formal PB systems were launched. It is important to understand that national governments managed to achieve these and other extraordinary results even though they lacked performance budgets and made spending decisions through the lenses of input-saturated accounts.

Governments performed well during the pre-PB era not despite line item, control-fixated budgeting, but because of it. Input budgeting established the rules and routines of financial control, the notion that money should be spent only as authorised in law, and should be accurately accounted for. These norms are essential building blocks for PB. Without them, budgets risk being unreliable statements of government finance; with them, governments can produce substantial results, regardless of the form of budgeting they have.

The unconventional truth is that a performing government depends more on the behaviour of politicians and civil servants than on the format of its budget; on managerial skill than on dexterity in measurement; on the professionalism of public employees than on performance bonuses; and on other financial incentives. This is why early adopters of performance-type budgeting were among the best managed countries in the world. They were ready for PB; others were not. Early PB was in step with the times because government was taking on new responsibilities, its programme and financial footprints were expanding, and political leaders and reformers were confident that orientation to results would enable government to intelligently allocate the dividends of economic growth. As later waves of innovation shaped budget perspectives, PB was joined by programme budgeting. This reform sought to align budget decisions with government objectives. The goal was to plan programme budgeting systems that aimed to rationalise budget decisions by means of economic and policy analysis, and by zero-based budgeting that claimed to extend the logic of results to existing spending levels, not just to the increments. While first generation PB was content with measuring outputs, later generations demanded attention to outcomes and impacts.

The multiple waves of reform have had overlapping agendas and common tools. They were fuelled by confidence in the capacity of government to produce rational, efficient policies and results, but they faded when economic and political conditions soured, growth dividends vanished and public trust in government plummeted. This is not to say that political and economic obstacles fully explain the disappointing fate of first-generation reforms. Other factors, such as overloaded reform agendas, burdensome informational and analytic requirements, and inadequate political and managerial support repeatedly undermined efforts to recast budgeting into the driver of improved government performance.

Political and economic conditions that prevailed at the dawn of PB were fundamentally different from those that dominate the landscape during PB's current revival. Instead of growth dividends, governments now face shrinking fiscal space as economies stagnate and debt levels rise. Old commitments and new demographic pressures claim almost all available resources, and in some fiscally-stressed countries more than is available. Rather than being an allocative process, contemporary PB it seems, is more likely to strive for reallocation and to shift money from less to more productive uses. This is happening at a time when interests groups are effectively mobilised to protect their benefits and citizens in many OECD countries, and when political leaders and institutions in are held in low regard.

The take away messages from this limited historical window into performance budgeting's first arrival are:

1. PB is a tough sell in good times and harder in bad times;
2. by itself, PB cannot compensate for a shortage of fiscal space;
3. PB cannot reverse the decline in public trust, but it is hamstrung by low regard for political leaders and institutions;
4. robust growth would improve the political market for PB-driven budget allocations, but PB cannot itself ignite needed growth;
5. valuing performance yields better results than merely going through the procedural motions of PB;
6. purging input data is not a precondition for effective implementation of PB, but consolidating line items may be.

This account does not find that previous PB efforts failed; rather that, they faded away. They did not however fade away before bequeathing some changes in budget practices, in particular, greater attention to measurable results in many countries and more recourse to policy analysis and programme evaluation in some. It would not be a stretch to conclude that first-generation PB altered conceptions of good budgeting. It thereby paved the way for expanded iterations of performance budgeting, including the contemporary variety of approaches.

At first glance, it appears that the main advance in PB processes has been in the sophistication of performance measurement. This certainly is PB's most conspicuous characteristic. Governments at all levels and in many countries have invested enormous amounts to define outputs, outcomes, impacts, benefits, targets, and so on. With few exceptions, however, PB has not become the government's budget process. It is an accessory to the budget. It adorns and enhances budget decisions, but does not fundamentally change the way they are made. Going forward, the key question is whether PB can become the process for allocating resources and targeting results.

3. PB: The information-allocation continuum

PB's status as an accessory to budgeting has given rise to ongoing debates over whether its principal aim should be to enrich the supply of information to budget makers or to change the way budgets are decided. The lines of disagreement were drawn in two prominent books, both published in 2007, that examined performance budgeting in an international perspective. One was issued by the OECD and drew from a survey of Member countries and case studies to argue for performance-informed budgeting. The other was assembled by Marc Robinson, a former IMF official, who favors the explicit linkage of resources and results. As the title to this section shows, the present writer considers it useful to view the information versus allocation distinction along a continuum that has numerous shadings rather than as either-or categories.

The OECD report endorses the PIB approach; its opening paragraph notes:

> "… a resurgence of efforts by the governments of OECD countries to introduce performance information into their budget processes. The central aim of this reform is to improve decision making by providing better quality and more concrete information on the performance of agencies and programmes."

In this book and in subsequent reports, the OECD has identified three varieties of PB: *i)* "Presentational" PB – the information does not play a role in spending decisions, though it may be used to promote accountability and public discussion of policies; *ii)* "Performance-informed budgets" – there is no automatic linkage between performance and funding levels; the weight given performance information depends on particular circumstances; *iii)* "Direct" PB explicitly links budget allocations to units of performance. While acknowledging that there are salient differences between information that serves merely as background and information formatted for use by decision makers, this paper prefers a bipolar continuum that recognises enormous variation in the actual utilisation of performance information. The line between presenting and using performance information can be quite thin; even within the same country, actual use may vary from one ministry to another or from one year to the next. How should one classify a country that intends to apply performance information to budget allocations but in the hectic rush to complete the budget fails to do so? Conversely, discrete classifications do not fit countries that publish information only as background but end up basing some allocations on results. On the one hand, information on results often influences expenditure decisions, not always formally or at once, but more likely over time. On the other hand, determining spending levels solely on the basis of quantified results is rare except in formula-based budgeting. Classifying PB into discrete categories makes it appear that these differences are clear-cut; they are not.

In congruence with the OECD, Robinson concedes that "performance budgeting is not monolithic"; there "are different forms of performance budgeting which seek to link resources and funding in different ways". Despite this ecumenical view, he defines performance budgeting as "mechanisms and processes designed to strengthen the linkage between funding and results through the systematic use of formal performance information." Robinson argues that linking resources and results requires fundamental changes in budget practices; just enriching the supply of information will not suffice. He insists that performance budgeting is unlikely to succeed "unless the budget process is reformed by the inclusion of mechanisms and procedures which … facilitate the effective use of performance information in allocative decisions." Robinson yearns for PB to transform budgeting, the OECD see it as informing decisions.

Comparing these approaches, one can readily identify the two poles of the continuum, with background information at one end and formula-based allocations at the other. Most OECD countries lie between these poles, but it makes a great deal of difference whether a country organises budget work to systematically feed results into decisions or merely makes the information available.

3.1. PB in OECD countries

During the past decade, the OECD has periodically surveyed Member countries on their use of PB and other modern budget mechanisms. The most recent (2011-12) survey focused on the extent to which PB and other mechanisms (top-down decisions, spending reviews, and productivity dividends) facilitate short-term austerity measures and medium to long-term expenditure reallocation.

Based on responses to the latest questionnaire, approximately two-thirds of OECD countries have issued guidelines and definitions for performance budgeting, and slightly fewer have standard methods for reporting performance information to the central budget authority. However, barely a handful of countries have a performance rating system or a standard set of performance indicators or targets. In most OECD countries, line ministries, not central agencies, have the lead role in generating and using performance information in the budget process. Overall, performance reports and programme evaluations are only used occasionally in budget negotiations between line ministries and central budget agencies. When it enters into these negotiations, performance information is about as likely to be used to increase as to decrease spending, but rarely to eliminate programmes.

What, then, do negotiators actually discuss in critical bilaterals between line ministries and central budget organs? OECD surveys do not explicitly address this question, but one may surmise that even when they do not focus on performance and results, negotiators have a lot to talk about. One perennial issue is the overall spending level, and within it allocations among major categories of expenditure. From the line ministry's side, negotiations almost certainly touch on the increases it must have and the cutbacks it cannot tolerate. Central negotiators stress the government's priorities and constraints, and sometimes propose initiatives that will enable them to freshen the budget. In the course of settling the budget, either side may draw on performance evidence to bolster their arguments, but they may also touch on cost issues, in particular the wage bill and other expenses.

It appears that the financial crisis and the austerity drives it has spawned have not swayed governments to emphasise performance issues in budget negotiations. In comparing its pre-crisis (2007) and 2011-12 surveys, the OECD found a marked increase in the role of line ministries and agencies as the main institutions responsible for setting performance targets. Moreover, there is lessened use of performance information in budget negotiations and to a growing, extent this information is not used at all. Evidently, negotiators have other things on their minds when they are pressured by time and fiscal constraints to hammer out a budget agreement.

3.2. Performance as information

Why doesn't results information weigh more heavily in budget work? Given large investments in measuring performance and collecting relevant data, why hasn't the expectation that better informed governments will make more effective use of public money been realised? Why is evidence on results often shunted aside in allocating scarce resources? The simple answer to these questions is summed up in the aphorism, "information is not transformation."

In both the private and public spheres, leaders and followers habitually ignore inconvenient truths and continue on their ways despite evidence that they are taking the wrong path. Of course, this saying does not ring true for PIB advocates, those who argue for versions of PB that make critical information available to budget people at key points in the process. Yet, they acknowledge that an information-centered PB will have more favourable prospects when certain prerequisites are satisfied. For example, Hilton and Joyce specify two sets of preconditions for the successful implementation of performance-informed budgeting. "First, certain fundamental institutional and technocratic prerequisites must exist to support effective budgeting and financial management". These include timely budget adoption; forecasting and audit capacities; transparency and reliable accounting systems; adherence to the adopted budget; and avoidance of structural deficits. The second category consists of "necessary characteristics" and includes valid measures of performance, explicit and coherent goals, and reliable information on costs. The first set of preconditions deals with generalised budget capacity, the second with capacities directly relevant to PIB. This writer would add a professional, motivated public service and the normative underpinnings discussed earlier.

It is important to stress that in every country and at every level of government, both the reliability of and usefulness of performance information depend on the conditions under which PB is implemented. Without exception, performance-based reforms can be effective only in well-managed governments which have low corruption, elevated levels of public trust, highly-skilled and well-motivated public employees, reasonably efficient and accessible public services, attentive media and groups, and the freedom of citizens to communicate their concerns to government. PB cannot overcome or compensate for government failures; it has a chance to succeed only when conditions are favourable.

These preconditions may be useful guides in determining whether a country is ripe for PB-type reform, but they do not assure that an information-based strategy will succeed. Recognising the preconditions required for introducing PB can counter the irrational exuberance of reform-minded consultants who pressure countries that lack basic financial and management capacities to introduce *avant-garde* budget practices. But even when the conditions seem favourable, PIB can founder on the rocks of budgetary *realpolitik*.

The built-in tension between its two basic elements – performance and budgeting – impedes implementation of PIB. Performance is about change, spending money more efficiently or on different things; budgeting is mostly about continuity, spending money next year on activities financed in previous years. The essential purpose of measuring performance and identifying results is to question whether government is spending money on the right things and in the right ways. The process of putting together the next budget typically entails looking back at what was spent in the last budget and making small adjustments to accommodate price changes, political priorities and current or projected fiscal conditions. It is feasible to lessen friction between these clashing perspectives. The optimal way is to prepare the ground for performance-oriented changes in budget allocation through the determination and skill of political leaders and organisation managers to get better or different results. The recent OECD survey indicates that these efforts may be more fruitful when they are processed through other actions rather than the budget, that is, when the budget is not the main driver of change but the means of accounting for changes made by other means. Another way is to target performance efforts on marginal decisions in budgeting. One practical means of accomplishing this is discussed in the next subsection.

There are multiple reasons why budgeting may not be the most effective means of feeding performance information into the policy stream. Information overload is a chronic problem in the time-compressed, deadline-driven world of budgeting. This chronic problem is exacerbated when PB adds new data, classifications and analyses to the old. Giving budget makers more data does not give them more time to complete their chores or more opportunity to resolve conflicts. They muddle through annual budget routines by paying attention to essential information and only giving short shrift to information that is good to have. This is not normally a conscious decision, but it enables them to make it from one budget cycle to the next. Much PIB-type information is good to have, but not essential to the ongoing operation of government departments and activities.

National governments have become information generating machines that produce copious amounts of data that are not used when spending decisions are made. The gap between producing and using information is especially wide when performance and budgets are at issue. PB becomes discredited when spending units which produce much of the information perceive that their efforts have been in vain. They become careless and treat demands for performance information as just another technical requirement they have to comply with in order to secure funds for the next year.

In budgeting, as in other hierarchical, principal-agent relationships, policies and guidance are supposed to flow downward, while information on services and results is supposed to move up. Political leaders and senior managers have formal authority in many countries to establish performance objectives, but they are dependent on service providers several or more echelons lower to supply essential information. This unbalanced relationship between principals and agents gives rise to the pervasive problem of asymmetric information. Even when they have fairly robust monitoring and reporting systems, central policymakers are dependent on what subordinates, whose perspective and interests differ from theirs, tell them. The problem is especially acute when government aims to base spending decisions on performance. When their budgets are at risk, wily agents may withhold or spin data, lie about results, emphasise data that put their performance in a favourable light and hide adverse information. It is the fate of PB that when performance indicators are ignored in budget work, managers can be truthful about shortfalls or problems, but when they influence budget allocations, line managers have incentive to mislead and deceive.

Agent-principal dissonance and the problem of information asymmetry diminish significantly when the drive for performance is redirected from budgeting to management, that is, from information that might be used against an administrative entity's interests to information whose use is largely controlled by the entity. This is the main reason why performance information has a safe harbour when it serves management, but stirs anxiety in adversarial relationships between budgetary claimants and guardians.

PB almost always increases the cost of generating and processing budget information. Traditional budgets depend on input and output information that is routinely collected in managing government organisations and activities; performance indicators that focus on results, impacts and outcomes require information that lies outside the four walls of government entities. For example, a well-managed hospital routinely compiles timely information on staff levels and payrolls, supplies and equipment consumed, the number of patients admitted and discharged, the occupancy rate, and much more. It takes little effort to organise this information for use in budget decisions. But to assess whether it is performing well and the impact of its activities on health outcomes, a hospital must actively seek to acquire information that is external to its operations, such as the health status of patients after discharge, whether they take prescribed medications, and a social-demographic profile of the community it is serving. To obtain this information, the hospital may have to conduct citizen surveys, make follow-up visits to former patients, and undertake other expensive efforts.

The cost of acquiring relevant performance data partly explains why many PB systems that aim for outcome measures end up with output data. Spending units often respond to demands for performance indicators by producing copious amounts of information on what they do rather than on what they accomplish. In operating a PB system, generating a surfeit of data sometimes substitutes for having the right kinds of data. Paradoxically, PB has both too much and too little data. In some countries, the PB system is inundated with thousands of indicators, all of which are deemed relevant in assessing programme or organisational results. Yet, governments often lack data on the marginal differences in results arising from marginal changes in expenditures. To produce information on the sensitivity of substantive results to marginal changes in expenditures government must first disaggregate outputs or outcomes into discrete units, and then account separately for fixed and variable costs. These steps, which have been mastered by few national governments, are necessary to distinguish between average and marginal costs. Without them, governments cannot reliably estimate how substantive results will vary when they decide during budget season to spend more or less on particular activities.

Summing up, it is this writer's view that stand-alone PIB may do more to enrich the quality of public information than the quality of public services. It should not be assumed that accomplishing the former assures the latter. The road to good performance must be paved with relevant information, but it also needs travellers who know how to get where they want to go, and destinations worth driving to.

The information-centred version of PB has several advantages: it reduces conflict over objectives and priorities; allows politicians and managers broad discretion in allocating resources on the basis of their preferences; and facilitates timely completion of budget work. But these advantages come at a significant cost, for they allow budget makers to disregard evidence on results in spending public money.

3.3. PB as allocation

The inadequacies of information-based PB justify the stronger efforts advocated by Robinson and others to formally link resources and results. It bears repeating that this linkage may occur along a continuum, ranging from quantitative dependence of allocations on results in formula-determined allocations to budget structures that format budget decisions to show the reciprocal effects of resources on results. Promoters of results-driven PB must walk a fine line between evidence-based decisions on the one hand and the acknowledged desirability or inevitability of political and managerial judgment on the other.

How can governments walk this line without regressing to information-centred PB while avoiding naive assumptions about politics-free budgets that automatically convert results into allocations? The fact that few governments have a true results-driven PB speaks to the difficulty of implementing this type of budget. Moreover, the revelation in the OECD's budget practices survey that national governments have not relied on results-centred evidence to apportion austerity-mandated spending cutbacks hints that it may be easier to link resources and results when the budget is expanding than when it is contracting. Expansive budgets have sufficient space to accommodate both allocations based on evidence and allocations based on politically-expedient responses to voter preferences and group demands. Contractionary budgets are dominated by calculations of what can be cut without provoking legal challenge or political unrest.

It may be unfortunate that PB is side-lined during stressful fiscal times when it has the potential to do most good in enabling governments to preserve effective programmes while trimming less effective ones, but this reality of budgetary politics cannot be ignored in efforts to connect resources and results. Accordingly, the ensuing discussion focuses on favourable economic times, when increments are available to finance investments in results. This form of allocative PB can be thought of as rational incrementalism, that is, as spurring governments to channel spending increases to programmes that promise the greatest returns. As will be described below, this form of PB can also prod governments to reallocate funds within programmes to improve results.

A key step in operationalising PB as a budget allocation system is to define and measure performance – whether outputs, outcomes, or impacts – in terms of the actual or projected changes in results produced by public action. It makes little sense to regard performance that would occur in the absence of an allocative decision as a budget-driven result. Performance budgeting should be conceived as a method for allocating incremental resources to achieve incremental changes in results. Change can be defined in reference to achieved or estimated results, or in reference to a target or benchmark set by the government or to an externally-established standard. For example, a performance budget might allocate additional funds to boost graduation rates, reduce class size, improve student reading competence, and introduce computer-based courses.

One may challenge this method on the ground that it exempts the "base" – the ongoing activities that account for almost all public expenditures from PB's purview. In the case of education, most funds are budgeted for regular classroom activities that are continued from one year to the next, typically with price and workload adjustments. At first glance, this appears to be a powerful argument against confining PB to marginal changes in expenditures and results. However, this writer believes that applying PB to the entire budget would doom the effort to failure, both because of the conflict it would spawn and the informational burdens it would place on harried budget makers. PB would become a form of zero-base budgeting.

There is little gain in having a PB that allocates money for activities that are continued without material change from year to year. The routine procedures of budgeting do a good enough job accounting for these activities and providing resources for policy-neutral price increases and workload adjustments. As a change focused process, PB can be deployed to allocate decrements to base activities, that is to reduce spending or reallocate funds among activities, usually within the same spending unit but occasionally between units. The same logic and methods that pertain to incremental changes can be applied to decremental ones as well.

To construct a change-oriented PB process, government must have capacity to apportion costs among the results produced by its spending agencies. Ideally, this should be done by means of cost accounting systems that disaggregate results into standard units of outputs (or less easily) outcomes and measures the cost of each unit. The budget would distinguish between costs that vary with the volume of results produced and costs that do not vary. Armed with this capacity, PB would become a system for marginal allocation. Governments would need to deepen their comprehension of how resources are translated into results. This specialised capacity must be programme-specific. In the case of education programmes, policymakers would have to comprehend the factors that impel students to continue in school or to drop out, the teaching methods that impart reading and other skills, the impact of community, home and peers on the learning environment, and much more. This type of knowledge cannot be honed through budget work alone; it derives from in depth studies of education policies and activities, assessments of how schools are managed, the training and motivation of teachers, and quite a few other relevant factors. The metamorphoses of PB, especially in the form of strategic reviews and public management reform, partly compensate for the inadequacy of relying solely on budgetary institutions to connect resources and results.

3.4. A practical method for linking resources and results

All successful efforts to connect performance to budgets share two important characteristics: they orient budget work to policy and expenditure changes, and they allocate resources at the margins. As previously explained, this means that decisions on incremental changes in expenditures are also decisions on incremental changes in results. Just hoping for this linkage is not enough; governments need data and procedures – the stuff out of which budgets are made – to recast budgeting to a process for purchasing marginal changes in results. The challenge for governments is to devise practical means within established budget frameworks for assuring that marginal changes in expenditures are considered in the light of marginal changes in performance. A separate PB process that is not integrated into procedures for compiling the budget will not suffice, for it can be ignored when spending decisions are made.

This subsection sketches a template for forging the resources-results link. The template, which has been adapted by this writer from work done by others, has actually been applied by a small number of (mostly sub-national) governments with apparent success. What is suggested here is a template – not a firm recommendation – that can be adapted to particular circumstances and can be grafted onto a government's including the pre-existing budget process.

The basic idea is that governments should focus allocative decisions on changes to the results that are projected to occur in the absence of policy initiatives. The starting points for the contemplated arrangement are parallel baseline projections of future expenditures and results if current budget and programme policies were continued without change. In recent decades, baseline (or forward) estimates of expenditures have become an essential budget tool in countries that have viable medium-term expenditure frameworks (MTEF). By means of the baseline, governments estimates the budgetary impact of proposed or adopted policy changes. However, in contrast to standard baselines which project expenditures, the method described here would add projections of services, outputs or outcomes, thereby enabling governments to measure the impact of policy changes on results. The expenditure and results baselines would be disaggregated to emphasise policy-relevant features of the budget, especially incremental changes in spending and performance. The baselines would highlight results for which policy changes have been made or are under consideration.

The second essential step is to explain the baseline projections through trend analyses of government programmes and results. The aim should be to provide policymakers and citizens with an understanding of why particular results have been projected to occur if current policies were continued. In education, for example, trend analysis would explain the baseline projection that 30 per cent of secondary school students will dropout before graduation. This analysis is essential because a government cannot justify changes in expenditures or programmes if it lacks understanding of why certain outcomes are projected to ensue from current policies. If policymakers do not know why 30 per cent dropout, they also cannot know whether allocating additional resources or modifying education programmes would alter the dropout rate. Because trend analyses seek to explain the connection between resources and results, it would be useful to publish summaries in the budget for programmes or spending units whose expenditures may be significantly changed by new policies.

The third step is to propose policy changes in the budget and to explain, in reference to the expenditure and results baselines, how they are expected to change the amounts spent and the results achieved. Continuing the education example, this type of PB might explain why adding guidance counsellors or other interventions are expected to lower the dropout rate from 30 to 22 per cent. Drawing from programme evaluations and other sources, the analysis would explain why youngsters leave school, why current policies have not been effective, and why proposed changes would “bend the curve.”

The three components – baseline estimates, trend analysis, and analysis of budget and policy changes - contain the essential elements of a PB system that links marginal changes in expenditures and results. Ideally, trend analysis should be supported by programme evaluations; relevant output and outcome indicators; statements of government objectives and priorities; procedures for estimating the budget and programme impacts of policy changes; and mechanisms for spending units to shift resources from lower to higher performing activities. For this process to work, it is necessary to focus budget work on policy issues by curbing procedural and informational requirements that distract budget makers from a focus on results.

The template outlined here is sufficiently elastic to accommodate country-specific variations. Running the template would impose some additional informational requirements, arising out of its focus on marginal analysis, but it is built largely on existing budget procedures, especially in countries that have effective medium-term frameworks and experience with baseline projections and sound procedures for estimating the budget cost of policy initiatives. The important thing about the template is that it recasts PB into a strategic process that focuses allocative decisions on expenditure and policy changes to produce public results. This method validates the argument made earlier that PB can be more effective operating at the margins than as a comprehensive process that purports to shape all expenditure decisions.

4. Extending PB to include processes outside the budget framework

The versions of PB discussed thus far are grounded on the notion that budgeting drives performance, that governments perform when they spend money to buy specified results or to motivate public managers to create public value. These versions take it for granted that performance is degraded when the budget is indifferent to results and bases allocations on the cost of inputs rather than on expected outputs or outcomes. PB advocates are confident that leveraging the budget's control of public spending has the potential to change the behaviour of spending agencies and service providers, and to thereby improve efficiency in purchasing outputs and effectiveness in producing outcomes.

The main problem with this expectation is that budgeting is not as potent as PB architects assume it to be. More often than not, each year's budget is largely shaped by decisions taken elsewhere, especially in previous budgets and in standing legislation. Viewed in this light, budgeting is a weak process that is handcuffed by incremental biases, laws entitling recipients to mandated payments, pressure to allocate sufficient funds to finance the running costs of government, and in some countries by activist courts that compel government to finance certain activities in the budget. In practice, budget officials typically exercise strong control over the incremental resources produced by economic growth or by marginal reallocations, which is why the PB variant described at the end of the previous section has the potential to work.

A self-contained PB faces an additional problem. As an insular process, budgeting does not itself generate sufficient data and analyses to base allocations on actual or expected performance. It is, as practitioners well know, a deadline-congested process that runs on routines that are repeated year after year, usually with little or no change. To function as a performance-enhancing process, budgeting must be open to externally-generated targets, indicators, evaluations, and other information.

Because the budget is impacted by decisions made elsewhere, it can also be shaped by performance information produced through other processes. Budgeting does not have to be in the driver's seat for government to drive for results; it can be an effective instrument for translating policies and measures developed elsewhere into expenditure decisions. Once it is recognised that the fundamental aim of PB is to improve government performance and that budgeting is just a means to this end, it is a short step to recast PB into a process that is open to a variety of initiatives outside the constrained framework of budgeting.

This redefinition is suggested in an important paper by Mario Marcel, which explores the deployment of PB to expand government's fiscal space. Marcel was led to an expansive view of PB by "the inability of indicators, monitoring, programme evaluations, and presentational schemes to contribute to fiscal consolidation measures…" Drawing on OECD's recent survey of budget practices which found "that performance budgeting tools were of little use for budget adjustments when the crisis hit in 2008," Marcel suggests a two-prong strategy to facilitate fiscal consolidation: "incrementalist" initiatives that do not uproot established budget practices, such as programme evaluations, spending reviews, efficiency dividends, and de-indexation; and "nonconventional" approaches that include changes in permanent legislation, curtailment of tax expenditures, greater recourse to PPPs, and zero-base budgeting. From one perspective, the only common feature of this hodge-podge of reforms is that they may generate savings to stabilise the government's fiscal position. From another however, each has potential to improve government performance. The various reforms, Marcel urges, "should not be seen as an alternative to a focus on results and performance but companion to it." Creating fiscal space should not be an objective in itself but a way of safeguarding and mobilising scarce public resources to priority objectives."

Marcel's menu of initiatives that seek to expand fiscal space by promoting performance may be regarded either as subordinating PB – treating it as only one of a number of tools available to government – or elevating it to be the organising basis for otherwise disparate innovations. A strong case can be made that PB has no special claim of pre-eminence; it is only one technique among many. Governments can extract efficiency dividends or evaluate programmes even if they do not have performance budgeting systems. Nevertheless, there is sound reason for labelling PB as a broad process that encompasses other efforts to improve performance. Doing so recognises that these initiatives may be effective only to the extent that they influence budget decisions. Viewed in this light, PB is not a distinct process but a conduit that translates data and analyses generated outside the budget process into programme decisions and resource allocations. Feeding externally-produced assessments into the stream of budget work requires that PB be an open process that actively searches for performance-relevant information and analyses. This can be a difficult task because budgeting's routines and deadlines tend to induce policymakers to adopt an insular perspective that screens out views and insights which challenge incremental spending patterns.

This problem can be summed up as follows: innovations that are formally attached to established budget procedures risk becoming technical exercises that reinforce incrementalist tendencies; and innovations that are distanced from the budget risk being ignored when spending decisions are made. This is not a new problem: it has repeatedly vexed countries that formalize programme evaluation rules and procedures. Although there have been a few notable successes, the usual fate of large-scale investment in programme evaluation has been marginal adjustment in expenditures, not wholesale reallocation. The successes provide useful clues, though they do not assure the same results when procedures are transplanted elsewhere. Since the early l980s, the Netherlands has selected a number of programmes for in-depth "reconsideration" each year. The effectiveness of this arrangement may be due to high-level political support – the selections are made by Cabinet – and the country's relatively stable multiparty coalition government. In some years, Chile has opportunistically emphasised "quick" evaluations that are fitted into the budget calendar and influence annual expenditure decisions. It has been willing to trade away deep studies in order to garner insights that are applied in the current round of budget work. Australia had significant success beginning in the late 1980s, when the Government launched an ambitious "evaluation strategy" that required ministries to schedule assessments of their programmes and to formally publish results. The strategy included an annual report on the extent to which evaluative findings were fed into budget decisions. The accomplishments of these countries demonstrate that programme evaluation can be effective when political support is forthcoming and procedures are in place to funnel results to budget decisions. Arguably, PB is the optimal form of budgeting for actually applying programme evaluations in budget work, for it sensitizes spending decisions to evidence on results.

The main aim of conventional evaluations is to improve the effectiveness of programmes or the efficiency of expenditure. If there is reallocation, it is mostly within programmes, and if there are savings, they typically are ploughed back into the same programmes or agencies from which they were harvested. Programme evaluation thus comfortably coexists with incremental spending behaviour. However, standard evaluations may not suffice for countries that cannot , or do not want to, continue along an incremental path. They may need bolder techniques that promote fiscal consolidation and stabilise public finance.

4.1. Spending reviews

In the wake of a still-festering fiscal crisis, many OECD countries have turned to strategic spending reviews that seek to address fundamental questions about a programme's or agency's purposes or effectiveness. Spending reviews were not included in early OECD surveys of country budget practices, but the 2011-12 survey reports that more than half of Member countries now claim to have used this practice. Curristine's 2007 study of *Performance Budgeting in OECD Countries* identifies half a dozen countries that have incorporated some type of spending review in their budget processes, and she also briefly discusses this technique in an essay published in Robinson's book. Significantly, Robinson's glossary of terms associated with PB has more than 70 entries, but spending reviews are not among them. Although they have antecedents that go back decades, contemporary spending reviews are by-products of the crisis and of the perceived need to loosen incrementalism's grip on public expenditures. They aim for significant spending reductions or reallocations, not for the marginal adjustments achievable through ordinary budgetary work.

Recent interest in spending reviews suggests that older processes do not suffice to blunt the adverse impact of incremental budgeting on the government's fiscal position. Programme evaluation, performance targets and indicators, medium-term frameworks, and other popular techniques tend to be undermined by the routines and biases of budgeting. They often become parts of the ongoing routines of budgeting, procedures that have to be completed in order to get through that year's budget work. The programmes targeted, evaluated or measured continue along their destined incremental paths.

Crisis-driven spending reviews strive to inject performance criteria into cutback decisions that usually are made opportunistically rather than strategically. When faced with pressure to immediately curtail expenditures, governments habitually resort to tactics that reduce political costs while saving money. Across-the-board cuts, freezes on pay or on hiring, and deferral of maintenance expenditures have nothing to do with performance but are expedient ways of saving money without making politically difficult choices. Spending reviews open the door to the political risk of cutting popular programmes that fail to produce value for money. How wide the door is open depends on the commitment of political leaders to make the case for performance-based cutbacks when fiscal conditions demand consolidation and for reallocating money when there is a yearning for programme enhancements.

Genuine spending reviews differ from ordinary programme assessments, Curristine argues, "in that they are centrally driven exercises and they concentrate on issues of allocative efficiency across government and examine the consequences of alternative funding levels." This writer prefers the word "politically" rather than "centrally" driven. That is, they engage ministers, either collectively in cabinet or individually through their assigned portfolios, in defining the questions to be addressed and deciding the policy and budget consequences of the evidence produced by the reviews. If political commitment is lacking, a review is prone to become yet another technical exercise that yields interesting findings but few hard choices. Every country that has successfully conducted reviews *and* then made significant policy changes has done so because the process has been led and supported at top political levels.

To be useful, a spending review should ask basic questions concerning purposes, priorities and effectiveness, and it should be organised to facilitate policy responses to the evidence adduced in conducting the review. While the scheduling of reviews may be *ad hoc*, the questions raised should be uniform, and pertain to a broad swath of programmes and agencies. If they aren't, reviews risk becoming self-serving exercises that weaken the government's capacity to rein in public expenditures. Policy reviews conducted in the Netherlands are based on uniform questions that include: What is the problem to be solved? What is the cause of the problem? Why is the solution a responsibility of government? Which alternative solutions are possible, and which policy instruments can be used? Every country that undertakes reviews has its own questions, but they all go to the issue of whether government should spend public money on the programme.

Spending reviews confront a problem that is the opposite that which besets innovations that are closely tethered to the budget cycle. Conventional innovations risk being captured by the perspectives and routines of budgeting; spending reviews risk being ignored when time and politically pressured expenditure decisions are made. Some countries have sought to surmount this problem by building spending reviews into the budget process. For example, in the United Kingdom, during Labour Government rule (1997-2010) biennial spending review led to public service agreements that specified departmental targets and resources. In the United States, the Bush Administration (2001-09) introduced a programme assessment rating tool (PART) in tandem with annual budget reviews. Because of critical differences in governing arrangements, the British were more successful than the Americans in translating reviews into performance targets and expenditure policies. Both countries, however, share one characteristic that calls the long-term efficacy of systematic – in contrast to *ad hoc* – reviews into question. In both countries, formal reviews were discontinued with a change in government. Not surprisingly, a process that is utterly dependent on political support is discarded or revised when political winds change. It may be that distinctive features of its political system, in particular, stable regimes and highly-developed coalition agreements, have spared the Netherlands this fate.

Are spending reviews merely crisis-borne adjustments that will fade away when crisis abates, and do they have much impact on budget policy while they are in vogue? Writing before the crisis ravaged public finance in many OECD countries, Curristine concluded that even with spending reviews, "much of the annual budget process remains incremental… reallocation is not necessarily the result of systematic spending reviews." My assessment is somewhat more positive, both because of the extraordinary effectiveness of spending reviews in some countries, such as Canada in the l990s, and the impulse to curb budget deficits in fiscally-distressed countries. Political support is rarely sustainable for an extended period, but when it is present, spending reviews can enable governments to make performance driven budget decisions.

This section began with the argument that budgeting needs external reinforcement to stay on a performance footing. Spending reviews currently serve this purpose. It is highly probable that if reviews are not viable for the long haul, governments will devise other methods to facilitate performance-based spending decisions.

5. PB as an instrument of public management

This writer once described budgeting as "government talking to itself", a characterisation that reflects the bounded structure of bids by spending units, review by central agencies, and dictated or negotiated decisions. The previous section argued that PB's dependence on externally-generated performance data and analyses inevitably opens it to extra-budgetary processes. This section discusses a more potent rationale for broadening PB's ambit: its dependence on government entities to implement performance objectives and targets. Performance budgeting is a hollow exercise if the agencies that spend public money and operate public programmes are not themselves capacitated and motivated to produce the results for which resources have been authorised.

Early PB systems foundered on the misguided notion that because the budget controls financial resources, it shapes the conditions under which government agencies are managed. In fact, organisations tend to be more beholden to their culture and traditions than to budget allocations, more influenced by the interests of their personnel and clients than by the format of the budget. If agencies manage operations by controlling inputs, the fact that the budget bases allocations on outputs will have little influence on the behaviour of managers or on the results they achieve.

To be effective, PB has to spread its wings and encompass performance management; it has to transform both the way budgets are made and implemented, and the behaviour and operation of government agencies. According to this line of reasoning, which has been most strongly advocated by the new public management (NPM) movement, budgeting is not a distinct process but a vital part of a family of managerial practices and an essential component of results-oriented reforms. Administrative organisations cannot manage for results unless they also budget for result transformation must proceed concurrently on both fronts. PB shifts budget allocations from inputs to outputs (or other performance indicators), NPM decontrols inputs and permits managers to purchase the inputs they regard as appropriate for producing intended results. Managing for results unleashes PB's potential, budgeting for results enables performance management. In this scheme, PB and NPM (as well as other results-focused management reforms) are interdependent innovations.

This "Copernican revolution" – PB is no longer deemed to be sufficient to manage for results, but is one of the processes within its orbit – boosts both the stakes and difficulty of implementing performance-based budgeting. On the one hand, its enlarged frame invests PB with a critical role in transforming public management; on the other hand, this transformation is exceedingly difficult to achieve. It is one thing to change the informational content and structure of budgets, but an order of magnitude more difficult to change an organisation's embedded culture and the behaviour of its managers and service providers.

One thing is certain: PB itself cannot transform organisations; it may be a necessary reform, but not a sufficient one. Countries that have had significant PB successes have coupled management and budget reform. New Zealand first legislated fundamental changes in public management, then adopted new budget tools. The two sets of reforms moved in tandem in Australia, the Netherlands, Sweden, Denmark and other successful PB innovators.

How does a country transform public management from a bureaucratised control and compliance regime into a continuing quest to create public value? Two broad strategies have been applied. In simple terms, one is to "let managers manage", the other is to "make managers manage". The former is grounded on the assumption that public managers want to produce results, but are handcuffed by controls and procedures that limit their freedom of action, and deny them the ability to apply their professional skills and public service values to the daily tasks they face. The latter starts with the expectation that administrative discretion does not suffice and that managers must be compelled by market-type arrangements to strive to for results. PB is a core element of the "let managers manage" approach because the shift from inputs to outputs expands managerial discretion, and the *ex ante* specification of programme objectives and performance targets gives managers clear signals on expected results. Pointing managers in the right direction is also encouraged by efficiency dividends, programme evaluation, and performance reports and audits.

In PB's early iterations, managerial competence and commitment were generally regarded as sufficient conditions to uplift organisational performance. Nowadays, however, greater emphasis is often placed on the critical role of leaders who not only manage the organisation's resources, but actively strive to remake its culture and to motivate rank and file personnel to continuously improve performance. Leadership is a rare quality that is shaped more by personal characteristics than by budgetary formats, more by experience than by rules. Shortfalls in leadership translate to shortfalls in performance.

An organisation's culture – the embedded, usually unarticulated, values and informal rules that are passed down from one generation of workers to the next – is often a formidable barrier to performance budgeting and management. Culture is obdurate; it can withstand waves of reform, enriched information, formal changes in organisational structure, and turnover in management. Organisational culture and performance can change, but letting managers manage by removing deadweight controls and turning the spotlight on to performance may not be enough.

An alternative pathway to performance would make managers manage by introducing market-type arrangements, such as user charges, consumer choice, competition, outsourcing, and performance contracts into the public sector. The budget itself becomes a performance contract that specifies the resources and results that will be forthcoming. Ideally, budget holders are legally and organisationally separated from service providers, and have the option of purchasing outputs from government providers or other sources. Citizens become customers and can choose their own service providers.

The market model has been amply applauded and loathed, but rarely applied. It is a bridge too far for the many countries strongly wedded to the idea that public services should be publically provided, and it encounters strong opposition from public workers whose status and financial wellbeing would be put at risk. The New Zealand model, which may be the boldest and most comprehensive effort to remake the national budget into a market-type instrument, has been adopted by few countries. Most countries that venture down this road settle for limited applications or pilot tests that maintain the public character of public management.

Efforts to organise public services along market lines faces a deeper problem. When they are applied in government, market type mechanisms do not work the way they do in real markets. Performance contracts are not arms lengths agreements, the parties do not usually have effective recourse when terms are breached, and government may be obliged to continue funding services when performance falls short of agreed levels. Marketisation may have a firmer foothold when choice is transferred from government agencies, as occurs in purchases-provider arrangements, to recipients of public services, such as parents or patients. But few national governments have tried this approach across a broad swathe of public services, and when they do, recipients may be ill-suited judges of performance.

The limitations of managerial and market innovations should not lead to the conclusion that public management is stuck in a rut and incapable of improving results. Across the OECD community, governments perform reasonably well, continually upgrading operations and shifting priorities to take on new responsibilities. Government agencies have taken on new tasks and (to a lesser extent) discarded old ones, and they have re-tooled work processes by modernising IT systems, retraining staff and gathering new types of information. Over the years, this writer has observed two distinct patterns for establishing new objectives and priorities and upgrading work processes. One makes use of incremental resources to expand an agency's or programmes' footprint, the other reallocates funds within the existing resource framework. The first unfolds within the budget's framework and can benefit from PB's drive for performance; the second occurs within internal agency budget processes, but usually outside the purview of central budget work. The first is transparent, garners much public attention, and is regarded as a signpost of whether government is budgeting for results. The second may receive little attention, though it contributes to ongoing improvements in performance. PB has a limited role in this approach because agencies do not seek central government resources or approval. Neither approach challenges the spending agency's control of its resources and activities. The first narrows central attention to expenditure increments, thereby protecting expenditures and activities approved in previous budgets; the second enables agencies to adjust expenditures and activities on their own initiative.

The financial crisis and austere budgets have disrupted these comfortable patterns, which calmed budget tensions and enabled governments to improve performance. The first approach has been undermined by weak growth and meagre increments, the second by pressure for explicit, large-scale reallocations managed by central agencies. PB's expanded scope, especially its linkage to spending reviews, reflects determination to generate savings while improving performance.

Government agencies can manage for results even if they do not have a full-blown PB system. It is important that they not be hobbled by line item controls, and it is beneficial that they be informed about outputs and outcomes, but it is even more important that they have a public-regarding ethic that inspires them to perform.

6. PB as an instrument for steering socioeconomic policy

The two main indicators of performance – outputs and outcomes – take PB down different paths. Outputs are measures of public services and activities; they fit well into the routines of budgeting and management. Outcomes pertain to results outside the boundaries of government, in particular socioeconomic conditions that are major responsibilities of government, such as the health and educational status of citizens. As discussed earlier in this paper, the impacts of government policies and expenditures on these conditions often cannot be casually linked to budget allocations. The difficulty of hitching outcomes directly to the budget explains why PB systems that begin with a focus on outcomes often end up measuring outputs.

Socioeconomic conditions are the natural habitat of planners who look beyond current policies to examine trends and needs, not of budget people whose vision is filtered through financial statements and agency bids for resources. Few OECD countries have national planning systems, but they do have a need to scour the socioeconomic landscape to assess the impacts of existing policies and trends that may justify new ones. This task usually falls to sectoral policy makers and programme planners, but in recent decades, their work has been supplemented or superseded in many Member countries by central policy staffs that have a broader perspective and have the ear of government leaders.

The rising prominence of central policy staff has the potential either to diminish the influence of the central budget office or to enhance budgeting's role as a policy planning process. Which possibility materialises depends on whether budgeting is itself transformed into a policy process or continues to function principally as an instrument of expenditure control. PB and other contemporary innovations (such as medium-term frameworks) aim to strengthen budgeting's policy capacity, but doing so may seed friction among rival central government policy organs.

Conflict is a likely outgrowth of multiple entities competing for policy influence, but so, too, is co-operation. Policy planners and analysts need the data and insights of budget experts to frame viable proposals; budget officials need the broader socioeconomic canvas of policy planners to produce budgets that address the interests of political leaders. PB can bridge the gulf between policy and budgets by establishing formal mechanisms for monitoring socioeconomic conditions, establishing targets and expectations for assessing trends in these conditions, intervening with policy initiatives to re-target or re-focus government programmes, and funnelling resource to programmes in accord with the targets. It is especially useful when politically-salient socioeconomic objectives cut across government programmes and agencies, and cannot be achieved through the actions or budget of a single ministry. Crosscutting objectives often are among the most urgent for political leaders and the most difficult to achieve.

The biennial spending reviews and public service agreements carried out in the United Kingdom by the Labour Government during the first decade of the new millennium comprise one version of a PB-influenced policy monitoring and steering process. This initiative was led by the Treasury, was strongly shaped by budgetary and performance considerations, and enabled the Government to set and monitor high-level social and economic objectives. The country had an effective PB-centred policy monitoring and steering process that extended outside the conventional boundaries of budgeting to focus on vital socioeconomic trends.

A different steering and monitoring arrangement has been implemented by the elected heads of some American state and municipal governments, such as the State of Maryland and Baltimore City.

These and some other governments use advanced IT systems to electronically display and track key socioeconomic indicators on large, colour coded screens. Government leaders organise periodic meetings with aides and department managers to review trends, assess progress in achieving targets and milestones, identify problems, and make policy or administrative adjustments. One big virtue of this approach is that it communicates information to politicians in ways that encourage them to actively discuss policy objectives and to oversee the performance of government agencies.

The foregoing examples differ in the linkage of PB and monitoring. The United Kingdom's approach was budget centred, the American subnational government approach is planning centred. Spending reviews were the starting point for the UK's public service agreements that bundled together decisions on resources and expected results. Their linkage to the budget signalled that the PSAs are not mere projections, but commitments that have financial consequences for spending units. The US version has a weaker connection to the budget, but realising its policy objectives almost always requires an infusion of financial resources.

To be effective, monitoring requires several supporting conditions, in addition to budgetary repercussions. One obvious precondition is set key targets set in advance, that enable policymakers to benchmark results against expectations. Targets promote sound policy monitoring when they are selective, pertain to issues that engage the interests of political leaders or senior officials, and are framed in a form that facilitates tracking of progress. Targets that try to cover all facets of performance lose potency, if only because they are unlikely to give strong directional signals to monitors. But selectivity increases the importance of getting the right targets that capture a programme's purpose or an issue's urgency and are salient to top policymakers. Ideally, monitoring is followed by steering through policy adjustments or managerial interventions to correct problems or identified shortfalls in results. Without follow-up, monitoring just adds to the ample stock of performance information, but does not generate improved results.

PB-relevant monitoring focuses not only on the results side of the ledger, but on expenditures as well. One of the objectives of monitoring is to determine whether funds have been spent as authorised by the budget; another is to assemble data on whether expenditures have accomplished the intended results. The PETS project devised by international financial institutions exemplifies the potential of monitoring systems to trace public expenditures from the budget through end use. It also demonstrates that monitoring the actual delivery of services and expenditure of funds can be as useful but difficult, costly and useful as monitoring policy outcomes.

Monitoring is often coupled together with evaluation, and is generally regarded as of considerably less value or as a means of producing data to be used in assessing programme effectiveness. In fact, monitoring and evaluation are distinct processes that employ different methodologies and produce different data sets. Obviously, the more that monitors focus on policy, the more fluidly their findings can be fed into programme evaluations. But the closer monitoring gets to the delivery of services, the more it is pulled away from standard evaluations. A sound case can be made for both practices, and coordinating them when monitoring produces data and insights that strengthen evaluative processes.

7. PB as an instrument of democratic accountability

PB and other performance-oriented initiatives go to the heart of a difficult problem in democratic societies. During recent decades, OECD governments have become more open and transparent, but trust and confidence in political leaders and institutions have declined. National governments have applied accounting standards to their financial reports and operations, and many have armed auditors with more resources and more independence. Freedom of information rules has been liberalised, and most OECD countries now routinely publish useful financial and performance information on the intern and other outlets. Some argue that citizens have lower regard for government because its performance has declined; others argue that greater transparency has abraded election campaigns and the news media.

Whatever the merits of these clashing views, PB is relevant to the march to greater transparency and citizen empowerment on the one hand, and to adverse trust in government trends on the other. Citizens have more access and more effective recourse than in the past, but many feel government dissembles or withholds important information on how public funds are used and the services provided. A robust PB system yields more relevant information for citizens, but also may inflame political debate and fuel political discontent. A government that candidly reports on its performance is likely to face more opprobrium for shortfalls in results than applause for its favourable accomplishments. There is little basis for expecting improved performance to itself elevate trust and confidence levels. Other considerations weigh more heavily in citizen disinvestment in government and other collective institutions.

The argument for informing citizens on government performance has to stand on its own, principally in terms of the value of government accountability in democratic societies. There are solid grounds for expecting performance to improve when government agencies and personnel are accountable for how they perform. Feedback on the results of public policy formation, the management of agencies and the delivery of services could be obtained through various political mechanisms or administrative processes. Effective feedback depends on several supporting conditions, in particular, attentive media and groups and a professional, public service. Without favourable conditions, more information will not produce more accountable governments or better results.

Performance monitoring is a means of making governments more transparent and accountable for the money they spend and the results they deliver. On the expenditure side monitoring abets determination of whether funds have been spent on intended purposes, for example, whether money allocated for textbooks has actually been received by eligible schools. In terms of performance, vigilant monitoring sheds light on the quality and volume of services and whether policies have produced targeted results.

Monitoring addresses issues and produces information that are beyond the scope of conventional audits which depend on data provided by entities responsible for expenditures and services. External auditing and performance monitoring share three characteristics that pertain to democratic accountability. First those responsible for gathering or analysing information are institutionally separated from those responsible for expenditures and services. Second, both processes are retrospective; they review what was actually spent or accomplished. But the two processes diverge on responsibility for compiling information and for preparing statements on performance. The standard role of external auditors is to attest to the accuracy and completeness of information prepared by agency managers. They review data produced by the entity undergoing audit. Monitors generate their own information; they do not rely on performance claims made by service providers. Third, audit findings are not routinely fed into the policy stream, but information produced by monitors often is. Many countries either require affected agencies to respond to audits or give them the option to do so, but few have procedures for assuring that findings will be taken into account when budgets or other policies are decided. Moreover, the audit profession does not yet have generally-accepted standards and procedures for reviewing performance statements issued by government agencies. Few countries conduct regular performance audits, which require different skills and work methods than those associated with financial audits.

These differences suggest that conventional auditing has serious gaps in its accountability framework that may be partly closed by active monitoring. Instead of being dependent on programme managers and service providers for essential performance data, monitors have their own methods for determining what programmes actually are accomplishing and the services actually delivered. They are not bound by the conventions of auditing, or limited by the use to which they can put information and analyses.

Whether it merely provides information on expected outputs or outcomes, or goes further and aligns resources and results, PB makes government more accountable for what it does and spends. But as discussed in the previous section, PB is not a precondition for effective monitoring. Having pre-set targets against which performance is measured systematises the process and enables monitors to assess whether government has performed according to expectations.

8. PB as a spur to citizen engagement

The various forms and offshoots of PB discussed thus far all pertain to information produced and decisions taken within government. They differ principally on the end use of performance information. Core PB is used to allocate financial resources, extended PB reaches to administrative management and policy steering, and PB offshoots promote transparency and accountability. This section reflects on an offshoot that transfers information and participation in budget decisions to civil society.

This offshoot is generally referred to as participatory budgeting (PARB), a label that indicates formal involvement of citizens and groups in discussions and decisions with respect to public expenditures and services. This process has been introduced in various local governments, mostly in developing countries, but because genuine participation inherently occurs only in small groups, it is hard to apply PARB at the national level. Although scholars credit the city of Porto Alegre, Brazil with inaugurating PARB in l989, some precursors date back centuries to town and village governance in the United States and other countries.

PARB is structured participation, and usually follows a number of formal steps. First, the government decides which amounts or portions of the budget should be open to participatory allocations. Obviously, fixed costs for pensions, debt service and various mandatory transfers are off limits, but expenditures for public services and public works (which are a much larger share of local than of national budgets) may be subject to PARB. Second, residents participate in local assemblies or select delegates to represent them. Typically, fewer than 10 per cent of eligible persons participate in the process, making PARB vulnerable to capture by organised groups or activists. In some communities, such as Lima, Peru which is divided into more than 40 municipalities, each with its own PARB, residents of affluent areas tend to have higher participation rates, though proponents of this process believe that greater benefits accrue to lower-income communities whose interests may be neglected when spending decisions are made in closed budget processes. Third, delegates establish priorities and recommend allocations for particular services and activities, usually with the active assistance of local budget experts. As will be discussed shortly, this is the point at which PB connects with PARB. Finally, the governing authority votes the budget, usually adhering to the priorities and guidance provided through PARB.

Vesting residents with a substantive voice in budget allocations risks turning the process into a beauty contest or one which gives primacy to those who are most assertive. In expanding direct democracy to budget and policy decisions, care has to be taken that PARB encourage informed decisions, and that participants have access to relevant data on the cost, aims, and accomplishments of public services. A community that has a robust performance budget apparatus will likely lead to different participatory decisions than one that is blind to results. Furthermore, the more than participants base their preference on performance criteria, the stronger the incentive to compile information on the outputs or impacts of public services.

Although PARB is still largely a boutique process, some claim that it has produced material improvements in the communities that have implemented it. Others wonder whether it does more to make residents feel good than to uplift their wellbeing. This is an argument that will not be resolved until PARB has much more widespread application in a variety of venues and under different economic and political conditions. For purposes of this paper, however, a well-run PARB exercise may make PB more relevant and immediately spur governments to give more attention to results.

9. Is PB underutilised and over-extended?

PB originated as a movement to transform budgeting from a means of purchasing inputs to a process that allocates money according to actual or estimated results by changing the structure and content of budget accounts. Over time, this paper has argued, that PB has been extended to programme assessment and management beyond the immediate purview of budgeting, and has spurred offshoots, such as performance accountability and participatory budgeting. PB's "mission sprawl" poses an anomaly: how is it that PB has had middling success in its generic purpose, but has strongly influenced peripheral activities? The question that heads this concluding section stirs reflection on the connection between the disappointing fate of core PB and its impact on other processes. In the paragraphs that follow, we offer three conflicting answers: PB has re-made budgeting, PB has been impeded by rigid budgets, and PB has awakened governments to new opportunities to perform.

9.1. PB has transformed budgeting

One line of reasoning concludes that the question's underlying premise is wrong, and that PB-type mechanisms have migrated to other processes because the drive for performance has reshaped budgeting, perhaps not in formally tethering resources to results, but in the mind-set of budget makers, the information they draw on, and their spending decisions. They pay much less attention to the line items and much more to evidence and expectations on performance than was the case decades ago. Essentially, this is the case for PB – as in the information argument discussed in Section 3 of the paper.

It is not necessary to repeat the case made earlier in the paper against undue reliance on performance information to change budget behaviour and decisions. It should be mentioned, however, that isolated success stories showing that performance information has swayed a particular budget decisions or improved particular programmes is not sufficient evidence of PB's impact.

9.2. PB has been hobbled by rigid budgets

An alternative explanation, however, is that the drive for performance has been exported to other policy and management arenas because it reached a dead-end in budgeting. According to this view, the rationale for basing financial decisions and other policies on performance is so compelling that proponents have sought other outlets despite their inability to remake budgeting into a results-driven process. Expanding PB to other processes compensates for failure to uproot established budget practices, but keeps the idea of performance budgeting vibrant and enables practitioners to claim success.

To make this case, one must explain why PB has had difficulty in its core budget function, but easier going elsewhere. What has PB failed to change in budgeting, but does not have to challenge in its other iterations? The usual answer is that a results orientation requires a shift away from inputs. But, if this were so, PB would have transformed budget practices in most OECD countries decades ago. The real obstacles to performance-based allocations are rigid budgets, political pressures, and the persistence of incremental norms and behaviour. Together, they block efforts to hard wire resources to results, and dilute PB into a expenditure-reclassification and data-compilation exercise that turns out to be highly useful for its extensions and offshoots.

These obstacles are well-known and need only a little elaboration.

i) Rigid expenditures that are locked into national budgets by law, contract, or the weight of past decisions are not allocated on the basis of performance criteria. Even when it nominally covers these expenditures, PB does not effectively govern them. Sticky expenditures account for at least three-quarters of total public spending across the OECD community, and significantly narrow the fiscal space open to results-based allocations. It is possible to de-rigidify expenditures though nonconventional methods or crisis-impelled policies, but, as Mario Marcel has noted, not through PB.

ii) As is commonly recognised in both theoretical and empirical writings on PB, coveting performance does not banish political influences, nor should it. Results are only one of the data sets considered by politicians when they decide on budgets, and are often far from the most influential. It is easy to agree that this is as it should be in democratic societies, but hard to know what space, if any remains for results-driven choices. Merely indicating that performance is one of the factors considered by budget makers does not justify PB's lofty ambitions.

iii) The net effect of rigid budgets and political influence is that budget makers allocate the incremental resources available after past decisions and political considerations have staked their claims. How this slice of expenditures is allocated determines whether PB is worth the effort. At the end of Section 3, this paper outlined one method for a "performance-based incremental budget system." Over versions may be feasible, but only if they recognise that targeting PB to budget increments has the potential to strengthen this reform.

9.3. Performance is the shared focus of PB,extenders,and offshoots

A final answer to the question that forms this section is that the status of PB is of less consequence than the idea of performance. PB is one outlet for a drive to spur improved public management and the well-being of citizens. This movement has advanced on multiple fronts, including a less trusting but more inquisitive media; the emergence of policy elites trained in data collection and analysis; refinement of performance measures and publication of league tables; rising expectations for public services coupled with declining trust in government; and weaker economic growth. This is not a complete list, but it does indicate that developments outside the orbit of budgeting have carried the message of performance across a broad swathe of government activities and processes. Some of the extenders and offshoots discussed in this paper may have non-budgetary roots.

If this is so, the final question is one whose answer can come only with the passage of time. Can governments perform if budgets do not?

Notes

1. Performance budgeting was the label applied by the first Hoover Commission in 1949 to its recommendation that US budget should be "based upon functions, activities and projects…" *US Commission on Organisation of the Executive Branch of the Government*, Government and Accounting, Government Printing Office, 1949, p. 8.
2. Almost half a century ago, Jesse Burkhead observed, "There is no precise definition for performance budgeting. It has come to mean something different in every jurisdiction which puts it into operation. Jesse Burkhead, *Government Budgeting,* John Wiley and Sons, 1956, p. 139.
3. Charles Beard, an eminent American historian, observed during the dawn of modern budgeting almost a century ago that "budget reform bears the imprint of the age in which it originated"; Charles A. Beard, "Prefatory Note", *in* Arnold Lahee, "The New York City Budget", *Municipal Research*, Vol. 88, 1917, p. 95.
4. The New Zealand model is described in Allen Schick, *The Spirit of Reform: Managing the New Zealand State Sector in a Time of Change*, State Services Commission, 1996; Australia's approach is discussed in Joanne Kelly and John Wanna, "Crashing Through With Accrual-Output Price Budgeting in Australia", *American Review of Public Administration*, Vol. 34, 2004, pp. 94-111.
5. This trend is discussed in Allen Schick, *Evolution in Budgetary Practice*, Chapter 2, "The Control and Management of Government Expenditure: Comparing Country Experiences", OECD, 2009.
6. This argument is elaborated in Allen Schick, "The Performing State: Reflections on an Idea Whose Time Has Come But Whose Implementation Has Not", Chapter 10, *ibid.*
7. OECD, *Performance Budgeting in OECD Countries*, 2007, p. 11.
8. *Ibid.*, p. 21.
9. Marc Robinson, *Performance Budgeting: Linking Funding and Results*, International Monetary Fund, published by Palgrave Macmillam, 2007, p. 113.
10. *Ibid.*, p. 1.
11. *Ibid.,* p. 114.
12. OECD, "Budgeting Levers, Strategic Agility and the Use of Performance Budgeting in 2011-2012", Presented to the 8th Annual Meeting on Performance and Results, Working Party of Senior Budget Officials, 26-27 November 2012.
13. Rita Hilton and Philip Joyce, "Performance Informed Budgeting: A Global Reform", *The Sage Handbook of Public Administration*, pp. 835-63.
14. The rationale for and failure of zero base budgeting are explained in Aaron Wildavsky, *Budgeting: A Comparative Theory of Budgetary Processes*, Little Brown and Company, 1975, pp. 278-96.
15. The template is adapted from Mark Friedman, *Trying Hard is Not Good Enough*, Booksurge, 2009; This method and applications can be accessed at *www.resultsaccountability.com* – Results-Based Accountability™ (RBA) and Outcomes-Based Accountability™ (OBA).
16. Mario Marcel, "Budgeting for Fiscal Space and Government Performance Beyond the Great Recession", OECD Paper, GOV/PGC/SBO(2013)1, February 2013, p. 18.
17. *Ibid.*, p. 32.
18. "A key challenge is … to ensure that evaluation is practical, useful and cost-effective", Robinson, *ibid.*, p. 40.
19. The Netherlands' experience was discussed at the 5th Meeting of Senior Budget Officials in 1984. See "Policy Review and Budgeting: Some Experiences with the "Reconsideration Procedure' in the Netherlands", Organisation of Economic Co-operation and Development, CT/PUMA/535, Distribute 15 June 1984.
20. See John Wanna, Joanne Kelly and John Forster, *Managing Public Expenditure in Australia*, Allen and Unwin, 2000, pp. 219-19.
21. Teresa Curristine, "Experience of OECD Countries with Performance Budgeting", in Robinson, pp. 135-38.
22. *Ibid.*, p. 135.
23. Adapted from OECD, *Performance Budgeting in OECD Countries*, p. 170.

24. Peter C. Smith reviews this process in "Performance Budgeting in England: Public Service Agreements", in Robinson, pp. 211-233.
25. See US Government Accountability Office, *Performance Budgeting: PART Focuses Attention on Programme Performance But More Can be Done to Engage Congress*, GAO-06-28, 28 October 2005.
26. Curristine in Robinson, *op. cit*, p. 138.
27. Canada's programme reviews are assessed in David Good, *The Politics of Public Money*, University of Toronto Press, 2007, pp. 266-72.
28. Allen Schick, "Twenty-Five Years of Budgeting Reform", in *Evolutions in Budgetary Practice*, p. 344.
29. Alta Folsher succinctly applies the tenets and methods of new public management to budgeting in "Budget Methods and Practices," in Anwar Shad (ed.), *Budgeting and Budgetary Institutions*, The World Bank, 2007, pp. 27.
30. New Zealand reformed public management in the 1988 State Sector Act, and budgeting in the 1989 Public Finance Act.
31. See Allen Schick, *Modern Budgeting*, Organisation for Economic Co-operation and Development, 1997.
32. The term is taken from Mark H. Moore, *Creating Public Value: Strategic Management in Government*, Harvard University Press, 1995.
33. One of the best studies of leadership is Ronald Heifetz, *Leadership Without Easy Answers*, Harvard University Press, 1994.
34. Although most studies of organisational culture discuss commercial entities, some are relevant to government; see Edgar Shein, *Organisational Culture and Leadership*, Jossey Bass, 2010.
35. This development is reviewed in Jonathan Boston (ed.), *The State Under Contract*, Bridget Williams Books, 1995.
36. See Robert Putnam and Susan Pharr, *Disaffected Democracies: What's Troubling the Trilateral Countries*, Princeton University Press, 2000.
37. See Robert Behn, *Rethinking Democratic Accountability*, The Brookings Institution, 2001.
38. Participatory budgeting is framed in terms of the larger question of social accountability in a joint OECD and World Bank project that consisted of 40 case studies in Member countries; see Joanne Caddy, Tiago Peixoto and Mary McNeil, *Beyond Public Scrutiny: Stocktaking of Social Accountability in OECD Countries*, The World Bank and OECD, 2007.

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Spending reviews

by
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This article focuses on the optimal design of spending review processes. It contents that sending review should be an integral part of the government budget preparation process, in order to support aggregate fiscal discipline and to increase the fiscal space available for essential new spending initiatives. The article discusses the appropriate focus and coverage of spending review, the assignment of roles and responsibilities during the process, and the information base of spending review.

JEL classification: H500, H610.

Keywords: Baseline expenditure, fiscal space, savings options, efficiency reviews, strategic reviews, bottom-up review, joint review, top-down review, comprehensive review, selective review.

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1. Introduction

In the years since the onset of the global financial crisis in 2007, spending reviews have come to be widely used by OECD governments. It has, during that time, been employed principally as a tool for reducing aggregate expenditure to achieve fiscal consolidation. A spending review is, however, much more than a tool for cutting aggregate expenditure. Properly viewed, it is a core instrument for ensuring good expenditure prioritisation – more specifically, for expanding the fiscal space available for priority new spending in a context of firm aggregate expenditure restraint. Given the difficult fiscal context facing many OECD governments in the medium and long term, it is essential that spending review become a permanent feature of the budget preparation process. The use of this important budgetary instrument must not be allowed to dwindle away once the immediate crisis has passed, as has happened in some countries in the past.

If spending reviews are to be institutionalised, it must be designed appropriately. This requires careful analysis of what has worked, and what has not worked, in spending review practices to date. It also requires explicit consideration of the ways in which a spending review, as an ongoing part of the budget preparation, may need to be designed differently from a spending review used as an essentially ad hoc tool of major fiscal consolidation. Moreover, because a spending review is a resource-intensive activity, it is crucial that it is designed in such a way as to be as cost-effective as possible.

The questions of how to design spending reviews as an ongoing process, and how to ensure that it survives as a core instrument of budget preparation, are the primary foci of this paper.

This paper is structured as follows: The initial sections discuss the definition and objectives of spending reviews and its relationship to the budget process. This is followed by an overview of the development of spending reviews in OECD countries over recent decades, contrasting the recent post-global financial crisis surge in spending review activity with the more limited pre-crisis use of spending reviews. The challenge of maintaining spending reviews in the future as a permanent element of the budget preparation process is then discussed. This is followed by three sections discussing key aspects of the design of a spending review – its scope, processes and roles, and its information base. Following on from this, the relationship between performance budgeting and a spending review is examined. This leads to final reflections on the means of maintaining the focus of a spending review as a permanent element of the budget preparation process. Conclusions follow, together with a set of suggested “Principles for the Conduct of Spending Reviews”.

In overview, the principles put forward at the end of this paper call for spending reviews to be a continuing process, fully integrated into budget preparation. They suggest that spending reviews should have wide coverage of government expenditure, and should aim to deliver both efficiency and strategic savings. Spending reviews should nevertheless normally be selective rather than comprehensive, with comprehensive reviews undertaken exceptionally when either fiscal circumstances or major changes in government priorities require special in-depth scrutiny of spending. Care should be taken to keep spending reviews focussed on the identification of savings measures, and to avoid the dissipation of energy through a broader focus on, for example, new spending proposals or broader public sector reform.

With respect to roles and responsibilities in the spending review process, firm political oversight and direction of the spending review process is critical. The overall management of the spending review process at the bureaucratic level by the Ministry of Finance (MOF) – together, where relevant, with any other central agencies which play an important role in the budget process – is essential for its success. The primary work of identifying savings options should normally be carried out by the civil service, with selective use of external expertise. In developing savings options, either a joint review or bottom-up approach can be taken with respect to the roles of the spending ministries and MOF. In either case, the process must be designed in such a way as to place substantial pressure upon spending ministries to "play the game".

Finally, steps should be taken to improve the information base of spending reviews – particularly through the greater availability of appropriately-designed evaluation studies.

The treatment of spending reviews in this paper is primarily thematic, as opposed to case study based. The paper draws upon a recent detailed study of spending review systems in six OECD countries (Robinson, 2013a), together with the OECD's 2012 survey of spending review practices, and other information on spending review practices in the broader set of OECD countries.

Box 1. **Overview of the conceptual framework for spending reviews**

The following key concepts are discussed in this paper:

A spending review is the process of developing and adopting savings measures, based on the systematic scrutiny of baseline expenditure.

Spending reviews may be efficiency reviews (focused on savings through improved efficiency) and/or *strategic* reviews (focused on savings achieved by reducing services or transfer payments).

There are four stages in the spending review process: i) the framework stage (deciding the key design features of the spending review system); ii) the parameters stage (deciding specific savings targets, review topics, procedural calendar, etc.); iii) the savings option stage (developing savings options to be put forward to the final decision makers); iv) and finally the savings decision stage (the final decisions on which savings measures will be implemented).

During the savings options stage, there are three alternative approaches which may be taken in assigning roles to the MOF and spending ministries: i) bottom-up review (spending ministries develop their own savings options, with alternatives prepared by the MOF); ii) joint review (savings options are developed in a joint spending ministry/MOF review teams); iii) and top-down review (savings options are developed by the MOF with limited spending ministry involvement).

Spending reviews examine review topics, which may be of three types: i) programme reviews (which seek to identify strategic and/or efficiency savings in specific programmes); ii) process reviews (focused on business processes); and agency reviews (which review whole ministries or other agencies); iii) a horizontal review focuses on the review topic which cuts across several government agencies (e.g. a review of government-wide procurement practices).

> Box 1. **Overview of the conceptual framework for spending reviews** *(cont.)*
>
> Selective spending review is a spending review which focuses on a specific list of review topics which are decided at the outset (i.e. during the parameters stage) of the spending review process. By contrast, a comprehensive spending review is not constrained by any such ex-ante list of review topics, and aims to review spending in greater depth. Comprehensive spending reviews do not literally try to examine everything.

2. Nature and objectives of spending reviews

A spending review is defined in this paper as the process of developing and adopting savings measures, based on the systematic scrutiny of baseline expenditures. [1, 2]

The appraisal of proposals for new or additional spending does not constitute spending review, even when focused on possible increases in the funding of existing programmes or projects.[3]

Spending reviews are used for either or both of two key purposes: firstly, to give the government improved control over the level of aggregate expenditure and secondly to improve expenditure prioritisation.

> Box 2. **The UK 2010 Comprehensive Spending Review (CSR)**
>
> The UK 2010 Comprehensive Spending Review (CSR) was a "roots and branches" review aimed at achieving large reductions in public expenditure for fiscal consolidation purposes. Reflecting this, the CSR was very much an efficiency and strategic review. Unlike the Netherlands CER, the UK CSR was not limited by any ex-ante list of spending review topics. It covered nearly all government expenditure – budget, mandatory and transfers to sub-national government – as well as tax expenditures. The CSR process was a primarily bottom-up one, in which the main source of savings options was spending ministries ("departments" in UK terminology) themselves. These were required to conduct their own internal spending reviews and then to present formal submissions detailing savings options to Treasury. After receiving departmental submissions, Treasury officials then also injected saving options of their own. The whole process was presided over by the Treasury Ministry's newly-created Public Expenditure (PEX) Committee of Cabinet.

There are two types of savings measures – efficiency savings and strategic savings – which spending review may be tasked to identify. Efficiency savings are expenditure reductions which are achieved by changing the way in which services are produced so as to deliver the same quantity and quality of services (i.e. outputs) at a lower cost. They have also been referred to as "operational" savings. Strategic savings, by contrast, are expenditure reductions achieved by cutting back services (outputs) or transfer payment delivered to the community.[4] They have been referred to elsewhere as "output" savings (Robinson, 2013a).

If – for example, the Gershon Efficiency Review in the UK in 2004 (see further below) – a spending review is targeted exclusively at achieving efficiency savings, it is referred to in this paper as an efficiency review. If, on the other hand, its focus is instead on both types of savings – like, for example, the Strategic and Operating Review carried out in Canada in

2011-12 – it is referred to here as a strategic and efficiency review. This differs from the terminology used in a previous OECD papers on spending review (OECD, 2011; 2012a: 9), in which the term “strategic review” was used to refer to spending reviews targeted at both strategic and efficiency savings.

Box 3. **The 2010 Netherlands Comprehensive Expenditure Review**

One notable recent example of a spending review was the 2010 “Comprehensive Expenditure Review” (CER) in the Netherlands. The CER examined 20 review topics, and was primarily a strategic review. Each topic review was carried out by a review task force, with uniform terms of reference and processes set by the Ministry of Finance and agreed on by the Cabinet. Following a well-established Dutch tradition, review task forces are comprised of both representatives of the spending ministry and of the Ministry of Finance (MOF). Indeed, the intense involvement of MOF officials with strong policy skills and detailed portfolio knowledge – particularly from the Inspectorate of Budget – in the development of concrete savings measures has been essential to the success of spending reviews. During the 2010 CER, each review task force was required to develop options capable of delivering at least a 20 per cent reduction in expenditure – over four years – in the programme under review. These options were then presented to the political leadership for a decision, and played a key part in both the 2010 election debate about budgetary savings measures, and in the subsequent Coalition Agreement on expenditure ceilings. The CER process built on lessons learned in the conduct of spending review processes in the Netherlands stretching back over two decades. There is now cross-party agreement to adopt a regular four-year spending review cycle, with something like the 2010 FER being conducted in the run-up to each election.

Savings measures arising from spending reviews are, in principle, specific in the sense that the government knows how the reduction in baseline expenditure concerned will be achieved – that is, what services or transfer payments will be cut back (in the case of strategic savings) or what cost-reducing changes to business processes will be made (in the case of efficiency savings). Expenditure reductions achieved through spending review are therefore different from non-specific cuts, defined as cuts which the government imposes on ministries without review and without knowing in advance how and where they will be implemented.

A final definitional point: systems for assessing or rating the effectiveness and efficiency of government expenditures do not, in themselves, constitute spending review. Consider, for example, the Programme Assessment Rating Tool (which operated in the US under the Bush administration), which assigned ratings such as “effective” and “ineffective” to US federal government programmes. Because the PART rating process did not recommend on whether programmes rated as “ineffective” should be cut, it cannot be considered to fit the definition of spending review. Any decision by the President on whether to recommend that Congress cut funding to an ineffective programme had to be made based on further analysis subsequent to the PART rating process. After all, the rating of a programme as ineffective does not automatically mean that the elimination of that programme is a viable savings option. The appropriate solution to the programme’s difficulties may instead be programme redesign or even additional funding.

For the same reason, government-wide evaluation systems (such as that which existed in Canada for many years) – which require ministries to evaluate their programmes and systems – cannot be considered to constitute a spending review. Only review processes which are designed to develop explicit savings options for government decision can be regarded as a spending review.

Rating and evaluation systems are better regarded as part of the information base available to spending reviews. Thus, for example, the knowledge that a specific programme has been rated/evaluated as ineffective is a valuable piece of information in determining whether the closure of the programme is a viable savings option.

3. Spending reviews and deficiencies in the budget process

As emphasised above, a spending review is a tool for better expenditure prioritisation (allocative efficiency) – that is, for helping reallocate limited government resources to programmes which deliver the greatest benefits to society. The increased use of spending reviews is in part based on the recognition that conventional budget preparation processes tend to be weak on prioritisation.

All too often, budget preparation focuses disproportionately on the consideration of new spending proposals, with little review of baseline expenditures. When this is the case, it is all too easy for scarce resources to continue to be wasted on existing programmes which are inherently ineffective, low priority, or which have long outlived their usefulness – or on inefficient business processes. The disproportionate focus upon new spending is a central feature of the well-recognised problem of budgetary incrementalism, which has been defined as "inattentiveness to the (budgetary) base" (Berry, 1990).

The failure of conventional budget preparation processes to fully address expenditure prioritisation is not accidental. It is no easy matter for central decision-makers, whether in MOF or at the level of the political leadership, to reallocate resources. To do so, requires considerable information about the efficiency and effectiveness of baseline spending and involves overcoming resistance from spending ministries and ministers. Particularly in the case of strategic savings, reallocation also creates political resistance on the part of those who benefit from the services or transfer payments being cut. There is consequently a great temptation to avoid reallocation to finance new spending initiatives, and instead to rely upon revenue growth or, when revenue growth is insufficient (as it usually is), to simply permit aggregate expenditure to grow faster than revenue notwithstanding the deficits this produces. And if expenditure cuts absolutely cannot be avoided, the path of least resistance is often to fudge the matter by relying on non-specific budget cuts, such as uniform "across-the-board" percentage cuts to all ministry budgets.

It is for these reasons that in many countries, in the "good times" before the GFC, both the MOF and the political leadership played a relatively passive role in expenditure reallocation. Authority to reallocate funds within ministry budgets was often deliberately delegated to the ministries concerned. Reallocation between ministries took place only at the margins, and budget flexibility was often limited.

Spending reviews aim explicitly to change this situation. It involves a deliberate re-assertion of the role of the centre in the reallocation of resources. It expressly recognises that only through a willingness to prune back waste and to cut services which are ineffective, outdated or otherwise of low priority can substantial room for new priorities be found while keeping aggregate public expenditure under control. Spending reviews acknowledge that good expenditure prioritisation requires not only careful consideration of all new spending proposals, but also continuing reconsideration of baseline spending.

4. Integration of spending reviews into the budget process

A spending review is not necessarily an integral part of the budget preparation process, but experience teaches that it should be.

During the 1980s, a number of governments set up ad hoc spending reviews which were, to a greater or lesser extent, separate from the budget process. The Grace Commission established by President Reagan, which reported to Congress in 1984, is a representative example: the Commission's timetable was not linked to budget preparation, it was not guided in its work by any budgetary savings targets, and its work was carried out largely outside government by individuals drawn from the private sector.

By contrast, most spending reviews conducted by the OECD governments over the past two decades have been deliberately and fully integrated into the budget preparation process. This means, that they have been designed to feed savings options to the government for consideration and decision during the preparation of the budget. That is, as part of the overall process of deciding how much funding to provide to each spending ministries for the year or years to come. They have therefore worked under deadlines intended to ensure that savings options are made available at the right stage of the budget preparation process.

There are two key reasons why spending review should be integrated into the budget preparation process.

The first is that both allocative efficiency and aggregate expenditure restraint benefit from simultaneous consideration of new spending proposals and savings options. Simultaneous consideration makes it possible for governments to adopt additional high-priority new spending proposals without increasing aggregate expenditure, by selecting additional savings options sufficient to fund the additional new spending. This encourages direct comparison of the merits of new spending proposals and baseline expenditure. It directly supports top-down budgeting, which requires adherence to a firm aggregate expenditure ceiling established at the start the budget preparation process (Robinson, 2012). In order to permit simultaneous consideration, the spending review timetable must ensure that savings options are ready for presentation to the political leadership in the budget preparation process at the same time that it considers major new spending proposals.

The second reason why spending review should be integrated into the budget preparation process is to ensure that the scale of the spending review effort is calibrated to the government's budgetary objectives for aggregate expenditure. If, for example, the government wishes to implement deep cuts in aggregate public expenditure, spending reviews will need to be particularly in-depth in order to identify correspondingly extensive and high-value savings measures. If the context is different, and the government sees spending reviews rather as a means of increasing the fiscal space for priority new spending (while properly controlling the growth rate of aggregate expenditure), spending reviews may not need to be as far-reaching.

It can be useful – particularly in the context of spending reviews designed to achieve major fiscal consolidations – to strengthen the link between the spending review process and the government's objectives concerning aggregate expenditure by setting targets for the quantum of savings to be identified via a spending review (see Box 4). Most countries which have used this approach have set uniform minimum targets which apply to all ministries (e.g. 5 per cent for all ministries), or to each of the programmes selected for review. However, it is possible – particularly during a tough comprehensive spending review – to set differentiated targets, which demand that lower-priority ministries identify larger savings than higher-priority ministries.

Box 4. **Savings targets and spending reviews**

Recent examples of savings targets set to guide spending review processes include:

- Canada: under the three years of Strategic Review (2007-08 to 2010-11), each agency reviewed was required to identify savings options totalling at least 5 per cent from their lowest-priority, lowest-performing programme spending. Under Strategic and Operating Review (2011-12), agencies were required not only to present options for a 5 per cent cut, but also a set of options for a 10 per cent cut.
- France: During the first round of the *Révision Générale des Politiques Publiques* (*RGPP*) process (RGPP1) in 2007-08, review teams were asked to identify efficiency savings sufficient to ensure that the policy of non-replacement of one in two retiring civil servants would not impact on services. This effectively set a target for the efficiency savings to be achieved. During RGPP2 (2010-11), an additional target of a ten per cent reduction in non-salary administration costs (to be achieved by 2013) target was set.
- Denmark: although savings targets have not been traditionally set as part of Denmark's long-standing spending review process (the Special Studies process, discussed further below), this has changed recently. In the recent review of the police budget, a savings target of DKK 600 million was set (equivalent to approximately 6 per cent of police spending). A savings target was also set in a major review of defence expenditure.

Precisely because the importance of integrating spending reviews into the budget preparation process is now widely understood, most spending reviews over the past two decades have been directed and managed, at the bureaucratic level, by the MOF, either exclusively or in partnership with other "central agencies", which may play a key role in budget preparation in particular countries (such as the president's or prime minister's office). Exceptions to this – such as the 2007 Gershon Efficiency Review in the UK – have been rare.

5. Spending reviews prior to the Global Financial Crisis (GFC)

In the years immediately prior to the GFC, spending reviews were not an important element in the budget preparation processes of OECD countries as a whole. Only three OECD countries could be unambiguously said to have systems of ongoing spending reviews – the Netherlands (Interdepartmental Policy Reviews), Denmark (Special Studies), and Finland (the Productivity Programme).

It might seem surprising in this context not to mention two other countries – the United Kingdom, and Australia. After all, in the UK, periodic so-called Spending Reviews (SRs) had taken place for almost twenty years prior to the GFC[5], and in Australia, the work of an Expenditure Review Committee (ERC) of Cabinet had been at the centre of the budget preparation since the mid-1970s. It is, however, important not to draw the wrong

Box 5. **Denmark's Special Studies review process**

Since the mid-1980s, Denmark has had a system of spending reviews known as "special studies", and this process has continued to operate right up to the present time. The special studies are part of the normal annual budget preparation process, although there have been some years when no special studies have been undertaken. Although in principle the special studies may recommend increases in funding for existing programmes, in practice this is rare and the focus is upon savings measures. There is no formal link to broader government performance-improvement processes.

There have typically been 10-15 special studies carried out each year, although this has increased significantly since the GFC. Historically, the primary focus of the special studies process has been upon increasing space for new expenditure priorities. However, at the present time the focus has shifted more towards aggregate expenditure reduction for fiscal consolidation purposes. This has led to an increase in both in the number of special studies and in the value of expenditure which they cover (e.g. studies of defense and police expenditure).

Most special studies are agency reviews or programme reviews, and the main focus has, over the years, been upon efficiency savings rather than strategic (output) savings.

Special studies are generally carried out by joint MOF/spending ministry taskforces, with formal terms of references approved by Cabinet. Taskforces present savings options to the Minister of Finance and the Economic Committee of Cabinet. These recommendations should in principle be based on consensus between the MOF and the spending ministry concerned, but if consensus not reached separate recommendations may be put forward. The Economic Committee generally makes the final decision about which savings measures will be adopted in the budget.

conclusions from the use of the words "spending review"/"expenditure review" in these contexts. Both the UK SR process and the Australian ERC focused on the budget preparation as a whole – including the review of new spending proposals. In neither case did the process necessarily or routinely include the review of baseline expenditure to identify savings measures. Thus, as the UK Treasury frankly acknowledges, the UK SRs prior to 2007 "focussed on allocating incremental increases in expenditure", giving little attention to savings measures (HM Treasury, 2006: 24). It would seem that, prior to the 2010 CSR, only the 2007 SR can mount a credible case for classification as a true spending review. Moreover, in Australia, the ERC – even though it had overseen two periods of intense spending review activity focused on delivering fiscal consolidation in earlier times (the first in the late 1970s, and the second in the mid-1980s) – did not pay much attention to the review of baseline expenditure in the years running up to the GFC.

Pre-GFC spending review processes were in most cases initially established in order to implement major fiscal consolidations, and were then either allowed to atrophy, or discontinued altogether, once the consolidation process was completed. When spending reviews were first introduced in the early 1980s (as the Reconsideration Procedure) in the Netherlands for example, more than thirty review topics were examined during each annual review cycle. By the time of the GFC, this had fallen to as few as five reviews annually. The Danish Special Studies saw a similar diminution in the level of review activity over time.

At least in the Dutch and Danish cases some level of continuing spending review activity was maintained. This was not the case elsewhere. As noted, spending review activity in Australia had largely dwindled away. The same was true in Canada. Canada's highly successful ad hoc Programme Review spending review process of 1994-1996 (see Box 6) was followed by a number of attempts to establish spending reviews as an ongoing process in order to deliver what one prime minister referred to as a "continuous culture of reallocation" (Good, 2008: 272). These were, however, essentially unsuccessful, and by the time of the GFC Canada had no spending review process.

Box 6. **Canadian Programme Review in the mid-1990s**

Canada is well known for the highly successful "Programme Review" (PR) spending review process which took place over two rounds in the 1995 and 1996 budgets. PR was explicitly aimed at fiscal consolidation to rein in high deficits and reduce debt. Tough agency-specific savings targets were established – as high as 50 per cent in the case of the transport ministry, and between 15-25 per cent for most other ministries. The PR process was based on agency reviews, and was guided by six "tests" (programme assessment criteria). The process was overseen by a Cabinet sub-committee. The Prime Minister "strongly and visibly supported his minister of finance" against spending ministers (Good, 2007).

The spending review activities that had existed in the years immediately preceding the GFC were often narrowly focused on identifying efficiency savings, with little or no effort devoted to the search for strategic (output) savings. Examples of this efficiency savings bias included:

- The Finnish Productivity Programme, established in 2004, and explicitly focused on efficiency savings.
- The Danish Special Studies process, which in practice focused overwhelmingly on efficiency savings.
- The 2004 Gershon Efficiency Review in the United Kingdom – a wide-ranging ad hoc efficiency reviews which constituted the most substantial British spending review (in the sense of the review of baseline spending to identify savings measures) in the pre-GFC period.

6. Spending reviews since the GFC

Since the GFC, everything has changed. In the OECD's 2012 survey, half of the member countries surveyed claimed to have a spending review process in place. This includes a significant number of countries – such as Ireland and Italy – with no significant previous experience of conducting spending reviews. It also includes countries such as Australia and Canada where spending review had, prior to the GFC, been discontinued or had largely withered away.

Examples of new spending review processes established in the wake of the GFC include:

- Ireland, which carried out an ad hoc spending review in 2008 (in order to deliver major reductions in aggregate expenditure) and then established a spending review in 2011 as an integral part of a new system of triennial Comprehensive Reviews of Expenditure.[6]
- Canada, which established an ongoing spending review process in 2007, initially in the form of Strategic Review (2007-08 to 2010-11), and then from 2011-12 as *Strategic and Operating Review* (SOR) (see Box 7 for further detail).
- Australia, which carried out a so-called *Comprehensive Spending Review* over three budget cycles during 2008-10.[7]
- France, where spending review was a key part of the "general review of public policies" (*Révision Générale des Politiques Publiques* (RGPP) undertaken under the presidency of Nicolas Sarkozy in two rounds of review [RGPP1 (2007-08) and RGPP2 (2010-11)], and formally terminated by President François Hollande after his election in May 2012.[8]

Box 7. **Recent Canadian spending review experience**

As noted above, the Canadian federal government carried out a so-called Strategic Review (SR) over four budget preparation cycles from 2007-08 to 2010-11. In 2011-12, this was replaced by a somewhat different Strategic and Operating Review (SOR) process. Under SR, the primary budgetary objective was to create additional fiscal room for new spending priorities, and the government claimed during the four years of the SR process to have reallocated all savings to new spending initiatives. Consistent with this, during the SR years spending ministries were permitted to present options for new spending financed by savings – which were referred to as "reinvestment proposals". In 2011, under SOR, the focus shifted towards fiscal consolidation and the gradual reining in of aggregate expenditure. Savings were primarily allocated to the bottom line, and agencies were no longer permitted to present reinvestment proposal.

The SR/SOR process was largely a process of agency reviews – i.e. ministry-by-ministry reviews to identify savings options. SR aimed to review all ministries over a four-year cycle. SOR was a much more intensive comprehensive review, in which all agencies were covered in a single year in preparation for substantial fiscal consolidation in the 2012 budget. These reviews are essentially decentralised (bottom-up), with each agency carrying out its own review and developing its own savings options without the direct participation of Treasury Board Secretariat (TBS) staff members. Agencies then present review submissions to the government.

Both the SOR and SR processes have been supervised at the political level by a Cabinet sub-committee. The TBS led the process at the bureaucratic level.

A striking feature of post-GFC spending review is its broad scope and more ambitious savings objectives. A leading example of this is the 2010 Comprehensive Spending Review (CSR) carried out by a newly elected government in the UK in order to deliver major expenditure cuts. Another example is provided by the Netherlands, where the number of review topics carried out in the 2010 spending review process increased dramatically to twenty, and the change of pace was symbolised in the renaming of the process as Comprehensive Spending Review (*Brede Heroverwegingenin*) from the previous more innocuous-sounding Interdepartmental Policy Reviews. Across the OECD, "comprehensive" spending reviews became the vogue.

Also apparent has been a widening of the scope of spending review processes. Most post-GFC spending review processes have placed at least as much emphasis upon the search for strategic savings as upon the search for efficiency savings. A strategic and efficiency review is, in other words, the predominant post-GFC mode of spending review.

The reason for this expansion and intensification of the spending review process since the GFC is obvious: governments have been aiming to consolidate public finances, and have in most cases viewed spending reviews primarily as a key instrument for cutting aggregate expenditure. The perceived need for fiscal consolidation reflects, or course, a number of factors the most important of which are:

- The damage done to public finances by the crisis itself – both as a result of cyclical deficits, and of the cost of crisis-linked bailouts.
- The increased awareness that in many OECD countries, public finances were structurally unsound even prior to the GFC.
- The perception in some countries that fiscal consolidation was crucial for market confidence.
- Pressure to comply with fiscal rules (e.g. the European Union's 3 per cent deficit limit).

In this context, governments have generally taken the view that they could not rely upon non-specific uniform across-the-board expenditure cuts to achieve the magnitude of reductions in aggregate expenditure which they have considered to be necessary. The use of spending review process to identify *specific* savings measures has appeared to be the only feasible means of achieving ambitious expenditure reduction objectives.

7. The future of spending reviews

As the world economy makes a slow recovery from the GFC, what will be the future of spending reviews? How should spending reviews be designed to make the best possible contribution to budgeting over the long haul?

An obvious concern is that, as crisis conditions subside, spending review will once again be allowed to wither away. The danger of this occurring may increase to the extent that there is a backlash against "austerity" policies, in a context where a spending review has come to be viewed merely as a tool for reducing aggregate expenditure.

Fiscal circumstances have, however, changed greatly since the pre-GFC era.

In the first place, whatever view one takes about the need for fiscal support for ailing economies in the recovery phase after the GFC, the need for medium and longer term fiscal consolidation in the majority of OECD countries can no longer be seriously disputed. In most OECD countries, baseline expenditure will, without major policy changes, grow unsustainably, particularly in areas such as pensions and health expenditures. The fiscal position has been greatly aggravated in most countries by the large jump in government debt during the crisis. Moreover, revenue growth is certain to be more subdued than in the pre-GFC era. Faced with these circumstances, most OECD governments will be compelled to make a much stronger effort to restrain aggregate expenditure in coming years. One way in which this has already manifested itself is in the new popularity of expenditure rules – such as the new EU rule that aggregate expenditure should not grow faster than trend GDP.

Recognition of these fiscal realities has nothing to do with one's stand on "austerity" policies. Most economists calling for more fiscal support in the recovery phase recognise clearly that any additional discretionary expenditure should be strictly temporary in nature – e.g. infrastructure projects – and should not undermine efforts to bring the growth of baseline expenditure under control.

Secondly, while it is possible in the short run, as part of a major fiscal consolidation programme, to largely ban new spending proposals and to focus the budget preparation process quasi-exclusively on cutting expenditure, this becomes impossible in the medium and longer term. New policy challenges inevitably arise which demand additional expenditure, and the challenge of finding fiscal space for high priority new spending is one which must be addressed.

Under these circumstances, the importance of maintaining spending reviews as an integral part of the budget preparation is clear.

It is, however, crucial to ensure that a spending review does not come to be seen merely as an instrument for dramatic expenditure cuts. Rather, it should be understood as an instrument for expenditure prioritisation, which is relevant whatever the prevailing policy objectives concerning aggregate expenditure may be. It is also essential to communicate the message that the need to be able to prioritise expenditures will be greater than ever before under the more difficult fiscal circumstances which face most OECD countries in the coming decades.

It will also be important to design the spending review process in a manner which is appropriate for its ongoing use as a key element of the routine budget preparation process. To do this, it will be necessary to distinguish clearly between, on the one hand, the type of spending review process which may be appropriate when a government wishes to make large and rapid cuts to aggregate expenditure and, on the other hand, the type of spending review process appropriate to the task of providing additional scope for crucial new spending initiatives in a context of generally tight public finances.

This distinction is crucial to the discussion in the following sections of this paper, where key aspects of the design of spending review processes are discussed with a view to drawing lessons, where possible, about optimal design. The central question is how to design spending reviews for the long haul, as an integral part of the budget preparation process.

8. Scope of spending reviews

A threshold question when designing the spending review process is whether to focus the process on either or both efficiency and strategic savings. It is no accident that since the GFC, strategic and efficiency reviews have become the norm. Past experience makes it clear that it is unrealistic to expect efficiency reviews alone to deliver major expenditure reductions, and to deliver them quickly (OECD, 2012a: 12)

Even a particularly in-depth efficiency review is unlikely to yield savings of more than two per cent of government expenditure. In all cases where a spending review has delivered large expenditure reductions relatively quickly, the review process has deliberately targeted strategic savings as well as efficiency savings. This is true, as in the 2010 UK Comprehensive Spending Review, which according to the government delivered cuts in departmental budgets (other than health and overseas aid) averaging 19 per cent over four years. Going back further in time, it was also true of the Canadian Programme

Review in the mid-1990s, which cut spending to something around 10 per cent over two years (Bourgon, 2009).

Estimates of savings achieved through recent spending review processes are discussed in an Appendix. However, the argument for focusing spending reviews on both efficiency and strategic savings is not based only upon the potential magnitude of savings available. If a spending review is to be used as an instrument of expenditure prioritisation, then part of its focus must be identifying ineffective or low-priority programmes. Prioritisation necessarily involves the search for strategic savings, and not only efficiency savings.

However broad its scope may be, the savings delivered by spending reviews can never be instantaneous. In most cases, it takes several years to put savings measures fully into effect, even with vigorous implementation. In the case of efficiency savings, new processes have to be introduced, sometimes in the form of significant new IT projects. Both efficiency savings and strategic savings often require personnel reductions, and these take time to achieve – particularly if civil service job security means that staff reductions need to be achieved largely through natural attrition.

Another aspect of the scope of spending reviews is their coverage – that is, what part of government expenditure is subject to review. Some spending reviews focus only upon budget expenditure (i.e. on expenditure which is legally authorised in the annual budget law), while others also cover mandatory expenditure (expenditure such as social security benefits which is authorised by standing legislation). For example, the coverage of the RGPP in France was relatively narrow, with a focus primarily at the personnel and operating costs of central government. At the opposite end of the spectrum, the 2010 UK CSR was particularly wide, including nearly all government expenditure – whether budget or mandatory – as well as tax expenditures. The recent tendency is towards broad coverage – 11 of the 15 OECD countries which claimed in the 2012 survey to have spending review processes indicated that the process covered both budgetary and mandatory expenditure.

The case for broad coverage of government expenditure by spending review is compelling, particularly given the contribution of mandatory social security and health expenditures to the fiscal sustainability challenges faced by many OECD countries.

As noted above, many of the spending reviews launched since the GFC have been labelled "comprehensive" reviews. This raises the question of whether spending review as an ongoing process should be comprehensive or selective.

To consider this question properly it is necessary to clearly define what is meant by a "comprehensive" spending review. After all, no spending review process has ever reviewed everything – i.e. every single government programme and every single business process. To do so would be completely impracticable. The term "comprehensive" cannot therefore be taken literally.

To distinguish meaningfully between comprehensive and selective spending reviews, it is useful to start by noting that any spending review process is comprised of a set of *review topics*. There are three key types of review topic:

- Programme reviews: These examine specific programmes (i.e. specific categories of services or transfer payments), and may deliver either strategic savings (by reducing the services provided by the programme) and/or efficiency savings (by lowering the costs of delivering services under the programme).

- Process reviews: These scrutinize specific business processes used in the production of government services – for example, procurement processes; IT systems and practices; or human resources management practices. Process reviews aim to achieve efficiency rather than strategic savings.
- Agency reviews: These review a whole government organisation (ministry or other agency), and may in principle cover all of the agency's programmes and processes.

Programme or process reviews may be agency-specific or they may be horizontal. A horizontal programme review examines a group of related programmes delivered by two or more agencies, while a horizontal process review looks at a particular domain of business process across several (or all) government agencies (e.g., a review of government-wide procurement practices). As noted previously by the OECD (2012a: 11), such horizontal process reviews are an important part of any good efficiency review.

Against this background, a selective spending review may be defined as a review which is limited to a specific list of review topics – programmes, processes and/or agencies – which is specified at the beginning of each round of spending review.

A comprehensive spending review, by contrast, is defined here as a review the scope of which is not limited by any *ex-ante* list of review topics, and in which review teams are asked to look at all ministries with the expectation that they should seek to identify, to the extent practically possible, the most important savings options. A comprehensive spending review is expected to have a greater scope, and to yield greater savings, than a selective review.

One implication of this definition is that, to qualify as a "comprehensive" review, the process must target both strategic and efficiency savings.

Despite the recent popularity of comprehensive spending reviews, selective spending reviews have over time been more common than comprehensive reviews. A key reason for this is the extremely demanding nature of a comprehensive spending review such as the Canadian 2011 Strategic and Operating Review or the UK 2010 CSR. Even a selective spending review is a demanding process for the MOF and spending ministry staff. But a comprehensive spending review is a truly exhausting process during which the MOF and other civil servants involved have no choice but to put other important responsibilities to one side and concentrate overwhelmingly upon the spending review process. It involves, in the words of one British minister (describing the 2010 CSR), an "enormous effort".

This suggests that comprehensive spending reviews are only desirable when a government wishes to achieve major aggregate expenditure reductions in a short period of time; whether to deliver fiscal consolidation, to reduce the size of government, or to pave the way for a dramatic shift in the direction of spending after the arrival in office of a new government with radically different expenditure priorities to its predecessor. In such cases, the government will be politically well-advised to make the cuts quickly at the start of its electoral mandate, in the hope that adverse voter reaction dies down by the time of the next election.

Under more normal conditions, a selective spending review is a better approach. Expenditure restraint rather than sudden major cuts is what is normally required, and it is easier to reallocate gradually than suddenly. Avoiding the extreme pressure of a comprehensive spending review has the added advantage that the review work carried out during each round of the spending review process will generally be more thorough and of higher quality.

If a spending review is normally to be conducted on a selective basis, the question of the principles guiding the selection of review topics during each spending review round arises. One possibility is the discretionary selection of review topics. Under this approach, central decision-makers select review topics based on the perceived probability that they will yield high-value savings measures (e.g., ordering the review of programmes, processes or even agencies the efficiency or effectiveness of which have been widely questioned. This is, approximately speaking, what the Netherlands and Denmark do. A different approach is the automatic review cycle. This is an approach which aims to review all programmes, or all agencies – not during a single spending review cycle, but gradually over time. This was the approach of the Canadian Strategic Review, which reviewed one-third of Federal agencies each year over three years between 2008 and 2010.

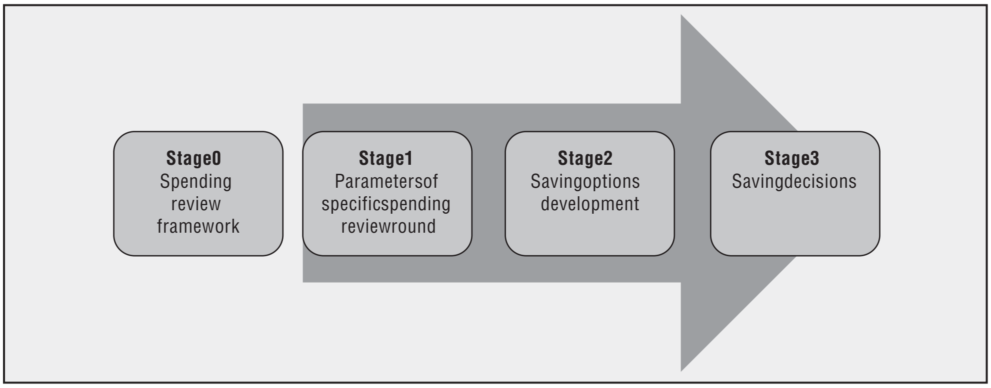
Each of these approaches has merits. The discretionary selection of topics enables the targeting of the spending review process on programmes or processes which are *prima facie* most likely to yield significant savings. On the other hand, the automatic review cycle approach can identify important savings options which might be missed under a purely discretionary selection process. It is not obvious that either of these approaches is superior to the other. There is, however, nothing to prevent a government combining the two approaches – that is, by putting in place an automatic review cycle, but at the same time building in the discretionary selection of specific review topics by the political leadership and the MOF.

One final point on the scope of spending review processes is that, in the great majority of cases, spending reviews do not include scrutiny of capital projects which are under construction or acquisition (e.g. infrastructure projects, IT projects which are already underway). Only in the exceptional case of comprehensive spending reviews intended by governments to deliver deep spending cuts have such "in the pipeline" capital expenditure reviews been included (e.g., in the 2010 UK CSR and in the Irish spending reviews of 2008 and 2011). In these cases, the scale and speed of the expenditure reductions targeted was such that there was no choice but to achieve them in part by cancelling capital projects currently underway. In more normal times, however, it is inappropriate to include such capital projects within the scope of spending reviews. The aim should, instead, be to ensure that the right decisions about which capital projects to finance are made ex-ante, through the establishment of excellent processes for the appraisal of new capital expenditure proposals put forward by spending ministries. Once these proposals are approved, it then makes little sense to duplicate the ex-ante appraisal process (unless the project experiences major unforeseen difficulties). Indeed, government should avoid the wastage involved in the cancellation of partially-completed projects which were carefully appraised by the MOF before construction commenced.

9. Roles and processes

Stage 0 – the establishment of the spending review frameworks or the "framework stage"– is the stage at which decisions are made on those design features of the spending review process which can potentially remain in place over multiple rounds of spending reviews. These include what part of government expenditure is to be covered (budget and/or mandatory); whether the review is selective or "comprehensive"; whether the focus is efficiency and/or strategic savings; the precise assignment of roles in the process; and whether or not quantitative savings targets will be set. These are general design features which the government does not need to revisit during every new round of spending review,

Figure 1. **The four different stages of spending reviews**



and need only consider when it is either establishing a spending review process for the first time, or when it wishes to modify the overall design of the spending review process used in the past. Collectively, it is these design features which determine the prevailing type of spending review system in the country concerned.

By contrast to the framework stage, the remaining three stages must be undertaken afresh during every new round of spending review. In that sense, Stages 1-3 may be said to constitute the spending review process proper – as opposed to the process of deciding how spending review will work.

Stage 1 – the setting of the parameters of the specific spending review round or the "parameters stage" – refers to the determination of those characteristics of the spending review process which are necessarily specific to each round of spending review. These include: choosing specific review topics (if the framework is one of selective spending review); specifying any criteria/review questions which review teams are required to address during reviews (see Box 8); deciding the magnitude of savings targets (if applicable); and specifying the key dates in the spending review calendar (in the context of the broader budget preparation calendar).

Stage 2 – the development of savings options or the "savings option stage" – refers to the development of recommendations and options on possible savings measures for presentation to those who make the final decision on which savings measures will be implemented.

Stage 3 – the savings decisions stage – refers to the final decisions on the savings measures which are to be implemented. This is the final stage of the spending review process.

The key players in the spending review process – the political leadership; the MOF; the spending ministries; and external players – have different roles to play in each of these stages. These roles are summarized in the following table, following which they are discussed in detail.

9.1. The Savings Decisions Stage – the role of the political leadership

In discussing the roles of key players in each of the stages of the spending review process, it is useful to start at the end of the process – at the savings decisions stage. The final decision on which savings measures to implement must, in general, be made by the political leadership.

Box 8. **Setting explicit review criteria**

In many recent spending review processes, an important part of the "parameters" stage at the outset of the spending review process has been the establishment of explicit criteria to guide the search for savings options. The identification of options for strategic savings must always involve the application of criteria to determine which services or transfer payments can be eliminated or scaled back, even if these criteria are not made completely explicit. Some criteria may be obvious (e.g. inherent ineffectiveness, low priority). Others may be less obvious, or may vary with the philosophical orientation of the government (e.g. criteria based upon a view of the appropriate role of government *versus* the private sector).

Particularly in countries where the spending review process is based on bottom-up reviews, it has proven to be useful to make these criteria completely explicit at the outset of the spending review process. During the 2010 UK CSR, for example, spending ministries were instructed to review their spending on the basis of a set of standard questions, such as: Is the activity essential to meet Government priorities? Does the Government need to fund this activity? Does the activity provide substantial economic value? This approach was broadly modeled upon that of the Canadian Programme Review of the mid-1990s, during which six defined "tests" were applied to assess programmes. The same broad approach was adopted by Ireland during its 2008 and 2011 spending reviews.

Table 1. **The key players in the spending review process**

	Stage 0 General S.R. framework	Stage 1 Specific S.R. process parameters	Stage 2 Savings option development	Stage 3 Savings decisions
Political leadership	X	X		X
MOF	X	X	X	
Spending ministries			X	
External players			X	

The term "political leadership" refers in this paper to those elected politicians who exercise dominant *de facto* power over the content of the budget. In all of the OECD countries which have carried out spending reviews in recent decades, *de facto* (as opposed to legal) power over the budget is located primarily in executive government, rather than the Parliament.

The way in which the political leadership decides which savings measures to adopt depends upon the institutional structure of the country – concretely, on the way in which power is distributed between the elected politicians who sit at the summit of executive government. In some countries, the final say essentially lies in the hands of the President and/or Prime Minister. In other countries, the Cabinet plays a central, or even dominant, role. To varying degrees, the minister of finance also exercises substantial budgetary power.

The UK provides an interesting illustration of the way in which the locus of political power in the spending review process can change. During the 2010 CSR, political decisions on the choice of savings measures were essentially collegial, involving a small group of ministers (the treasury ministers, the prime minister and the deputy prime minister) and the newly-created Public Expenditure (PEX) Committee of Cabinet. However, this arrangement was very unusual for the UK, where historically (including during the 2007 CSR) budgetary decisions have been made by either or both of two powerful figures – the Chancellor of the Exchequer (finance minister) and the Prime Minister, and the role of Cabinet was marginal. The broader ministerial participation, and the important role of the PEX committee during the 2010 CSR, reflected the highly unusual circumstances of a coalition government.

The locus of political decision-making with respect to savings measures also depends to some extent upon the nature of spending reviews. If the focus is upon strategic savings, the political sensitivity of decisions to cut or scale back programmes means that such decisions will almost always be taken at the very top. By contrast, in the case of a purely efficiency review without dramatic savings targets, it could be the case that the final decision is left, say, to the minister of finance.

9.2. The Framework and Parameters Stages – the role of the political leadership and the MOF

In almost all recent spending reviews, the political leadership has also played a key role in establishing the general framework and parameters of the spending review process. Far from leaving the design of the general spending review framework solely to the bureaucracy, political leaders have tended to be highly assertive in ensuring that the framework is one which is capable of delivering savings measures of the type and magnitude which they wish to see. Political leaders have also played a key role in the selection of review topics and the setting of savings targets, where relevant.

Experience also demonstrates the need for the political leadership, when setting the parameters of each round of spending review, to put the spending ministries on notice that it requires them to contribute fully to the process.

At the bureaucratic level, the role of the MOF is quite fundamental to the success of the spending review, starting with the detailed work of designing the spending review framework. In most countries, it is also predominantly, if not exclusively, the role of the MOF to advise the political leadership on the parameters of each spending review. Consistent with this, the OECD 2012 survey reported that in thirteen of the fifteen countries claiming spending review processes, the MOF played the main role in defining spending review procedures.

9.3. The Savings Options Stage: The roles of the MOF,spending ministries and external players

In most countries, the development of savings options has primarily been undertaken by the spending ministries and the MOF, with external players playing a supporting role at most. It is useful therefore to discuss the considerable differences in the roles played by the spending ministries and MOF, prior to considering the role of external players.

It is with respect to the roles of the spending ministries and the MOF in the development of savings options that the greatest differences of approach between countries become evident. Broadly speaking, there are three main approaches which OECD countries have taken in assigning roles in the development of savings options between these two key players:

- Bottom-up spending review: In this approach, the spending ministries themselves are required by the government to identify savings options for presentation to the central agencies and political leadership. For this purpose, the spending ministries constitute internal review teams which do not include representatives of the MOF. Canada, the United Kingdom and Ireland are examples of this approach.

- Joint spending review: In this approach, the spending ministries and the MOF constitute joint review teams to develop savings options. The savings options presented by these review teams to the political leadership are approved by both the spending ministry and the MOF. The Netherlands and Denmark are examples of this approach.
- Top-down spending review: In this approach, spending review teams are composed of MOF staff or nominees, and there is little or no participation of spending ministry staff. There is no process for requiring or requesting spending ministry endorsement of the savings options which are identified. This was essentially the approach taken in France during the RGPP.

Both the bottom-up and joint spending review approaches aim to tap into the information possessed by the spending ministries, and each appears to have worked well in a number of countries.

On the other hand, experience suggests that the top-down approach to spending review does not work well. Marginalising the spending ministries during the process of identifying savings options comes at a heavy price. Not only do the spending ministries have unparalleled detailed knowledge of their own programmes and processes, but it is they who have to implement any savings measures which the government decides to adopt. If they do not at least understand the logic of the savings measures which they are expected to put into effect, implementation may prove very difficult. The French experience is an example. The lack of understanding and acceptance of savings measures on the part of the spending ministries proved to be a significant problem for the implementation of the French RGPP, and it is now a generally accepted in France that the RGPP's highly centralised approach to the identification of savings options was a mistake (OECD, 2012b: 63, 65).

The main choice with respect to the roles of the spending ministries and the MOF in the savings option stage of the spending review process is therefore between the bottom-up and joint review approaches. Graphically, these two approaches may be represented as follows (where "Cabinet" is shorthand for the political leadership):

The graphical representation of the joint review process recognises that, in joint review systems such as the Netherlands and Denmark, there is usually a provision that if the spending ministry and MOF are unable to reach full agreement on certain savings options, each side retains the right to put unilateral positions to the political leadership. However, such failure to reach an agreement on savings options is rare in the joint review systems (see below).

It should be acknowledged that, in practice, the differences between national approaches are not quite as stark as the stylised models suggest. For example, in a bottom-up review process such as in the UK, there is considerable pressure on spending ministries to modify the options which they develop to make them more palatable to the MOF prior to presentation to the political leadership. This means that the pure bottom-up and joint review approach should be regarded as polar extremes, with most real-world spending review systems placed somewhere on the spectrum between the two.

Whether the bottom-up or joint spending review approach is used, it is necessary that substantial pressure is applied to overcome the natural resistance of spending ministries

Figure 2. **Savings options stage: The bottom-up review approach**

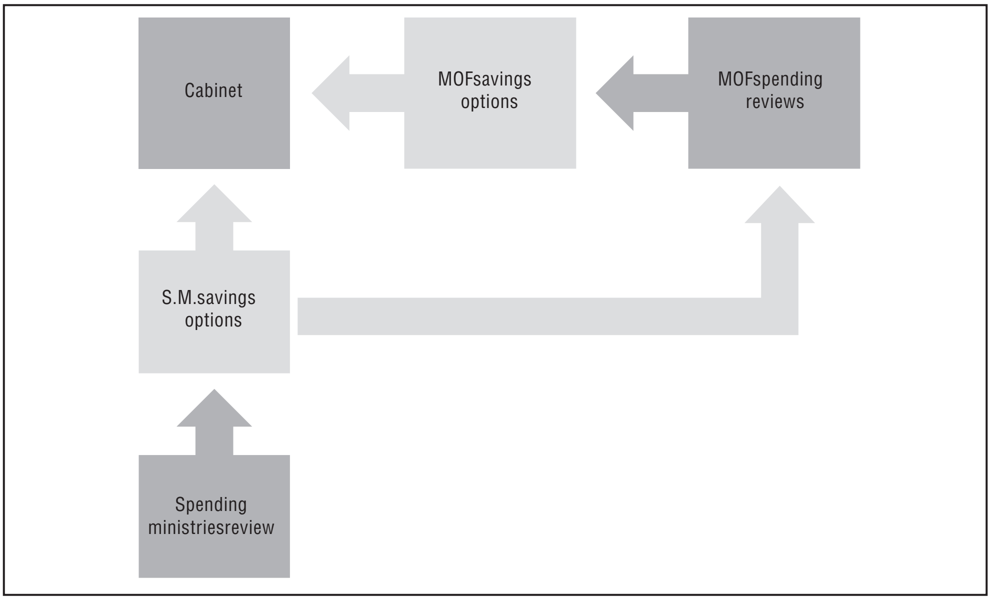
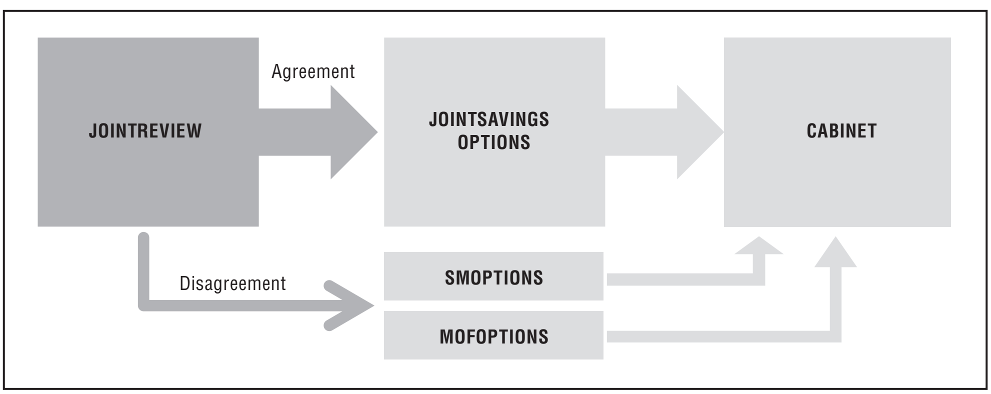


Figure 3. **Savings option stage: The joint review approach**



to budget cuts and to ensure that they participate in the process in good faith. Pressure from the political leadership is, as previously mentioned, particularly important here. Spending ministers and top executives of the spending ministries must be in no doubt about the commitment of the President/Prime Minister and/or Cabinet to the spending review process, and must understand that they and/or their ministries are likely to pay a price for obstructive tactics. In Canada, for example, certain spending ministries which initially failed to co-operate in the Strategic Review process when it got underway in 2008 found themselves either or both i) ordered to rework their savings options submissions and ii) treated more harshly when the cuts were decided. As a consequence, spending ministry co-operation improved substantially in subsequent years.

Other mechanisms for applying pressure to spending ministries may be useful. The possibility of setting savings targets – e.g. requiring that a specific ministry present savings options to the value of at least 15 per cent of its budget – as already mentioned. Another possibility, which is discussed further below, is to permit spending ministries to present reallocation options which, if adopted by government, would allow them to retain part of the value of any expenditure cuts and reapply the funds to other priority areas.

The joint review approach places considerable pressure upon the spending ministries because only by convincing the MOF representatives on the review teams of the adequacy and appropriateness of its preferred savings options can a spending ministry be reasonably confident that these will be the options finally adopted by the government. If a spending ministry chooses instead to put forward inadequate and/or politically unrealistic savings options to the joint review team, it must assume that they will fail to receive the endorsement of the review team. This will then trigger the circumstances mentioned above, where the MOF and the spending ministry concerned may put forward separate savings options proposals to the political leadership. Choosing to "fight it out" in this manner is a risky game for a spending ministry, which has a high probability of depriving it of the chance to at least minimising the damage – from its perspective – of the spending review cuts.

Whether the spending review process is based upon joint reviews or upon bottom-up reviews, the challenge function of the MOF and any associated central agencies is of fundamental importance in getting the spending ministries to "play ball". It is essential that the MOF actively analyses the merits of, and where appropriate opposes or calls for modifications of, savings options put forward by the spending ministries. That MOFs are playing this role seems to be supported by the results of the 2012 OECD survey in which twelve of the fourteen countries claiming to have spending review processes, the MOF was reported to be the (or one of the) main institutions responsible for the supervision and review of reports prepared during the spending review process.

In a joint review process, it will be the MOF members of the joint review teams who must bear prime responsibility for carrying out the challenge function. This makes it vital that the MOF commit substantial resources to the work of the joint review teams. This is why, for example, the Netherlands Ministry of Finance insists upon nominating senior staff members – even including the deputy budget director – as its review team representatives. These representatives, incidentally, not only challenge spending ministry proposals, but also sometimes put forward their own savings options for consideration.

In a bottom-up process, explicit mechanisms and structures must be established to carry out the challenge function, and MOF officials will inevitably play a central role in these. During the 2010 CSR in the UK, savings options put forward by spending ministries were reviewed at a number of levels prior to presentation to the PEX. There was a review by a senior civil service committee (led by top Treasury officials), and a review in bilateral discussions between the treasury ministers and a relevant spending minister (with extensive participation of Treasury officials). (The challenge function was further supported by an "Independent Challenge Group" of experts – see further below.) Similarly, during the 2011 spending review in Ireland, all spending ministry savings options were scrutinized in the first instance by a high-level Steering Group, chaired by the head of the Department of Public Expenditure and Reform. [9]

To effectively carry out its challenge role in the spending review process, it is essential that the MOF officials have strong policy – as well as financial – skills and knowledge. The transformation of MOFs in many leading OECD countries from purely accounting/ economic institutions into organisations with stronger policy skills – in which the desk officers responsible for the budgets of specific spending ministries are expected to acquire in-depth understanding of their policies and programmes – has therefore been crucial to the success of contemporary spending reviews. The creation of a specific spending review unit within the MOF can also greatly facilitate spending reviews, on the assumption that such units co-operate closely with the MOF's sector budget analysts.

Should the role of the MOF in the development of savings options go beyond challenging spending ministry proposals and extend to the development of its own savings options? As previously mentioned, the MOF does not hesitate to play this role in the Netherlands, where the process is based on joint reviews. The same is true in most countries where spending reviews are structured as a bottom-up process. For example, during the 2010 UK CSR, following the presentation by spending ministries of their savings options submissions, Treasury officials frequently injected savings options of their own into the process. The same has historically been the case in Australia where, during spending reviews, the Cabinet Expenditure Review Committee receives not only spending ministry savings proposals, but also counter-proposals from the Department of Finance.

The Canadian case is, however, one notable exception to this generalisation. Although the Canadian Treasury Board Secretariat (TBS) staff have played a very active challenge role in respect to spending ministry savings options during the spending review processes which have operated since 2008, they have (according to the TBS) deliberately abstained from presenting ministers with alternative savings options.

The case for mandating the MOF to present alternative savings options nevertheless appears strong. As noted, to successfully carry out the challenge function, it is essential that the MOF develop a cadre of staff with substantial expertise and knowledge of the policies and programmes of spending ministries. In doing so, the MOF develops a capacity not merely to challenge the spending ministry savings options, but also to identify credible savings options of its own. There is no evident reason why the MOF should then be prevented from using this capacity to propose savings options. Indeed, the knowledge that ministers may receive alternative savings options from the MOF must put additional pressure on spending ministries to carry out their own reviews in a thorough manner and to put forward a well-developed range of savings options to the political leadership.

One final point in respect to the role of the MOF during the savings options stage is that it is almost invariably the role of the MOF to carry out operational oversight of the process of developing savings options – i.e. to ensure that those who are mandated with the responsibility for developing savings options approach the task in a manner consistent with the framework and parameters of the spending review process. Consistent with this, the OECD's 2012 survey reported that of the 15 countries claiming spending review processes, the MOF was the main institution providing guidance, steering and technical assistance in 14 countries.

9.4. *The MOF* vis-à-vis *other key central agencies*

The discussion above has referred to the fundamentally important role of the MOF in the development of the spending framework and parameters, and in the subsequent development of savings options. In some countries, this pivotal bureaucratic support role is played virtually exclusively by the MOF as for example, in the UK where HM Treasury has unquestioned leadership of the spending review process at the bureaucratic level.

In other countries, however, bureaucratic leadership of spending reviews is shared with other "central agencies". Australia is a case in point. The Department of the Prime

Minister and Cabinet plays a major role in the spending review process alongside with the Ministry of Finance.

A particular striking example of a system with multiple central agency players in the spending review process is France. In France, budgetary power lies mainly with the president and the Prime Minister, and the Minister of Finance[10] is less powerful than in many other OECD countries. This allocation of budgetary authority at the political level is mirrored at the bureaucratic level, and this had a major impact on the distribution of central agency roles in the RGPP spending review process. In particular, the RGPP Monitoring Committee (*comité de suivi de la RGPP*) which supervised the RGPP process was chaired jointly by the heads of the office of the President and the office of the Prime Minister, with the Budget Minister serving only as a committee member. The MOF would appear, as a result, to have played a somewhat less powerful role in the spending review process than in the most other countries.

Clearly, the sharing of roles between the MOF and any other relevant central agencies must take into account the nature of the political and administrative system. However, what is clear is that, if the President/Prime Minister's office or some other central agency plays a major role in the spending review process, it is essential that there be close co-operation between that agency and the MOF, and that the two do not compete or conflict with one another in the advice provided to the political leadership or in the supervision of the spending review process. The importance of such co-operation is borne out by the experience of Australia, where one of the great strengths of the spending review – and indeed, of expenditure policy more generally – has been the tradition of close co-operation between the Department of Finance and the Department of Prime Minister and Cabinet.

9.5. The role of external players in the Savings Options Stage

So far, nothing has been said about the role of those outside government in the spending review process. This reflects the fact that spending reviews have in recent decades been carried out primarily by civil servants. Although the use of outside experts is very widespread, these outside experts in most cases serve as advisers to (or sometimes members of) review teams which are themselves directed by, and predominantly composed of, civil servants. Moreover, many of the "outside" consultants and academics which have been engaged as advisers are themselves former civil servants. (This was true, for example, of the "Independent Challenge Group" during the 2010 UK CSR. Of its external members – note that the great majority of its members were serving civil servants – many were former civil servants.)

In this respect, contemporary spending review practices generally differs from the approach used in the ad hoc reviews of the 1980s previously referred to, which were often (including in the case of the Grace Commission) led by prominent businessmen and staffed mainly by outsiders. The results of spending reviews carried out at that time were widely considered disappointing, in significant measure because outsiders did not have sufficient detailed knowledge of government to do the job properly. It is therefore broadly accepted today that the civil service should play a central role in the conduct of spending reviews. This makes particular sense when spending review is carried out as an ongoing process rather than as a purely one-off exercise, because of the importance of accumulated knowledge. The importance of the civil service role is underlined by the problems which Denmark – the only country with long-term spending review experience where external consultants undertake most of the detailed analytic work in the development of savings options – has had as a result of the weakness of the knowledge base within the MOF.

Notwithstanding this, it should be recognised that private sector experts can potentially play a major role in the search for efficiency savings. Business process review – e.g. of procurement processes, or IT systems – is an area where spending review work is often rather generic, and where private sector expertise is more directly applicable to government. This explains why the most important recent major example of spending review carried out primarily by outsiders – the Gershon efficiency review in the UK – is generally considered to have been a success.

Box 9. **Ireland: Building civil service spending review capacity**

Facing very difficult fiscal circumstances, Ireland initiated its first spending review process in 2008. This first round of spending review was managed by a so-called Special Group comprised of external experts, supported by a secretariat provided by the Department of Finance. The process was essentially a bottom-up review, in which the Special Group requested each spending ministry to submit to it an "evaluation paper" outlining savings options (together with an analysis of the impacts of these options on outputs and outcomes). The Department of Finance also prepared its own evaluation papers with options for expenditure and staff reductions for the Special Group. Based on these inputs, the Special Group presented a report on savings options to the government in 2009, and these options greatly influenced the 2010 budget.

This initial heavy reliance upon external expertise to carry out the spending review reflected the weak expenditure analysis capacity of the bureaucracy at the time. In order to build that capacity, the government in 2011 established the Department of Public Expenditure and Reform with responsibility for expenditure analysis and the management of the spending review process. Following this, the government in 2011 established a continuous spending review process modelled quite substantially on the UK system. As in the UK, this remained a bottom-up review process based on agency reviews. Agency reviews are guided by a standard set of review criteria, including efficiency, effectiveness, and the validity and relevance of programme rationale. The second round of spending review based on this new system was carried out in 2011, with the next round to be carried out in 2013. Spending reviews are now established in Ireland as a process in which the savings option stage is primarily the responsibility of civil servants (with relevant external input), by contrast to the initial external expert-led process in 2008-09.

Source: Drawn from "Combined Countries Case Study" carried out within the budget group of the OECD Secretariat by Atsushi Jinno, unpublished internal document.

The other channel for external input into the spending review process is suggestions for savings options from the general public. Whereas invitations to the general public to make suggestions for savings options were rarely a feature of spending reviews prior to the GFC, a number of countries have incorporated such public input in the post-GFC period. Examples include the UK (where the government labelled its invitation for public input into the 2010 CSR as the "Spending Challenge"), Australia (in 2008, at the start of its Comprehensive Spending Review), and Italy (2012).

9.6. Role of the parliament

What about the role of the parliament? As mentioned above, OECD countries which have carried out spending reviews in recent decades have all been countries in which *de facto* budgetary power lies in the hands of executive government. The Parliament's role is essentially to give formal approval to the budget rather than determine its parameters. This reflects the fact that almost all the countries concerned are pure parliamentary systems,[11] in which the political leadership of executive government is drawn from the parliament and where, as a result, executive government can normally be sure of securing the passage of its recommended budget through the parliament (perhaps with some second-order amendments). Reflecting this, in no recent case could the parliament be said to have been a key decision maker in the choice of savings measures to be adopted as a result of the spending review process.

Although not changing the fact that spending reviews have in general been an essentially executive government process, one important characteristic of the parliamentary system – namely, whether it tends to produce single-party governments or coalitions – has had a substantial impact on the spending review process. In countries with coalition governments – such as the Netherlands, Denmark and (exceptionally) the UK under the Conservative-Liberal coalition elected in 2010 – the role of the Cabinet in the spending review process is greatly strengthened relative to that of the Prime Minister, because it is particularly in the Cabinet and its committees that agreements can be negotiated between the coalition parties.

10. The information base of spending reviews

MOF officials in countries which have conducted major spending reviews in recent years concur in the view that more performance information is needed to improve the spending review process. In particular, many take the view that more evaluation – and more relevant evaluation – is needed. The belief in the necessity of strengthening the information base of spending reviews appear to already be leading to efforts to breathe new life into programme evaluation. The Netherlands, Canada and France (under the RGPP) are amongst the countries which have explicitly identified the need to boost evaluation in order to improve spending reviews (see Robinson, 2013b). MOFs in these and other countries increasingly believe that spending reviews needs to be able to draw on high-quality evaluation which is carried out outside the spending review process itself.

The tight time limits which usually apply to spending reviews tend to make it difficult to carry out evaluations – which in many cases take substantial time – as part of the spending review process itself. This has meant that, unless evaluations are already available (which has rarely been the case), spending reviews have been forced to rely to a large degree upon quite informal expenditure analysis. MOF officials therefore increasingly recognise that spending review teams do not carry out evaluations – rather, they use and commission evaluations.

It is important, however, to guard against the illusion that merely increasing the amount of evaluation activity will improve the quality of spending reviews. It is also important not to mistakenly believe that government-wide evaluation systems – that is, systems requiring ministries to evaluate all their programmes and processes over time – are either necessary or sufficient to assure the information requirements of spending reviews.

Past experience with the use of evaluation as an input into budgeting has been generally disappointing. In the period from the 1970s to the 1990s, many OECD governments undertook massive efforts to build government-wide evaluation systems, and a handful of these countries (Canada being a notable example) maintained these systems up to the present time. Evaluations carried out by spending ministries pursuant to the requirements of such government-wide evaluation systems were little used, and of limited value, in budget preparation process. These evaluations tended to predominantly focus upon management/policy improvement objectives rather than on budget decisions, and often failed to provide timely or conclusive information to managers (Robinson, 2013b). This is part of the more general phenomenon noted previously by the OECD (2012a) that "performance information adds value to the management and service delivery tasks of line ministries and executive agencies but has proven difficult to use for fund allocation as per the needs of Ministries of Finance".

This negative view of the budgeting relevance of evaluations carried out by spending ministries was reinforced in recent years in countries such as the Netherlands and Australia, where MOFs seeking to draw on such evaluations in spending reviews concluded that their quality was generally too low for them to be useful.

This makes it clear that what spending reviews need is not more evaluation, but more relevant evaluation. In this context, there needs to be an explicit recognition that the type of evaluation which is useful to the MOF and the political leadership in making budget decisions is significantly different from evaluation which help spending ministries improve their policy design and management.

At the same time, it must be recognised that evaluation to support spending reviews – even when "comprehensive" – does not require that all programmes and processes being examined by review teams be formally evaluated. On the contrary, many savings options can be identified without any need for formal evaluation. For example, the identification of low priority programmes which could be cut does not require the evaluation of the effectiveness or efficiency of the programmes concerned. It is, rather, simply a matter of deciding that the outcomes which the programme aims to achieve are not sufficiently important to justify the expenditure involved.

What spending reviews require are two main types of selective evaluation. The first is formal efficiency analysis aimed at identifying and quantifying opportunities for efficiency savings. The second is outcome evaluation with respect to programmes that are pursuing objectives which are clearly worthwhile, but through means with questionable effectiveness.

This suggests that for evaluation to make a useful contribution to spending reviews, the choice of evaluation topics, and of the type of evaluation technique employed, should be explicitly geared to the task of identifying savings options. A single government-wide evaluation system cannot be expected to do this. Instead, the MOF and political leadership need to be able to commission evaluations specifically intended to feed into the spending review process.

The system of Strategic Reviews introduced in Australia in 2007 is an example of how evaluation geared to spending reviews can operate. *Strategic Reviews* are reviews of programmes or processes which are formally commissioned by the Expenditure Review Committee of Cabinet, usually on the recommendation of the MOF. The Strategic Review reports cannot themselves be regarded as spending reviews, because it is not in general part of their terms of reference to recommend options for budget savings. Instead they review programme or process performance in a way which is intended, in part, to support spending reviews by providing the DOF with better information. Once specific strategic reviews are completed, the DOF usually develops and presents to the ERC savings options which draw upon the reviews.

A related issue is the role of performance indicators in providing the information base for good spending reviews. MOF officials with recent experience of spending reviews usually assert that performance indicators are one significant information source for spending reviews. However, many also indicate disappointment that performance indicators have not made a greater contribution to the spending review process despite what has been, for many countries, a massive effort over recent decades to develop more and better indicators.

It is, however, necessary to be clear about the role which indicators can potentially play, and about the limitations of indicators. Performance indicators by themselves rarely provide clear and conclusive information on the effectiveness and efficiency of programmes and processes. To take one important example, outcome performance indicators in general either do not distinguish, or distinguish only to a limited degree, between the outcomes achieved by the government programme and the impact of so-called "external factors".[12] This means that it is usually not possible to judge the effectiveness of the programme solely by looking at the programme's outcome indicators. It is precisely the task of outcome evaluations to analyse outcome indicators in order to distinguish actual outcomes achieved from the effect of external factors.

It is therefore unrealistic to expect that performance indicators alone – without evaluation based on those indicators – can provide the necessary information base for good spending review.

Disappointment with the contribution of performance indicators nevertheless also reflects, in some countries, a failure to develop enough of the right type of performance indicators. For example, the development of good outcome (effectiveness) indicators has unfortunately been an area where progress has been disappointing even in some countries which have introduced performance budgeting systems. Sometimes, performance budgeting has been seen more as a matter of stuffing the budget documents full of performance indicators than of ensuring the relevance of those indicators for budgetary decisions. As a consequence, many essentially operational indicators (activity and input indicators, the primary relevance of which is to internal ministry management) have found their way into the budget papers and annual performance reports. These types of indicators tend to be of limited value for the spending review process.

11. Spending review and performance budgeting

Spending reviews have an important connection with the most widespread form of performance budgeting – programme budgeting. Under programme budgeting, expenditure is classified in the budget primarily by "programmes" based on objectives and types of services (outcomes and outputs), rather than solely by economic categories (such as salaries, supplies and communication costs) and organisational categories (e.g. ministry and department with the ministry). Good performance information about the performance of programmes – in the form of both programme indicators and evaluations – is then used to inform budget preparation. The main objective for which programme budgeting was designed is improved expenditure prioritisation.[13] Basically, the assumption is that by providing information on the costs of delivering groups of services, and the results achieved, programme budgeting facilitates decisions about which areas of expenditure to cut back on and which to augment, in order to best meet community needs. By contrast, a traditional budget, in which funds are mainly allocated by line item, is of limited value as a vehicle for choices about expenditure priorities.

The existence of some type of spending review process should be seen as a critical pre-condition for programme budgeting to succeed in improving expenditure prioritisation. Experience makes it clear that it is a mistake to believe that merely developing programme performance information will ensure that this information is used in the budget preparation process. Rather, it is necessary to create routine processes to ensure the use of such performance information to ensure that programme performance is systematically taken into account when deciding how to allocate limited government resources. Spending reviews provide precisely such a process.

In the context of a programme budgeting system therefore, spending reviews should be viewed as the primary mechanism by which programme performance information is systematically taken into account during the budget preparation process.

Not only do spending reviews support programme budgeting, but the converse is also true. Firstly, the emphasis placed by programme budgeting (and performance budgeting more generally) on the development of good programme performance information, strengthens the information base of spending reviews. Secondly, the programme classification of the budget helps because it identifies programmes and sub-programmes upon which spending review will need to focus, and indicates how much money is being spent on the programmes.

Expressed differently, it is an essential starting point for good spending review that the MOF knows exactly which programmes are being delivered by each spending ministry and how much is being spent on each. This makes the programme classification of the budget particularly relevant to programme review, and to the search for strategic savings.

A key problem facing programme budgeting over recent decades has been that, in many OECD countries where it was implemented, there was no strong desire on the part of either the MOF or the political leadership to become progressively involved in expenditure reallocation. This was true, for example, in France (in respect to the LOLF programme budgeting system introduced between 2001 and 2006) and also in the Netherlands (in respect to the VTBT system introduced from 2000). Yet expenditure reallocation is, as noted above, precisely the main purpose of programme budgeting. The result was, inevitably, programme budgeting systems which were all dressed up with nowhere to go. By contrast, if the new post-GFC emphasis on reallocation is maintained and strengthened, programme budgeting will have the opportunity to demonstrate its true worth as a tool for expenditure prioritisation.

12. Keeping the spending review process focussed

The challenge for OECD countries over the medium term is to build on the valuable experiences of spending reviews accumulated during recent years in order to transform spending reviews into a permanent feature of the budget preparation process. This will require that spending reviews be viewed not only as an instrument for making deep public expenditure cuts, but as an instrument for ongoing reallocation in the context of aggregate expenditure restraint.

It will also require that spending review processes be designed in a manner appropriate to an ongoing role, as opposed to a role exclusively as a crisis instrument. As suggested above, this has a range of implications, one of which is that spending reviews should normally be selective rather than comprehensive.

It also has implications for the frequency in which spending reviews are carried out. Transforming spending reviews into a permanent feature of the budget preparation process implies that spending reviews should occur with the same frequency as budget preparation – that is, at the same time intervals as spending ministry budget funding allocations are decided. This means that if, as in the majority of countries, budgeting is primarily annual, then spending review should also be an annual process.

By contrast, in countries where budgeting is truly multi-annual, spending reviews should be conducted only every two or three years. The crucial factor here is the frequency in which spending ministry budget allocations are set. In a truly multi-annual system such as that of the United Kingdom, budget preparation is essentially a process which occurs every three years, and in which each spending ministry is told how much money can expected for the three years to come. Under such a system, it makes sense to also conduct a spending review every three years. In cases where firm multi-year expenditure ceilings are set for ministries, it is more appropriate to conduct some spending review every year.

The proposition that spending reviews should be conducted with the same frequency as budget preparation applies to routine, selective spending reviews. By contrast, comprehensive spending reviews – when required – should be held only at irregular and infrequent intervals.

Integrating routine spending reviews into the budget preparation process also raises issues about the relationship of spending reviews to other elements of the budget preparation process, and in particular to the new spending process. Spending reviews and the scrutiny of new spending proposals are different processes and, while it is important that they be synchronised (as discussed earlier), they need to be kept separate. In virtually all cases, countries with spending review processes have therefore ensured that the review teams tasked with identifying savings options do not undertake appraisal of new spending proposals.

An important qualification to this generalisation is the so-called "spend to save" measures. This refers to proposals for achieving efficiency savings via investments in cost-saving technology (e.g. labour-saving IT systems). In this case, there is an integral link between the potential savings in baseline expenditure and new spending, and for this reason most spending review processes have permitted such options to be presented.

Nevertheless, "spend to save" measures present significant challenges for the MOF. Supposedly cost-reducing investments have often ended up costing more than they save as, for example, in the case of major IT systems which greatly exceed their budgets and deliver disappointing cost savings. It is therefore crucial that, if "spend to save" options are permitted during the spending review process, they be subject to particularly intense critical appraisal by the MOF. It can also make good sense to create incentives to make the spending ministries themselves much more cautious in requesting budget funding for such investments. For example, the MOF may require a prior agreement with the spending ministry that the cost of the supposedly cost-saving investment will be repaid over time by the ministry through deductions from its budget allocations. This makes the funding for such investments essentially a loan to be repaid by the spending ministry.[14]

In the context of a comprehensive spending review aimed at delivering large and rapid expenditure reductions, it may make sense to (temporarily) ban the presentation of "spend to save" options. This is what happened in Canada under the SOR process in 2011-12. Under the SR process during the preceding three years, the presentation of such options had been permitted. However, during the SOR the combination of larger savings targets and skepticism on the part of the MOF about the capacity of such options to deliver substantial savings led to spending ministries being prohibited from putting forward these proposals.

In a few cases, spending review processes have permitted spending ministries to put forward options for new spending to be financed by savings achieved through spending reviews. As mentioned earlier, under the SR in Canada, for example, spending ministries were permitted to present, together with savings options, so-called "reinvestment proposals" (perhaps better referred to as "reallocation options") which the government could either accept or reject. This mechanism was intended to provide additional encouragement to spending ministries to approach the task of identifying savings options seriously, by convincing them that by presenting attractive new spending options they would be able to retain some or all of the funding they would otherwise lose in the SR process. This approach no doubt has merit, although good expenditure prioritisation requires that any such reallocation be subject to exactly the same review processes in the MOF and at the level of the political leadership as any other new spending proposals.

The success of spending review also requires that its focus on the identification of savings options be rigorously maintained, and that the process not be permitted to drift off into the pursuit of other diverse objectives. In particular, spending review should be kept separate from any broader management and performance improvement processes. This is one of the lessons learnt from the French experience with the RGPP. The RGPP's stated objectives were not only the "rationalisation of public expenditure", but also the improvement of service to clients, and the modernisation of civil service human resources management. It was partly as a result of this diffused focus that the RGPP tended to be diverted from the task of identifying savings options with the result that, according to *Cour des Comptes* (2010: 19-20):

> "… few of the work responsibilities of government agencies were eliminated or even scaled back … Government agencies are certainly heavily involved in the RGPP, but were more focused on revising their organisational charts than on revising their programmes."

The spending review process will, of course, often point towards programmes which require management improvement or policy redesign. However, the follow-up of such matters should be kept separate from the spending review process itself.

For precisely the same reasons, spending review teams should not be tasked with identifying new revenue options (OECD, 2012a: 11). Maintaining the focus of spending review on the search for savings options is of critical importance.

13. Conclusion

Spending reviews are critical to good expenditure prioritisation, because good prioritisation requires not only that the right choices about new spending are made, but also that baseline expenditure is subject to constant critical scrutiny. It is important that the momentum created by the post-GFC surge in spending review activity in OECD countries not be lost, and that spending reviews become a permanent feature of the budget preparation process. For this to happen, the spending review process must be designed appropriately, and fully integrated into the broader budget preparation process. At the same time, spending reviews must take full account of the institutional specificities of member countries.

Notes

1. Defined as expenditure on existing programmes and projects, at the level required by prevailing policies or laws (i.e. on an "unchanged policy" basis).
2. This is broadly consistent with the definition provided in OECD (2012a: 3) of spending review as "assessments of the strategic orientation of programmes and/or the efficiency of spending and are broadly used to reduce and/or (re)allocate budgetary expenditures."
3. Although spending review processes may be designed so as to identify not only savings options but also options for increases in baseline expenditure, it is only through the inclusion of the deliberate search for savings options that such a combined process qualifies as spending review.
4. More precisely, expenditure reduction achieved by reducing the quantity or quality of services, or cutting transfer payments, delivered to the community.
5. Spending reviews took place under the Blair and Brown Labour governments in 1998, 2000, 2002, 2004, and 2007.
6. Despite their name, the CREs should not themselves be equated with a spending review process. Rather, they constitute a multi-annual budget preparation process which sets three-year ministry expenditure ceilings – just like the UK SRs upon which they are essentially modelled. Critically, however, the government has decided that the CREs should routinely include the review of baseline expenditure for savings options, in the form of a set of "Expenditure Reports".
7. Australia introduced a system of "Strategic Reviews" in 2007. However, as discussed later, these Strategic Reviews should not be regarded as spending reviews per se, but rather as part of the information base of spending reviews.
8. However, the Hollande government indicated in December 2012 that it was establishing a new spending review process to be known as "modernisation de l'action publique".
9. The Irish DPER is a separate ministry created by splitting the Department of Finance in order to create a ministry to specialize in spending review and associated functions.
10. Note that the minister of finance role is, in a sense, divided between a senior minister – the Minister of Economy and Finance – and a lower-level minister, the Budget Minister.
11. The one partial exception is France, which is a quasi-parliamentary system in which the president is elected separately from the parliament but the Prime Minister comes from the parliamentary majority. However, with relatively rare exceptions (the periods of so-called cohabitation), the presidential party/parties have also dominated the parliament. This was the case during the period when the RGPP was carried out. As a result, the parliament as an institution played no role in deciding the savings options to be made during the RGPP process, although several members of parliament were associated with the work of the RGPP Monitoring Committee.
12. External factors refer to external events or client characteristics which influence the measured outcome of programmes but are beyond the control of government.
13. This is not, of course, to say that expenditure prioritisation is the only objective of programme budgeting. By making programme performance a more important factor in decisions on ministry budget allocations, programme budgeting also aims to place significant pressure on ministries to improve the effectiveness and efficiency of their existing services.

14. Such mechanisms have operated in several countries, including Denmark and Australia. While they have often been part of capital charging" systems which are today somewhat discredited, they do not require the introduction of a full capital charging regime.

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ANNEX 1

Principles for the conduct of spending review

Spending review as part of the budget process

1. Make spending review a regular rather than ad hoc process.
2. Integrate spending reviews in the budget preparation process.
3. Ensure that spending reviews present savings options to the political leadership at the stage in the budget preparation process where decisions are made about new spending proposals are put forward by spending ministries – so as to permit savings and new spending options to be considered simultaneously.
4. Base the frequency of spending reviews on the frequency with which government sets spending ministry budget allocations. In countries where budget allocations are set annually, this means carrying out spending review annually. However, in countries where firm ministry budget ceilings are set every, say, three years,[1] it means that spending review should also be carried out every three years.
5. Recognise that a spending review is a resource-intensive activity, and that all aspects of the process need to be designed so as to deliver the best possible return (in the form of credible savings measures) on the resources committed to the process.

Coverage of spending review

6. Include the selective review of mandatory (statutory) expenditure as well as budget expenditure in the spending review.
7. Structure the process to identify both strategic ("output") savings options and efficiency savings options.
8. Include both agency-specific and horizontal reviews.
9. Ensure that routine spending reviews are selective in their coverage.
10. Carry out comprehensive spending reviews only exceptionally, such as in response to unusually difficult fiscal circumstances requiring deep expenditure cuts, or a change of government involving a major shift in expenditure priorities.
11. Focus routine spending reviews on current expenditures,[2] and exclude reconsideration of major capital projects which have already been given budgetary approval.[3] Consider including the review of approved capital projects only in the context of exceptional comprehensive spending reviews which need to deliver large and rapid reductions in aggregate expenditure.

12. In the context of routine selective spending reviews, build into the process an opportunity for the political leadership to nominate specific review topics (e.g. specific programmes) for inclusion in the spending review.

Relation to other elements of the budget process and broader public management systems

13. Focus the spending review process tightly on the identification of savings options.
14. Do not dilute the budgetary focus of the spending review process by mandating it also to pursue broader policy and management improvement.
15. Exclude consideration of options for tax increases from the spending review process, with the possible exception of the review of tax expenditures.
16. Keep the spending review process separate from the process whereby decisions on new spending proposals are made. As part of this, spending review submissions presented to the political leadership should only present savings options, and should not present recommendations with respect to new spending proposals other than "spend to save" proposals.[4]
17. Permit "spend to save" options as part of routine SRs, while retaining the possibility of excluding them during exceptional comprehensive spending reviews which are designed to achieve deep and rapid expenditure reductions. However, the MOF should always take a critical and sceptical view of spend-to-save options, and should consider creating incentives to ensure that spending ministries themselves appraise such projects very critically (e.g. requirements that ministries repay the cost of such projects).

Responsibility for the spending review process

18. Build in leadership of the spending review process by the top political leadership. This should include approval of the procedures to be followed, the setting of criteria for the identification of savings options, instructions to spending ministries to co-operate in the process, and ultimate decisions on which main saving measures to adopt.
19. Assign responsibility for the identification of savings options primarily to the civil service, rather than outsourcing this role entirely or primarily to the private sector. In particular, civil servants should carry the main responsibility for the identification of strategic savings options, because of the detailed knowledge of government programmes that this requires. (This is contingent on the civil service in the country concerned having the necessary capacity to play this role.)
20. Private sector expertise should nevertheless be fully harnessed in the spending review process. In general, the appropriate contribution of private sector experts will be greatest in respect to the identification of efficiency savings, many of which will involve the application of generic business process improvements. However, external experts – including academics and former civil servants with relevant policy knowledge – also often have an important contribution to the make to the search for strategic savings options.
21. The process should be structured so as to place maximum pressure on spending ministries to put forward meaningful savings options. As part of this, appropriate sanctions should be applied to ministries which fail to do this.

22. All savings options put forward by spending ministries should be subject to critical review by the MOF, and when possible with review participants from elsewhere in the civil service (e.g. panels of selected senior members of other spending ministries), prior to presentation to the political leadership.
23. If the spending review process is designed so as to permit spending ministries to put savings options to the political leadership unilaterally (without prior endorsement by the MOF), the process whereby by the political leadership considers these options should be structured as an interrogative process aimed to subject such options to searching test and challenge. To support this, the MOF should prepare an analysis and recommendation with respect to each savings option.
24. Irrespective of how the spending review process is structured, the MOF should retain the right to present its own savings options to the political leadership.
25. Savings options developed by the MOF and/or other central agencies should not be presented to the political leadership for decision without extensive and meaningful consultation with the relevant spending ministries. This should not be interpreted as giving spending ministries any right of veto over such options.
26. The MOF should ensure that its staff have sufficient policy analysis skills and knowledge of government programmes to be able to successfully analyse savings options proposed by the spending ministries and, where appropriate, put forward their own savings options.
27. The MOF should have a specialised spending review unit which leads the spending review process and which supports savings options analysis, in association with the sectoral desk officers.
28. Where the political and administrative structure of the country requires that bureaucratic leadership of the spending review process be shared between the MOF and other relevant central agencies (e.g. president or prime ministers' office/ministry), these MOF and any such agencies should co-operate and co-ordinate closely in order to present a "united front" to the spending ministries. Conflict and competition for control of the spending review process should be carefully avoided.

Other process aspects

29. Set standard terms of reference to be followed by the spending review teams. These should include a defined set of questions/criteria to be applied in the search for strategic savings.
30. In the context of a comprehensive spending review aimed at achieving large savings, set *ex ante* savings targets (e.g. minimum values for the savings options to be identified by ministries or spending review teams).

Information base of spending review

31. Continue developing performance indicators which are as useful as possible for the identification of savings option, including programme effectiveness indicators (particularly for programmes which are potentially expendable).
32. Ensure that a spending review is able, where appropriate, to commission outcome (impact) evaluations of programmes the cost-effectiveness of which is questionable,

and to frame the terms of reference of those evaluations to ensure that they meet the information needs of budgeting.

33. Increase the use of efficiency-oriented evaluation designed specifically to support the search for efficiency savings options during the spending review process.

Notes

1. Even if these exclude expenditure the level of which is determined by standing legislation rather than budget appropriation (like the UK "annually managed expenditure").
2. Including minor capital.
3. I.e. under construction/acquisition, or already given budget approval and moving towards construction.
4. Options where the realisation of the potential efficiency gain depends upon an investment in cost reducing technology.

ANNEX 2

Savings generated by spending review

The following summarises information which is publicly available, including in member country responses to the 2012 OECD questionnaire, concerning the magnitude of expenditure reductions achieved through spending reviews in selected countries. Most of these savings estimates are self-reported estimates and are therefore subject to the risk of self-reporting bias, although in several cases noted below savings were subject to independent scrutiny by national audit offices. It is also not always clear that savings estimates presented by government fully distinguish between specific savings identified through spending review and non-specific budget cuts.*

Canada

The Canadian government publicly reported savings of approximately CAD 5.2 billion from the 2011-12 Strategic and Operating Review, an amount equivalent to a little less than 2 per cent of direct federal programme spending. Savings delivered by the Strategic Review which took place in the three preceding years were estimated by the government at CAD 2.8 billion.

France

The French government claimed total cumulative gross savings from the whole RGPP process (RGPP 1 and 2) of EUR 15 billion, an amount equivalent to 3.4 per cent of 2011 public expenditure. Moreover, the accuracy of the government's estimate of savings was a matter of some public dispute, and the *Cour des Comptes* (national audit office) expressed the view that the exercise had only "limited budgetary impact".

Ireland

In the OECD questionnaire, Ireland indicated that the two rounds of spending review in 2008 and 2011 had resulted in savings of EUR 7.8 bn, which would amount to a large portion of the EUR 9.5 bn of expenditure reductions which the government reports publicly to have achieved between 2009 and 2011 (Government of Ireland, 2012: 7).

* As discussed at the outset of this paper, the savings realised from spending reviews should in principle be specific in the sense that the governments know how the reduction in baseline expenditure concerned will be achieved, and should therefore differ from non-specific cuts which the government may impose on ministries without knowing in advance how they will be implemented.

Netherlands

The Netherlands reports in the OECD questionnaire having achieved EUR 36 bn in savings from the 2010 Comprehensive Spending Review.

United Kingdom

In the OECD questionnaire, the savings from the 2010 UK Comprehensive Spending Review was estimated at GBP 81bn over the four years period to 2014-15. As previously noted, the Government indicated publicly at the time of the review that this equated to cuts in departmental budgets (other than health and overseas aid) averaging 19 per cent.

The 2004 Gershon Efficiency Review claimed to have identified, and negotiated agreements with spending departments which would deliver GBP 21.5 billion in efficiency savings by 2008. In 2007, the National Audit Office (NAO) carried out an independent estimate of savings achieved to that point, indicating that Gershon had generated demonstrable savings of at least GBP 10 billion. This was equivalent to about 2.4 per cent of total UK central government expenditure in 2007-08 or (perhaps more meaningfully, given that efficiency savings do not apply to transfer payments) 4.3 per cent of "DEL" expenditure (i.e. expenditure including demand-driven social security transfers and similar expenditure). The NAO estimate of GBP 10 billion may well represent an underestimate both because it was made prior to the target date for the realisation of the targeted savings (2008), and because measurement problems may have prevented some realised savings from being counted by the National Accounting Office in its (appropriately) conservative estimates.

Glossary

Agency review: A review which covers a whole government organisation (ministry or other agency), and which may cover all of the agency's programmes and processes.

Baseline expenditure: Expenditure on existing services, transfers and projects, at the level required by prevailing policies or laws. Baseline expenditure includes expenditure required to meet existing contractual and quasi-contractual commitments.

Comprehensive spending review: Aspending review in which the scope of the review is not limited by any ex-ante list of review topics (i.e. which is not a selective spending review), in which spending review teams are asked to look at all ministries with the expectation that they should seek to identify, to the extent practically possible, all of the most important savings options. It should not be assumed that a comprehensive spending review examines everything.

Efficiency savings: Savings which are achieved by changing the way in which services are delivered so as to deliver the same quantity and quality of service at lower cost.

Horizontal review: A review which covers a group of related programmes delivered by two or more agencies (horizontal programme review) , or looks at a particular domain of business process across several (or all) government agencies – for example, a review of government-wide procurement practices (horizontal process review).

Output savings: See strategic savings.

New spending: Expenditure on new services, transfers or projects, or additional expenditure on existing programmes and projects in excess of that required by prevailing policies or laws. All expenditure which is not baseline expenditure constitutes new spending.

Process review: A review of specific business processes used in the production of government services – for example, procurement processes; IT systems and practices; and human resources management practices.

Programme: A category or type of government services or transfer payments. (More precisely, in a programme budgeting context, expenditure on a category of outputs with a common objective, including a common outcome.)

Programme review: The review of specific programmes to deliver either strategic savings and/or efficiency savings.

Review topics: Specific programmes, processes or ministries which are chosen for review during the spending review process.

Spending review teams ("review teams"): Groups tasked to carry out a review one or more spending review topics in order to identify savings options.

Selective spending review: A spending review which is limited to a specific list of review topics – programmes, processes and/or agencies – which is specified at the beginning of each round of spending review.

Spending review: The process of developing and adopting savings measures, based on the systematic scrutiny of baseline expenditure.

Strategic savings: Savings which are achieved by scaling-back or eliminating services or transfer payments which are considered to be ineffective or low-priority.

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Budgeting in Albania

by
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The Republic of Albania is located in south-eastern Europe and has a population of 2.8 million (2011 census). It was established as a unitary parliamentary republic in 1991 after 46 years of Communist rule. This review of the budget process of the Republic of Albania was carried out as part of the work programme of the OECD Working Party of Senior Budget Officials. In preparation for the review, a team for the OECD Secretariat led by Knut Klepsvik undertook a mission to Tirana from 29 October to 2 November 2012. The substance of this review is divided into 4 sections which details the budgeting process in Albania and includes an Annex summarising recent budget reviews that have taken place in the country.

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Keywords: Annual budget, budgetary process, budget structure, fiscal policy, fiscal rules, parliamentary budget, procurement.

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Foreword

This review of the budget process of the Republic of Albania was carried out as part of the work programme of the OECD Working Party of Senior Budget Officials. In 2004, the working party established the Network of Senior Budget Officials of Central, Eastern and South-Eastern European countries (CESEE). Budget reviews serve as a basis for the examination of a country's budget institutions by the network at its annual meetings, and enable the participants to discuss the budget procedures of a country in depth.

A team of the OECD Secretariat consisting of Knut Klepsvik (lead) and Brian Finn, supported by Richard P. Emery Jr. (independent consultant) and Regina Bernhard (consultant from the German International Co-operation, GIZ), undertook a mission to Tirana from 29 October to 2 November 2012 to prepare the review. During the mission, the team met with Dorian Teliti, General Secretary; Mimoza Dhembi, General Budget Director; Endrit Lami, Director of the Macroeconomic Directorate; Mimoza Peco, Director of Treasury Operations; Anila Cili, Director of the Central Harmonization Unit of Financial Management and Control; Igli Stambolla, General Director of the Central Harmonization Unit of Internal Audit; and other officials of the Ministry of Finance.

The OECD team also met with: Bujar Leskaj, Chairman of the High State Control, and other officials of the Supreme Audit Institution; Edmond Spaho, Chairman of the Parliamentary Commission of Economic and Finance; Mimi Kodheli, Deputy Chairman of the Parliamentary Commission of Economic and Finance, and other members of parliament; as well as senior officials from other ministries, the Office of Council of Ministers, the Public Procurement Agency, the Social Insurance Institute and the Municipality of Tirana. The OECD team is grateful to all of these officials for the information they provided and for their willingness to explain the Albanian budget procedures and practices.

The team would like to thank in particular, Gelardina Prodani, Director of Budget Management and Monitoring in the Ministry of Finance (at the time), for the excellent organisation of the meetings, her help with the collection of documents and her practical support during the team's stay in Tirana.

Summary of recommendations

Budget formulation

Budget formulation procedures in Albania are more effective than those of many countries. The process is organised to ensure that participants in the budget process have constructive roles. Decisions are based on programmatic information, tied to policy goals and integrated into programme planning. The form of the processes, for the most part, should be continued. Issues that remain are primarily to improve the quality of the budget analysis.

Albania should develop a policy neutral baseline. It should continue to strengthen the accuracy and reliability of its economic forecasts. One specific improvement that should be considered would be to develop a policy neutral baseline and to incorporate the results of the baseline in the Economic and Fiscal Program. Policy proposals and structural reforms should be treated separately from economic and technical factors.

Programme objectives should be refined to more clearly represent the basic nature of programmes and performance indicators should be better focused to reflect the critical policy sensitive nature of programmes. Changes needed include improvements in the quality of review, not in the nature of the procedures undertaken. Continuing improvement to programme budget measures will require additional use of the Medium Term Budget Programme procedures within ministries and in the local communities. These efforts can receive feedback through the decision process, but could be facilitated by training within the ministries and/or localities, by informing the public on the results, and by translating the budget decisions into programme implementation.

The budget schedule should be reviewed periodically to confirm that the sequential review adds value to the decision-making process. The budget schedule defined by the Management of Budget System Law requires repetitive procedures which consume substantial resources from the budget office, and ministry authorising and executive officers. At a minimum, the National Assembly should have more time to review budget policy and a greater opportunity to allocate resources.

Budget documents should be reviewed on an on-going basis to ensure that the budget is transparent. It should not require a budget expert to understand the policy presented in the budget. Comparisons over time (two prior years, the budget year, and two succeeding years) are particularly effective in conveying an understanding of changing budget policies. The solution is frequently not more information, but information presented in tables, graphs and displays that are easy to understand. Budget writing should also be simplified and made more direct.

Responsibility and accountability for budget formulation and management should be delegated to budget institutions and spending units. Programme budgeting is based on an assumption that budget responsibility is delegated to the extent possible. The MBS authority creating authorising officers may need to be clarified to ensure that lines of authority are clear and do not conflict with the broader goal of delegating programme accountability.

The Ministry of Finance should take an active role in reviewing any PPP proposal. Many countries have found that public interest is frequently not served by these arrangements. The OECD Principles for Public Governance of Public-Private Partnerships should be considered in developing PPP oversight and governance arrangements.

Budget approval

The parliamentary budget process in Albania is regulated by a comprehensive legal framework. Most crucial parliamentary rights are granted by the Organic Budget Law. Amending the Organic Budget Law to reflect the parliamentarian practice of exercising amendment powers would eliminate doubts about the Assembly's rights and assure that minority requests are responded to following a regulated procedure.

The schedule and procedures of budget approval in the Assembly should be revised to provide the Assembly with more time for debating the budget. While the Assembly theoretically has two months to discuss the budget, it takes usually no more than four to five weeks, limiting the possibilities for in-depth discussions in the relevant committees. The Assembly could put more effort into the approval process under the existing timeframe and revise its procedures to expand the budget hearings and budget debate to increase its impact on budget deliberations. Considering the importance of the Medium Term Budget Program (MTBP) document, the Assembly should be granted the right to review and approve the medium-term financial strategy during the budget process, e.g. together with the annual budget.

The Albanian Assembly should reconsider establishing a non-partisan budget office in order to address the lack of independent analytical capacity for members of parliament (MPs). Increasing the non-partisan analytical capacity in the Assembly and its availability for the Committee on Economy and Finance for all MPs, including the minority MPs, would strengthen the quality of the parliamentarian budget discussions.

The Assembly, and especially the Committee on Economy and Finance, should assure that the majority of hearing sessions are open to the public and that information on the sessions is adequately published. Concerns about the publicity of parliamentary hearings (including those of the Committee on Economy and Finance) should be taken seriously. While the Albanian regulatory framework for the budget process entails all of the necessary provisions to guarantee full transparency of the content of the Assembly's session, in practice, publicising the hearings is contested.

The Committee on Economy and Finance's role of budget oversight could be significantly enhanced, with a more prominent role for the opposition. Since the tasks of budget approval and budget oversight are both carried out by the Committee on Economy and Finance, the minority raised concerns about its role in controlling budget execution. As a means to minimise changes to the existing system, the German or the British model would be suitable for the Albanian Assembly. While the German Budget Committee also exerts both functions of budget approval and oversight, a sub-committee on public accounts usually led by the minority has been established. In Great Britain, the oversight committee on public accounts is led by the minority.

Budget execution

Broadly, the government has established sound systems and procedures for budget execution, generally in line with practice in OECD countries, though there is still some way to go before all of the elements are fully implemented. The Treasury system respects international best practice, although its proper implementation still needs to be addressed.

The government should establish better commitment control where spending units are required to register commitments in the Treasury system when a contract is signed (before an invoice arrives). The Ministry of Finance (MOF) is on the right track with its plan to introduce the commitment module as of 2013, primarily for investment contracts. However, the government should establish a more comprehensive commitment control integrated with the Treasury system.

The MOF should consider an electronic link between the budget institutions' financial system and the Treasury system in order to facilitate efficient payment execution and commitment control. This could increase the efficiency of the budget execution and help the spending units to better plan the use of allocated resources and it would give the

Treasury a better basis for cash planning. Giving all budget institutions access to the Treasury system would also help reconciliation and planning at the spending unit level.

Over time, the government might consider allowing small carry-overs to the next budget year, in combination with a compensation strategy for the next year's budget, in order to secure efficient use of resources over the year-end and to allow budget institutions to reallocate smaller amounts between programmes.

The government should consider reducing the reserve fund in order to increase budget discipline, although at this stage of development it seems to be well suited for Albania to continue its limited right to exercise reallocations through a centralised procedure.

The MOF should emphasise monitoring actual expenditure against the budget and actual outputs against targets but focus less on direct links to unit costs in the budget formulation and monitoring. The Albanian performance budgeting system represented by the MTBP and the budget monitoring process is broadly in line with practices in some OECD countries. However, recent international research indicates that it is difficult to use non-financial performance as a direct tool for budgeting.

Line ministries should have more responsibility of their own budget execution and use the MTBP pro-actively in management and as a basis for internal management and control. This will create better understanding of the interaction between inputs and outputs, better ownership of the results and better reports to the Ministry of Finance. The management culture should be changed by structural reform and training, and the Civil Service Law should be amended to shift to a performance structure from position-based personnel controls.

The government should continue to pursue professionalism, depoliticisation, meritocracy, transparency and accountability and secure the implementation of the approved legislative and institutional frameworks. The roles concerning the design of the civil service wages policy and performance elements in wages should be reconsidered in order to allow the MOF a better opportunity to co-ordinate wages policy with fiscal policy.

The government should continue to refine the legislative and institutional framework of public procurement and secure training and across-the-board implementation to secure the successful implementation of the modern ICT system for electronic procurement processing. Defence procurement outside the public procurement procedures is a potential major loophole in procurement procedures.

Accountability,control and audit

The adoption of a full accrual system of accounting is less important than controlling arrears and recording commitments. Procuring complete information on commitments so that arrears are stopped should be a higher priority than the adoption of full accruals in an administration that does not have the capacity to use the information that a full accrual system provides.

More emphasis should be placed on practical improvements to the financial control and audit system. While positive steps have been taken in these disciplines over the past few years, many of the steps have been in the field of legislation and regulation. This provides a basis for these disciplines but is not sufficient in itself to ensure successful implementation.

The Albanian authorities should aim to raise the level of understanding throughout the administration as to what financial management and control (FMC) and managerial accountability actually mean. Despite a reasonable legal framework for the introduction of FMC and despite the efforts of the CHU/FMC in promoting the new FMC Law, there is a poor understanding in Albania of what FMC and managerial accountability mean in practice. Responsibility for decision making is mainly centred on the head of the budget institution with very little delegation of tasks. This is an issue which will take time to improve as the traditional administrative arrangements cannot be changed overnight.

One step towards developing more delegation would be for the official responsible for the overall financial management and control of the finances of the spending unit to be positioned at the highest level of management and report directly to the authorising officer. The FMC Law of 2010 requires this, but it does not happen in practice. The solution to this problem may be a redefinition of the role of the executing officer.

Emphasis should also be given to achieving performance targets within budget limits in the budget institutions. This is not currently the case since the focus of reporting is mainly financial and does not contain information about management performance. Despite the work that has been invested in improving the Treasury system over the past decade, it continues to exist as an accounting system for transaction control, cash-flow management, and formal accounting and budget reporting purposes.

Internal audit units need more practical guidance to perform their work more effectively. Therefore, the relatively recent formal co-operation agreement between the Minister of Finance and the HSC and the strategy for the training and certification of internal auditors are both positive developments. The Central Harmonisation Unit for Internal Audit could ensure that the implications of internal audit for financial management and control policy are reflected in the training of internal auditors as this is not currently the case.

The law should be amended to clarify the role of the Directorate of Public Financial Inspection and the Minister of Finance with regard to financial inspections. Managers should be aware of the difference between an internal audit unit providing top management with advice about corrective actions and the top management taking responsibility for ensuring that the necessary corrective action is implemented.

The HSC should move beyond a concentration on regularity/compliance audit. The HSC recognises this, and is taking steps to improve its capacity for performance audit, but it will eventually need to save resources on compliance audit by reducing the audit procedures and by applying professional audit sampling techniques.

Finally, an independent body should be appointed by the parliament to audit the accounts of the HSC as foreseen in the Law on HSC.

1. Introduction

1.1. Basic information on Albania

1.1.1. General characteristics

The Republic of Albania was established as a unitary parliamentary republic in 1991 after 46 years of Communist rule. Albania has enjoyed the status of independent country since 1912 after the dissolution of the Ottoman Empire, but the country suffered an Italian occupation from 1939 and later a German occupation during World War II.

The country is situated in south-eastern Europe, bordering the Adriatic Sea and the Ionian Sea, between Greece to the south, the former Yugoslav Republic of Macedonia to the east and Montenegro and Kosovo to the north. Across the Strait of Otranto, Albania is about 70 kilometres from the coast of Italy. Albania is mostly mountains and hills with small plains along the coast.

Albania has a population of 2.8 million (2011 census) about half of which live in urban areas. The population of the capital, Tirana, is 537 000. About 20% of the population is below 15 years old, almost 70% is in the 15-64 year old cohort and 10% is 65 years old or above. The population is rather homogenous with only smaller ethnic minority groups. The majority are Muslim with sizeable contingents of Orthodox and Roman Catholics.[1]

1.1.2. Political situation

The Albanian parliament is a unicameral assembly with 140 deputies elected for a 4-year term under a closed-list regional proportional representation system.

The parliamentary work has been seriously hampered for some time due to the political standoff between the ruling majority and the opposition, a lack of constructive political dialogue and the mutual suspicion which is characteristic of Albanian politics. In November 2011 the situation eased somewhat when the ruling parties and the opposition reached a political agreement of co-operation. The political climate has improved since then with a temporary set-back in connection with the presidential election. The political agreement allowed progress in a number of areas like amendments to laws requiring a three-fourths majority vote, appointment of an Ombudsman and approval of the presidential nomination of a judge to the High Court.

The centre-right Democratic Party (DP) and the centre-left Socialist Movement for Integration (SMI) combined to form a coalition government after the 2009 general elections, the first coalition government in Albania's history. After the general elections in 2009, the distribution of seats by party is: DP 68, SP 65, SMI 4 and other 3. The Socialist Party (SP) contested the results of the 2009 parliamentary elections and the 2011 local elections.

Election of the Albanian president requires a three-fifths vote of the parliament. The president is elected for a five-year term and is eligible to be elected for a second term. President Bujar Nishani took office on 24 July 2012. The prime minister is appointed by the president and the Council of Ministers is proposed by the prime minister, nominated by the president and approved by the parliament. Prime Minister Sali Berisha has been in office since 10 September 2005.

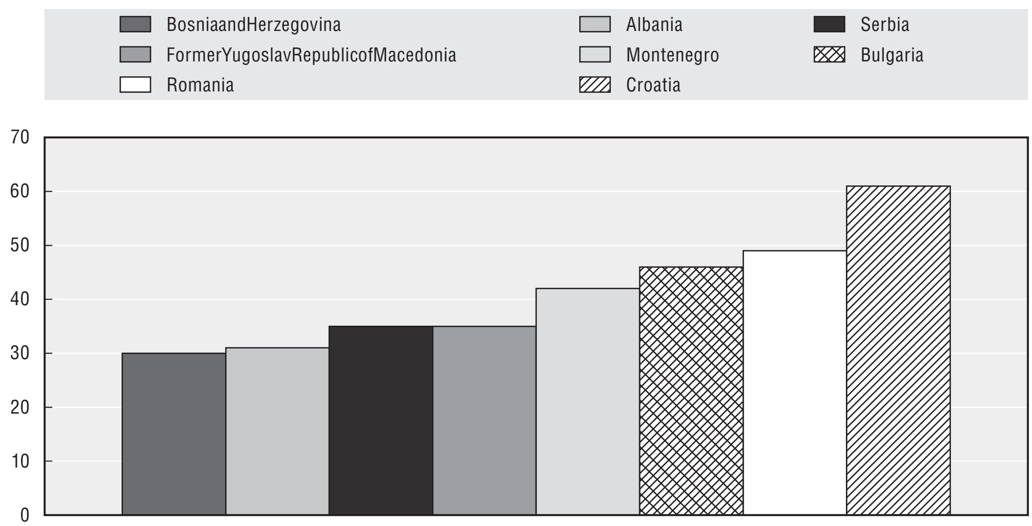
1.1.3. Judiciary

Judicial power is exercised by the High Court and courts of first and second instance. According to the European Commission, Albania needs to further accelerate the implementation of the judicial reform strategy in order to ensure the independence, efficiency and accountability of its judicial institutions. Reform of the laws on the High Court and the Constitutional Court are pending.

1.1.4. Economy

Although Albania's economy continues to grow, the country is still one of the poorest in Europe. The informal economy is large and the energy and transport infrastructure is not yet of modern standard and presents a long-standing barrier to sustained economic growth. Compared to the neighbouring European Union (EU) candidate countries (the former Yugoslav Republic of Macedonia, Montenegro and Serbia), the potential candidate country (Bosnia and Herzegovina), the two most recent EU member countries (Bulgaria and Romania) and the prevailing EU accession country (Croatia), Albania's gross domestic product (GDP) per capita in purchasing power standards (PPS) is among the lowest (about 30% of the EU average).

Figure 1. **GDP per capita in purchasing power standards (PPS) in 2011[1] (index EU27 = 100)**



1. The volume index of GDP per capita in purchasing power standards (PPS) is expressed in relation to the European Union (EU27) average set to equal 100. Basic figures are expressed in PPS, i.e. a common currency that eliminates the differences in price levels between countries allowing meaningful volume comparisons of GDP between countries (Eurostat).

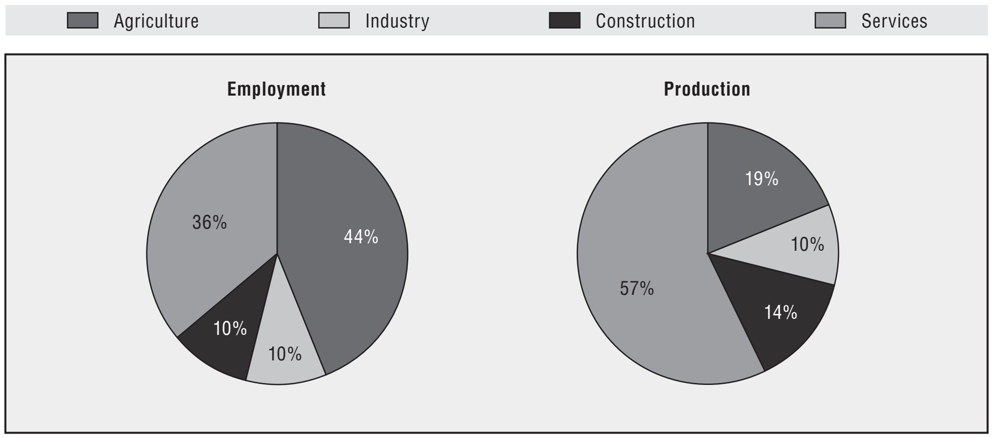
Source: *Eurostat Database, http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&plugin=1&language=en&pcode=tec00114.* Data extracted on 19 April 2013.

Services are the main contributor to Albania's GDP at nearly 60% in 2009, with trade, hotels and restaurants accounting for the bulk of this sector. The share of agriculture in GDP was about 20% and construction about 14%. The industry sector (10% of GDP) is dominated by manufacturing and extractive industries. Agriculture remains the largest employer with 44% of total employment in 2009 (Figure 2).

Albania's manufacturing base remains concentrated around three main sub-sectors, which accounted for some 83% of total exports of goods in 2011 and which are either dominated by low value-added products or vulnerable to fluctuations in global commodity prices: textiles and footwear (32%); minerals, fuel and electricity (30%); and building materials (21%). The largest foreign trade partner is Italy, receiving about 45% of Albania's exports.

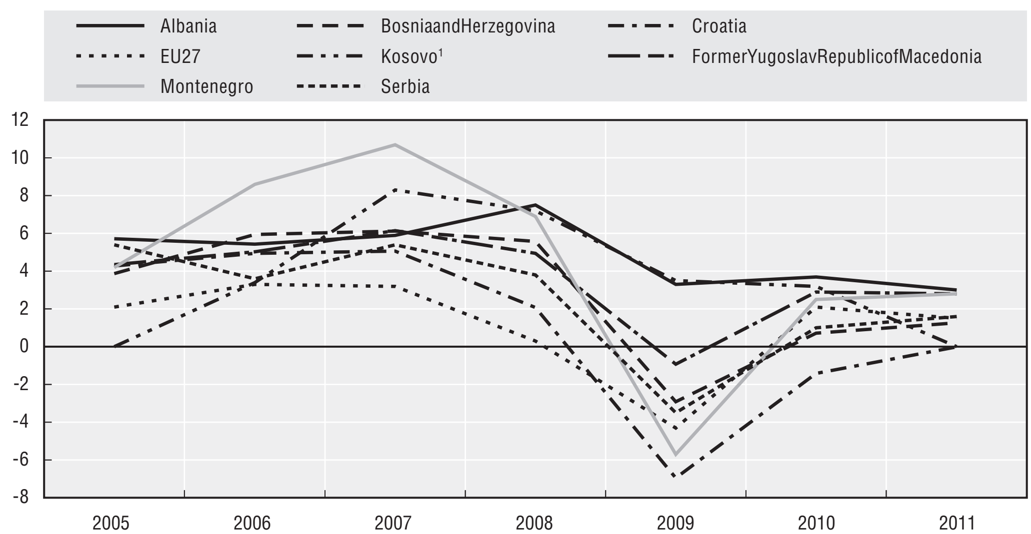
The Albanian economy has performed at a persistently high growth rate (averaged around 6% between (2004-08), higher than the EU average and most of its neighbours. The growth rate outperformed these (except Kosovo[2]), especially during the global financial crisis, and continued to grow in 2011 (on average lingering at 3-4%), driven by domestic demand (Figure 3).

Figure 2. **Employment and production by sector in Albania (2009)**



Sources: INSTAT (*www.instat.gov.al/en/themes/national-accounts.aspx*, Gross domestic product by economic activities; production data extracted on 20 November 2012); employment data are from European Commission (2012), *Albania Progress Report 2012*, European Union, Brussels.

Figure 3. **Real GDP growth rate**



1. Under the United Nations Security Council Resolution 1244/99.

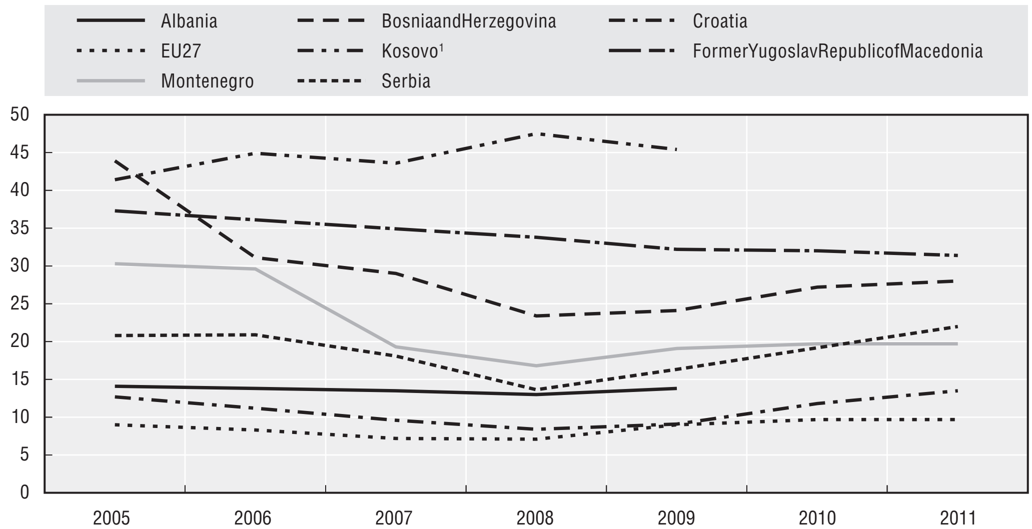
Source: *Eurostat Database* (*http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&plugin=1&language=en&pcode=tec00115* and *http://epp.eurostat.ec.europa.eu/portal/page/portal/enlargement_countries/data/database*, select Economy and finance/ GDP and main aggregates). Data extracted on 17 April 2013.

Although Albania has relatively high growth, it has experienced an unemployment rate substantially above the EU level, higher than Croatia but considerably lower than most of the neighbouring countries (Figure 4).

1.1.5. International relations and foreign aid

In 2009, Albania submitted its formal application for EU membership. Three years later, in October 2012, the European Commission recommended that Albania be granted EU candidate status, subject to completion of key measures in the areas of judicial and public administration reform and revision of the parliamentary rules of procedures.

Figure 4. **Unemployment rate: Share of labour force that is unemployed (%)**



1. Under the United Nations Security Council Resolution 1244/99.

Source: Eurostat Database (*http://epp.eurostat.ec.europa.eu/portal/page/portal/statistics/search_database*, select Population and social conditions/Labour market and *http://epp.eurostat.ec.europa.eu/portal/page/portal/enlargement_countries/data/database*, select Structural indicators/Employment), accessed on 17 April 2013.

Pre-accession financial assistance to Albania is provided by the EU under the Instrument for Pre-Accession Assistance (IPA). Through IPA national programmes, the EU allocated a total of EUR 83.2 million in 2010 and EUR 82.0 million in 2011.

Albania completed a three-year arrangement with the International Monetary Fund (IMF) in 2009 and the government plans to finance its prevailing debt and future investments through commercial loans.

1.2. Overview of fiscal and monetary policy

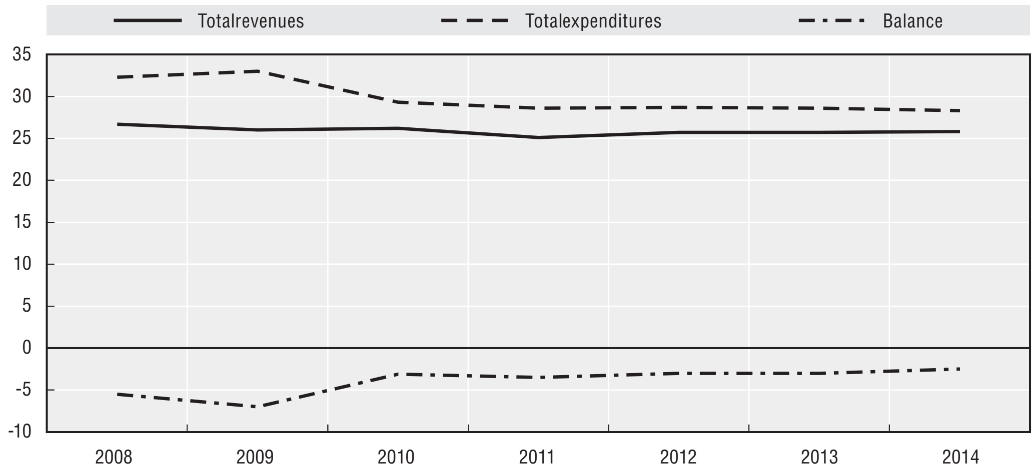
1.2.1. Fiscal position and public debt

Albania's fiscal policy has become more prudent in the last two or three years. The budget deficit shrank to 2.9% of GDP in 2010 and 3.5% in 2011 (from 7% in 2009), following a sharp reduction in capital expenditures that followed the government's push before the 2009 election to finish large public investment projects (Figure 5). The expansionary fiscal policy of 2009, mainly carried out through higher capital expenditures, helped Albania to avoid the recession in 2009 that its neighbours experienced. Notwithstanding, the government has failed to meet its revenue targets over the past several years. This has affected its deficit targets as well, and has necessitated mid-year spending cuts to restore the fiscal balance projected in the budget. These cuts have the potential to delay payments, potentially build up arrears and adversely affect the private sector operators, who have the greatest potential to contribute to job creation and increased economic growth.

Albania's track record of fiscal deficits prior to the global financial crisis is worse than that of its neighbouring countries and the EU27. Albania has weathered the financial crisis better than most other regional and European economies so far and has managed to limit its deficit two of the last three years. Only the former Yugoslav Republic of Macedonia and Bosnia and Herzegovina had a lower deficit in 2010-11 (Figure 6).

Figure 5. **Expenditure, revenues and balance of general government in Albania**[1]

% of GDP

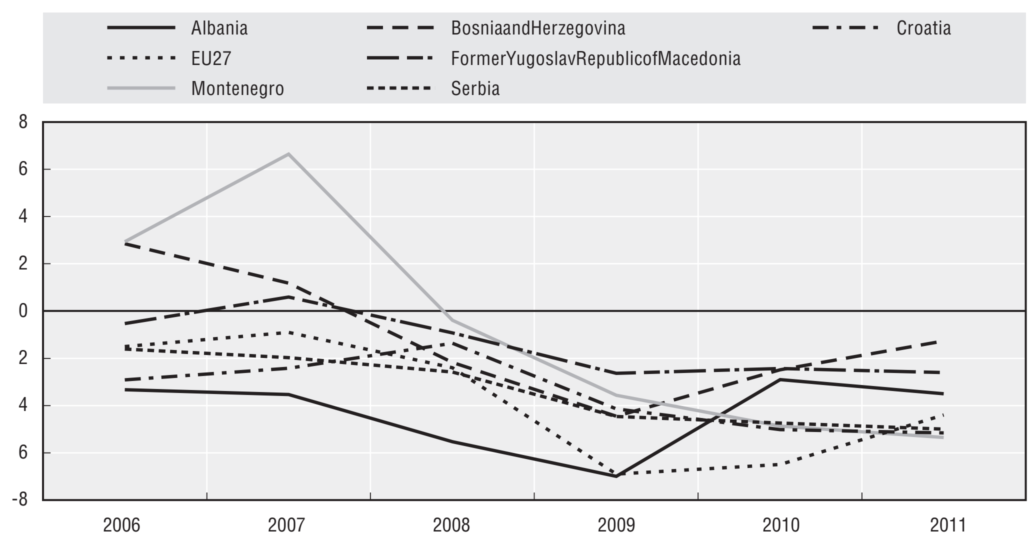


1. Data for 2012-14 are the government's forecasts.

Source: Ministry of Finance (2012), "Economic and Fiscal Program 2012-2014", Republic of Albania, Tirana.

Figure 6. **General government deficit/surplus, relative to GDP**

In %



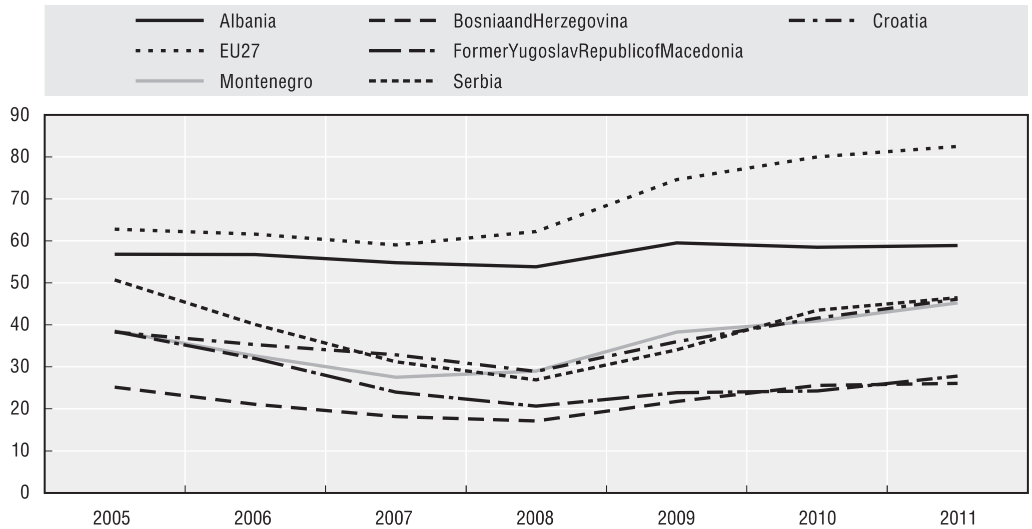
Source: Eurostat Database (http://epp.eurostat.ec.europa.eu/portal/page/portal/statistics/search_database, select Economy and finance/Government statistics and *http://epp.eurostat.ec.europa.eu/portal/page/portal/enlargement_countries/data/database*, select Economy and finance/Government statistics). Data extracted on 17 April 2013.

Compared to the unsustainable debt level of the EU, Albania is in a better position, but its high public debt may create hindrances for further development. Public debt is approaching the EU limit of 60% of GDP (Figure 7). Strong trade, remittance from migrant workers, and banking sector ties with Greece and Italy make Albania vulnerable to spillover effects of the global financial crisis. Foreign-denominated loans stood at 68% of the total credit outstanding in 2011, more than half of which consists of unhedged loans, while foreign currency-denominated deposits account for 50%.

The government successfully placed its first ever Eurobond in October 2010, and its policy is to continue to rely on commercial loans to finance its external and fiscal deficits.

Figure 7. **General government debt relative to GDP**

In %



Source: *Eurostat Database* (*http://epp.eurostat.ec.europa.eu/portal/page/portal/statistics/search_database*, select Economy and finance/Government statistics and *http://epp.eurostat.ec.europa.eu/portal/page/portal/enlargement_countries/data/database*, select Economy and finance/ Government statistics). Data extracted on 17 April 2013.

The current account deficit widened to 12.2% of GDP in 2011, up from 11.3% a year earlier, primarily reflecting a higher trade gap and a lower services account surplus. Foreign direct investment (FDI) inflows are estimated by the European Commission to have increased by about 17% in 2010 (9.5% of GDP), mostly in the hydrocarbons sector, and to have declined in 2011 by 10%. The FDI inflows covered some 65% of the current account imbalance, down from 78% in the previous year. Notwithstanding, the accumulated stock of FDI is among the lowest in the region.

1.2.2. Monetary policy

The Bank of Albania (BoA, the central bank) is owned by the state and is accountable to the parliament. The BoA is managed by the Supervisory Council, composed of nine members, who are appointed by the parliament for a term of seven years, and who are eligible for reappointment. Their main target is to achieve and maintain price stability. Though the BoA enjoys the attributes of a modern central bank and pursues a sound monetary policy, the Law on the National Bank has still not been adopted and there are some concerns about the independence of Council members and the accountability of the bank (European Commission, 2012).

The annual inflation rate in Albania averaged 3.6% in 2010 and 3.4% in 2011, the highest level in ten years, and remained within the Bank of Albania’s target range of 2-4%. The main contributors to inflation in 2011 were international prices for food and fuel.

After raising its key repo rate by 25 basis points in March 2011, to 5.25%, as inflation exceeded its target band of 2-4%, the Bank of Albania has cut the rate on five separate occasions by a total of 125 basis points, bringing it down to a historical low of 4% in July 2012. This followed a sharp disinflationary trend in the second half of 2011; inflation in February 2012 (0.6%) was the lowest in 12 years (Economist Intelligence Unit, 2012).

Albania pursues a free-floating foreign exchange rate system. The Albanian lek (ALL), which has depreciated sharply since 2009, was more stable in 2011, depreciating by some 2% against the euro. During the first eight months of 2012, the Albanian currency appreciated marginally, reaching 1.8% year on year in August (European Commission, 2012).

In general, the Albanian banking system remains capitalised and liquid. The banking sector, which accounts for 85% of GDP and comprises 16 commercial banks, are all privately owned. The share of foreign ownership stands at some 90% of total assets. Non-performing loans continued to rise in 2011 and stood at 21% of total loans in June 2012 which is a cause for concern (European Commission, 2012).

2. Budget formulation

The concepts and procedures for budget formulation in Albania are well developed and comprehensive. Some structural reforms are fully mature, others are in the process of being developed and some need to be developed further. This section reviews the formulation of the budget in seven sub-sections: the legal framework for the budget, the structure and classification of the budget, fiscal rules, the annual budget cycle, a review of the elements of budget formulation, documents and transparency, and the organisation of the Ministry of Finance. Conclusions and recommendations for further actions are provided at the end of this section.

2.1. Legal framework

The Albanian budget system is defined in law, most of which has been enacted over the past few years. Albania began its transition from communism to a democratic state in 1992, enacting its Constitution in 1998, its first Organic Budget Law in 2000 and the current Organic Budget Law, the Law on Management of the Budgetary System of the Republic of Albania, in 2008. Albania has enacted a broad spectrum of related public financial management legislation: the Law on Organisation and Functioning of Local Governments of 2000, the Debt Policy Law of 2006, the Public Procurement Law of 2007, the Internal Audit Law of 2007, the Law on Public Financial Inspection of 2010, and the Law on Financial Management and Control of 2010.

The Albanian Constitution of 1998 established a parliamentary republic, based on free elections and a governance system reflecting the classical separation of powers between the legislative, executive and judiciary branches. Executive power is vested in the Council of Ministers. Part 13 of the Constitution establishes provisions for public finances. It establishes a budgetary system composed of state and local budgets, provides for the Prime Minister to present a budget to the National Assembly and authorises the Assembly to make changes to the budget.

The Management of Budgetary System (MBS) Law, enacted in 2008, provides legislative specifications for programme budgeting, sets out a clearer budget preparation and monitoring calendar, clarifies budgetary roles and responsibilities, and establishes "authorising officers" (AO) for each budgetary institution, the senior civil servant with authority for public expenditure management (PEM). The MBS establishes "executive officers", who are high-level civil servants appointed by authorising officers to implement financial management rules, keep accounts and prepare financial statements. The MBS establishes requirements for budget classification and specifies provisions for establishing special funds. It also improves the framework for PEM at local levels, requiring balanced budgets, common classification systems, and accounting standards to be determined by the Ministry of Finance. Authorising officers are also authorised for localities. Scheduling requirements for budget preparation instructions require information on the sharing of functions between central and local governments and the methods of calculating unconditional and conditional transfers to localities by February, 11 months before the beginning of the budget year.

Albania began the Stabilization and Association Process (SAP) with the EU in 2000. The SAP has both provided a catalyst for PEM reforms and contributed significantly to Albania's legal framework for financial management, as Albania has moved toward the *Acquis Communautaire* expressed in treaties and secondary legislation and policies of the EU (European Commission, 2012).[3] Albania's public finance laws are, for the most part, clearly written and generally reflect best practice in budget procedures and financial management.

Authorising officers created under the MBS Law report to the First Authorising Officer (FAO), the General Secretary of the Minister of Finance. This reporting arrangement makes them accountable to the FAO for public finance. It potentially creates a managerial conflict between the FAO of the Ministry of Finance and the minister of their ministry. This could undermine the allocation of managerial accountability that the programme budget tries to establish. The MBS attempts to clarify the roles and responsibilities for budget and public finance. It may need to be clarified to avoid unintended conflicts.

2.2. Structure and classification of the budget

The budget of Albania is composed of the State Budget, Local Budget and Special Funds: social insurance, health insurance and ex-owners compensation. Revenues, expenditures and balance for each component are presented separately in the annual budget. Total government spending in 2012 was projected to be 28.6% of GDP and revenues 25.6% of GDP. Table 1 shows general government operations and identifies the major categories of government spending and revenues. Personnel expenditures account for just over one fifth of current government spending. Social insurance expenditures account for approximately 25% of total spending or one third of current expenditures. Local government expenditures are a little over 10% of current expenditures. Capital expenditures account for one fifth of expenditures. Interest and operations and maintenance expenditures account for the remaining 25% of spending. The value added tax (VAT) is the largest source of revenue followed by social insurance contributions (Table 1).

Budget classification requirements are established by Article 11 of the MBS Law. Budget classifications are specified by the Minister of Finance in compliance with international standards. At a minimum, budget classifications cover an administrative classification, an e+conomic classification, a functional classification, a programme-based classification and a classification of the source of financing. Table 2 presents this classification graphically. Budget decisions are taken on a programme basis. Allocations are approved by administrative unit, programme and major economic category: current and capital, personnel, interest, operations and maintenance, and subsidies. All general governments are subject to the same classification requirements.

Table 1. **General government operations in Albania (2011-13)**

% of GDP

	2011	2012	2013
Revenues and grants			
Value added tax	9.2	8.8	9.1
Profit tax	1.5	1.2	1.3
Excise tax	3.1	2.7	3.0
Personal income tax	2.2	2.1	2.1
Other taxes	3.3	3.9	4.3
Social insurance contributions	4.4	4.3	4.3
Non-tax revenues	1.8	1.7	1.5
Grants	0.3	0.3	0.9
Total revenue and grants	25.5	24.7	25.6
Expenditures			
Personnel	5.2	5.1	5.1
Interest	3.2	3.1	3.6
Operations and maintenance	2.5	2.3	2.3
Social insurance outlays	8.8	9.0	9.1
Local government expenditures	2.2	2.0	2.1
Other expenditures	1.7	1.8	1.7
Total current expenditure	23.6	23.3	23.9
Capital expenditure	5.4	4.8	5.0
Reserves and contingency funds	0.0	0.3	0.2
Total spending	29.0	28.4	29.1
Overall balance	-3.5	-3.7	-3.5
GDP (ALL billions)	1 297.7	1 346.2	1 407.0

Source: Data provided by the Ministry of Finance, based on the Fiscal Table of the 2013 Budget Document.

Table 2. **Structure of budget allocations for spending units in Albania**

Dimension	Classification	Specification
Administrative	Central government (44)	Line ministries (14) Independent central government institutions (30)
	Special funds (3)	Social insurance fund (compulsory and supplementary) Health insurance fund Ex-owners compensation fund
	Regional government (12)	Districts (36)
	Local government (373)	Municipalities (65) Communes (308)
Functional (COFOG)	General public services Defence Public order and security Economic affairs Environmental protection Housing and community amenities Health Recreation, culture and religion Education Social protection	
Programme	1-10 programmes per budget institution (on average 6 per line ministry)	Outputs
Economical (expenditures)	Current	Wages Social insurance contribution Goods and services Subventions Other internal current transfers Foreign current transfer Transfer for families and individuals
	Capital	Tangible capital expenditure Intangible capital expenditure
Economical (revenues)	Grants	
	Taxes	
	Non-tax revenues	
Financing	Own non-budget revenue Annual budget External financing	

Source: Data provided by the Ministry of Finance, based on the Annual Budget Law 2011.

2.3. Fiscal rules

Albania has recently modified its single fiscal rule concerning the limitation on public debt. Article 58 of the MBS Law originally restricted total public debt, including guarantees, not to exceed 60% of GDP. In 2013, this specific numerical limitation was replaced by language limiting borrowing to the financing of capital expenditures. The revised rule, described as a “golden rule”, prohibits borrowing for current expenditures; current expenditures are to be covered by revenues and borrowing is only to be used to finance capital investment. Local budgets have similar requirements: they are required to be balanced, except in cases where borrowing is to finance investment projects. All borrowing is subject to review by the Ministry of Finance. Limitations on total state debt and total loan guarantees are established in the annual budget law.

In recent years, public debt has been just below 60% of GDP. Budget revenue projections have been too optimistic, requiring mid-year reductions in expenditures to keep borrowing below this limit. Difficulties in operating the budget within this constraint may have led to the change in the MBS Law. The shift from a fixed debt limit to a “golden rule” may provide more flexibility, but may also be a less effective constraint. Spending pressure may result in attempts to expand the definition of capital expenditure to cover more government operations.

Candidate status for the EU may impose additional standards to be met, possibly requiring more enforceable fiscal rules. Fiscal rules may be incorporated in the National Strategy for Development and Integration (NSDI) for 2013-20. An alternative would be to enact fiscal rules in law, comparable to the debt rule. The IMF has recommended establishing a fiscal rule limiting expenditures, explicitly tied to debt reduction. Such a rule would keep the size of the public sector in check.[4]

Box 1. **Fiscal rules in OECD countries**

According to the definition of a fiscal rule proposed by Kopits and Symansky (1998: 2), a fiscal rule is a permanent constraint on fiscal policy expressed in terms of a summary indicator of fiscal performance. A fiscal rule has two fundamental characteristics. First, it presents a constraint that binds political decisions made by the legislature and executive. Second, it serves as a concrete indicator of the executive’s fiscal management.

There is no one-size-fits-all fiscal rule. Four broad, yet distinctive, categories of rules exist, namely: expenditure, balance (surplus or deficit, hereafter called “balance”), debt, and revenue rules.

- **Expenditure rules:** Limit the amount of government spending and can be expressed in nominal or real terms as limits on spending levels or expenditure growth, or as an expenditure-to-GDP ratio.
- **Balance (i.e. deficit or surplus) rules:** Limit nominal or cyclically adjusted government spending *vis-à-vis* revenues, and can be expressed in nominal terms or as a per cent of GDP.
- **Debt rules:** Limit the amount of government debt and can be expressed in nominal terms, as a debt-to-GDP ratio, or as an explicit reduction of the debt-to-GDP ratio.
- **Revenue rules:** Impose constraints on the tax-to-GDP ratio and place restrictions on government revenues raised in excess of the projected amounts.

Anderson and Minarik (2006) argue that an expenditure rule that governs discretionary spending and tax expenditures (but excludes automatic stabilisers) is a superior alternative to deficit rules because it:

- is more transparent for monitoring purposes and reduces opportunities for creative accounting;

Box 1. **Fiscal rules in OECD countries** *(cont.)*

- is inherently counter-cyclical and allows automatic stabilisers to function properly;
- provides firm guidance to policy makers regardless of economic conditions;
- increases the predictability of resources, most notably for annual appropriations related to core government functions and public investments;
- reduces the risk of adding to tax burdens (when combined with expenditure ceilings).

The introduction of an expenditure rule or an expenditure framework anchored in a structural balance rule is a common tendency in many OECD countries. For example, in EU member countries, following the tightening of the *Stability and Growth Pact* in 2011, a new expenditure rule requires expenditure growth (adjusted for interest payments) to not exceed medium-term potential growth in order to assess compliance with a medium-term budgetary objective of a structural deficit ceiling of no more than 1% of GDP.

A structural balance rule puts a constraint on the budget balance over the economic cycle in order to guarantee debt sustainability in the long term. This may require gradual debt reduction if public debt is currently unsustainable (with interest payments growing at a higher rate than GDP), or it may require temporary debt reduction in the coming decades to allow for some growth of public debt during a foreseeable period of demographic imbalance (in the case of an ageing population). For structural balance rules to work, however, governments need to identify where in the economic cycle their economies currently are. This has proven to be inherently difficult and subject to optimism bias.

For example, Sweden uses a structural surplus rule, requiring that the budget have at least a 1% surplus over the economic cycle. Even though the financial crisis has pushed some countries off this path in the last few years (for instance, the Netherlands aimed at a structural surplus in the past and its current target is to restore balance by 2015), a surplus rule remains necessary to achieve long-term sustainability for countries with high debts and ageing populations.

2.4. Annual budget formulation cycle

2.4.1. Budget calendar

The annual budget cycle of Albania is set out in detail in the BMS Law. The process is centred on the development of a programme-oriented Medium Term Budget Programme (MTBP). It is somewhat unique compared to OECD countries in that it provides for two complete rounds of budget formulation each year. The annual budget calendar is approved by government decree in December, one year before the budget year begins. The Finance Minister proposes to the Council of Ministers (CoM) the detailed deadlines for the public expenditure management process as an element of the strategic planning calendar. The calendar takes effect on 1 January, the first day of the fiscal year. The major steps in the budget formulation calendar are shown in Table 3.

2.4.2. Macroeconomic and budgetary forecast

The first step in the process is for the MOF to prepare the Macroeconomic Fiscal Framework (MFF). The framework reviews the past two years, the budget year and the following three budget years (out-years). It includes assumptions and methods used in making the forecast, comparisons to recent forecasts, estimates of general government revenue and expenditure under both existing policies and proposals for new or amended policies, proposals for expenditure ceilings, and detailed information on domestic and foreign debt stock. The MFF is completed in January and presented first to the Committee

Table 3. **Budget formulation calendar**

Preparation of detailed calendar for coming year	December
Preparation of macroeconomic and fiscal framework	January
Approval of programme expenditure ceilings by the Council of Ministers	February
Budget preparation instructions	February
Line ministries draft Medium Term Budget Programme	March/April
Requests submitted to the Ministry of Finance	May
Ministry of Finance analyses requests, holds hearings	May/June
Draft Medium Term Budget Programme presented to the Strategic Planning Committee and the Council of Ministers	June
Revised macroeconomic and fiscal framework	July
Ministries prepare revised Medium Term Budget Programme	July-August
Ministry of Finance analyses revised budget, second round of hearings	September
Medium Term Budget Programme and Annual Budget Law presented to the Strategic Planning Committee and the Council of Ministers	October
Budget presented to parliament	31 October–beginning of November
Parliamentary commissions hold hearings on budget with the Ministry of Finance and other ministers	November
Budget approved	1st week of December
Budget enters into force	1 January
3rd round of Medium Term Budget Programme produced, incorporating changes made by the Council of Ministers and parliament	January

on Strategic Planning and then to the CoM for revision and approval no later than mid-January.

The forecasts are developed within the MOF. The report is prepared by the Macroeconomic and Fiscal Policy Department (MFPD) of the MOF, with input from the Budget Analysis, Policy and Programming Directorate (BAPPD) and the Budget Management and Monitoring Directorate (BMMD). The Tax Office provides input on revenue forecasts. Tax and revenue targets are used for revenue estimates for the budget. Inflation is tied to the central bank's assumptions. The central bank does not, however, project economic growth. The Statistics Office provides data, but does not develop forecasts. The economic assumptions published by the IMF are used as a point of comparison. Comparisons also focus on Albania's principle trading partners: Greece, Italy and Kosovo. The forecast developed in January is updated at mid-year, in July. The revised forecast serves as an input for revisions to the MTBP. Recent forecasts have been overly optimistic.

The MBS Law provides for projections based on both existing policies and new proposals. The estimates are combined, not presented separately in the MFF report. Failure to distinguish between current law estimates and policy estimates fails to highlight the impact of budget policy. This will be addressed in the baseline section below.

2.4.3. Macroeconomic and budgetary forecast

In February, the Ministry of Finance issues budget preparation instructions to all authorising officers. The instructions include expenditure ceilings for the MTBP, unconditional transfers for local government units, methods of calculating conditional and unconditional transfers to local governments, and regulations for sharing functions between central and local governments. Authorising officers are required to submit the MTBP in compliance with the requirements and deadlines specified in the instructions.

2.4.4. Medium Term Budget Programme

Line ministries and other budgetary institutions and spending units (secondary level) develop their initial MTBP in March and April, consistent with the expenditure ceilings and budget guidance. The MTBP presents programmes, sub-programmes and projects according to the objectives of the government units. The draft MTBP is reviewed and assessed by the MOF. Each ministry's recommendations, output targets, performance on previous years' budgets, and questions of fact are discussed by the MOF and in a series of hearings with ministry budget officials according to a pre-established calendar. The conclusions of the hearings are consolidated into a draft MTBP which is then presented to the Strategic Planning Committee (SPC) and the CoM for approval by the end of June. The MOF submission includes the Ministry of Finance's proposals for revised expenditure ceilings and adjustments to the draft MTBP and any additional requests. The CoM revises and approves the draft MTBP by 10 July. The MOF then prepares revised instructions and expenditure ceilings by government unit. Government units are required to incorporate changes into the MTBP by 1 September. The MOF reviews the revised submissions, raises questions and holds hearings as necessary. Once all of the issues have been resolved, the principle authorising officer (the General Secretary of the MOF) prepares the draft annual budget, including the MTBP.

2.4.5. Budget formulation within the line ministries

Ministries receive instructions and ceilings by the beginning of March. The authorising officer, the General Secretary, establishes a "Strategic Management Group" (SMG) consisting of the executive officers and main programme officers to oversee budget development. "Programme management teams" (PMT) are organised for each programme to review the programme's policy, discuss its objectives, measurable indicators and overall strategy, detail activity trees and co-ordinate the budget needs for each programme within the approved ceilings. The PMTs then discuss their proposals with the SMG. Each PMT then revises the proposal as appropriate and identifies additional requirements. Proposals for additional requirements are then discussed with the SMG and the General Secretary. Following the second round of updates and feedback from the MOF, the line ministry prepares the MTBP in full format, including the accompanying documents. The full MTBP presents the objectives of each programme, the funds allocated to the programme and the programme's intended outputs. Supporting documents allocate funds according to all budget classifications and list investment projects separately.

2.4.6. Submission and consideration of the annual budget law

The draft annual budget is approved by 25 October. Within ten days after the CoM approves the budget and the revised MTBP, the principal authorising officer informs each local government of the approved transfers from the central government. By 1 November, the Prime Minister submits the annual budget to the National Assembly on behalf of the CoM. The National Assembly must approve the budget by 31 December. Once approved, the budget law is published in the *Official Gazette*. After approval of the annual budget law by the National Assembly, the MTBP is revised to reflect any changes made by the CoM or the National Assembly. The MOF publishes the final MTBP by the end of February.

Box 2. **Medium-term expenditure frameworks in OECD countries**

An expenditure framework is a normative instrument which captures the government's policy objectives and imposes limits on spending over the medium term. The design of expenditure frameworks differs across countries. They can either be flexible (updated each year in light of the previous year's outcomes, new estimates of the consequences of current policies and new political priorities) or fixed (when the figures remain unaltered from year to year once they have been set).

The major advantage of a flexible framework in comparison to no framework is that, at the time of budget formulation, the multi-annual consequences of all policy changes have to be traded off against each other and against the adjustment of medium-term targets. This guarantees that the consequences of new spending initiatives in future years (which may be larger than in the first year, so-called "camel noses") are accounted for. Similarly, it allows for due consideration of savings measures which phase in slowly – which is the case with most major measures since they require changes to the law or reorganisation of administrative units.

A few countries (notably Austria, the Netherlands, Sweden and the United Kingdom) have fixed expenditure frameworks. The major advantage of a fixed expenditure framework over a flexible framework is that it is (more) effective in realising multi-year expenditure targets. Precisely because the overall ceiling cannot be changed from year to year, the target is automatically realised as long as the framework is maintained. In addition, a fixed framework contributes to automatic stabilisation because autonomous fluctuations in tax revenues are not allowed to affect the expenditure level. Although only a few OECD countries work with a fixed expenditure framework, many others seek to keep their expenditure framework as stable as possible from year to year (without formally committing to a fixed framework).

An expenditure framework can be rolling like in Austria and Sweden, or it can be periodical like in France and the United Kingdom. In a rolling framework, an additional year is added at the end of the framework period when the first year (or budget year) expires. In a periodical framework, a new sequence of ceilings is drawn up at periodic intervals, for instance at the beginning of every new Cabinet period.

Expenditure frameworks can be distinguished along several other dimensions, notably the number of future budget years covered, the number of ceilings they establish, and their comprehensiveness (the share of expenditures subject to the ceiling). In terms of future budget years covered, many frameworks cover a three-year period (France, Sweden) or a four-year period (Finland, the Netherlands). In 2010, the United Kingdom moved from a three-year to a five-year forward framework. In terms of the number of sub-ceilings, some frameworks establish only a single aggregate ceiling on expenditures (Sweden), while others contain a number of binding sub-ceilings at the ministerial level (the Netherlands, United Kingdom) or at the policy area level (France). In terms of comprehensiveness, some governments have exempted particularly volatile items or items determined by entitlements from the ceilings (for instance, the United Kingdom has exempted interest payments and social security expenditure).

2.4.7. Interim budget

If the National Assembly does not approve the proposed budget by the day preceding the start of the budget year, the CoM must authorise the implementation of an Interim Budget. The Interim Budget expenditures for each month and each programme shall not exceed one twelfth of the actual expenses financed by the budget for the previous year. Similarly, if the local government councils have not approved local budgets by the beginning of the fiscal year, the chairman of the local council can authorise up to one twelfth of the local government's actual expenditures from the previous year.

2.4.8. Supplementary budget

The authorising officers of central government units may submit supplementary funding requests to the principal authorising officer for expenses that were unforeseen at the time the budget was prepared and that cannot be postponed until the following year. The principal authorising officer makes recommendations to the Minister of Finance on whether or not to approve the proposal. The minister then submits a proposal to the CoM to approve funding the proposal with funds from the reserve fund. The minister periodically informs the Assembly of requests that have been approved. In general, supplementary budgets have corresponded with the mid-year budget revision in June.

2.5. Elements of budget formulation

2.5.1. Performance and results

Programme budgeting began in Albania in 2001. Pilot efforts were undertaken during a five-year period. In 2006, programme budgeting was implemented in all ministries. In 2008, programme budgeting was incorporated into the Organic Budget Law of the MBS Law and became the central legal structure for the budget. The programme budget is intended to strengthen the link between government policies and the allocation of resources while achieving value for money. It incorporates policy objectives, goals, outputs and performance indicators. According to the MBS Law, local governments have been required to prepare and approve medium-term budgets since 2009. The implementation of programme budgeting was launched at the local level in 2009. In 2012, the preparation of medium-term budgets at the local level was expected to be co-ordinated with regional and national policies and planning processes.

The MTBP process begins with ministries preparing a programme policy review (PPR) for each programme. Each programme is expected to be based on one or more specific policies that should be clearly expressed in the National Strategy for Development and Integration (NSDI). The PPR produces a policy statement for each programme, including: a mission statement, programme policy goal, a programme policy objective and programme policy standards. The PPR should be clear, understandable and periodically revised – for example, on an annual basis. The second component of the MTBP process is the programme expenditure and investment planning (PEIP). The PEIP is used to allocate resources among programmes and builds on the PPR process. The main outputs are identified and costed for each programme. As noted above, the MTBP process is an ongoing iterative process beginning with the approval of expenditure ceilings, continuing through two rounds of MTBP development with ministries and reactions by the MOF, and concluding with the presentation of the annual budget. The process is a rolling budget planning process where the annual budget and medium term are reviewed and revised to reflect results and changing budget constraints.

The MTBP is more fully integrated into the budget procedures of Albania than programme budgeting is in most countries. Most budget participants understand the system. Programme indicators may not be useful measures in some instances. A focus of the spring review is to improve the unit cost analysis for outputs. Attention going forward should continue to emphasise improving the clarity of definition of programme objectives, utility of measures and the accuracy of cost figures. Going forward it may be appropriate to reassess the time consumed by two rounds of programme budget review annually. The budget schedule in many countries is too compressed to allow for such a deliberative process. The schedule in Albania restricts the amount of time available for parliamentary review to the extent that the National Assembly has limited impact on the budget.

Performance budgeting practices are widely implemented, but vary; while countries might face similar challenges and share a common need to focus on demonstrating the extent to which spending achieves policy outcomes, they need to tailor their performance budgeting system to fit their particular circumstances. As shown in Box 3 and Figure 8, there is currently no consensus among OECD countries on the optimal way of using performance budgeting.

Box 3. **Trends in performance budgeting**

Performance budgeting is a term that focuses on how output and outcome information is used in budgeting for resource allocation. The OECD has identified three broad categories of performance budgeting:

- presentational performance budgeting;
- performance-informed budgeting;
- direct performance budgeting (formula-based budgeting).

Performance targets on output and outcome levels constitute important information about the strategic direction of programmes. The corresponding results of such targets indicate whether or to what degree the programmes are effective and efficient. The regular (annual) performance reports from programmes and government institutions as well as programme evaluations may provide important information to line ministries and the central budget authority when the centre of government discusses long-term policy changes to programmes.

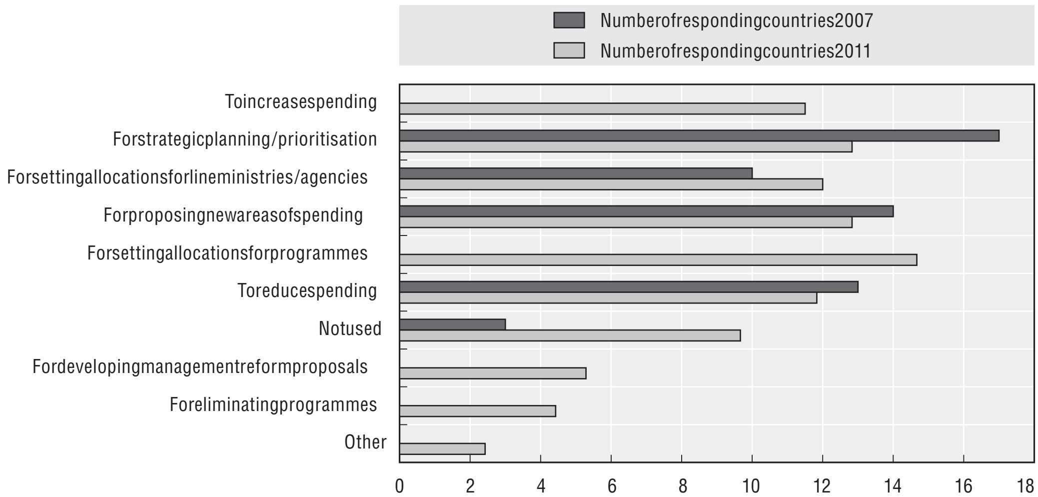
In OECD countries, experience so far indicates that although performance information adds value to the management and service delivery tasks of line ministries and executive agencies it has proven difficult to use for fund allocation as per the needs of ministries of finance. For programme managers, spending unit heads and line ministries, performance information is important both in the short run and in the long run. Performance information is also a vital part of an open government approach and may provide the legislature, supreme audit institution and civil society with essential background for assessing the government's accountability.

2.5.2. Baseline estimates

"The Economic and Fiscal Program" (February 2012) describes the baseline scenario of the macroeconomic framework as being based on the actual policy mix and the implementation of planned structural policies for the medium term. The MBS Law requires the Report on Macroeconomic and Budgetary Assessment and Forecast (RMBEF) report to include estimates of general government revenues and expenditures under both existing policies and proposals for new or amended policies. However, the report does not distinguish between current policy and proposed policy.

The primary purpose of baseline estimates is to highlight the impact of policy changes on government finances. The calculation of baselines requires a rigorous analysis of revenues and expenditures under current law. Estimates are revised to reflect the economic forecast and technical factors such as pre-commitments for construction projects, rising prices for prescription drugs or demographic changes affecting pension

Figure 8. **How is performance information generally used by line ministries in their negotiations with central budget authorities?**



Source: Hawkesworth, Ian and Knut Klepsvik (2013), "Budgeting levers, strategic agility and the use of performance budgeting in 2011/12", *OECD Journal on Budgeting*, Vol. 13/1, *http://dx.doi.org/10.1787/budget-13-5k3ttg15bs31*.

programmes, i.e. the aging population. This function should be implemented as a technical exercise within both ministries' budget offices and the MOF. The MOF should verify the accuracy of the estimates. The objective is to show budget outcomes in the absence of new policy. Having a policy neutral baseline would strengthen the "Economic and Fiscal Program" document by highlighting the impact of new policy proposals. The difference between current law estimates for revenues and policy targets could improve revenue forecasts by making policy changes more transparent. The baseline concept used in Albania which mixes actual policy and the implementation of structural reforms does not provide the benefit of a policy neutral benchmark.

2.5.3. Investment budgets

In 2007, the government of Albania introduced new public investment management (PIM) procedures to set out a coherent appraisal and planning process for public investment projects based on government priorities, sectorial policies and a better allocation of domestic and external budget resources. The PIM process is designed to ensure that public investments are clearly linked to the MTBP, that investments are prioritised within a framework of a realistic assessment of available domestic and external financing, and that public investments are co-ordinated over the medium-term time frame of the MTBP. In this context, investments are defined as increasing assets, having a life time of over one year and costing ALL 1 million (EUR 7 031) or more. The following information must be produced for each project: project justifications; full description of the project; alternative approaches; total project cost; cost for the budget year, cost for two out-years and remaining cost; recurrent cost implications as a result of the investment; project revenues if any; donor funding, if any; and net budget cost. The project plan, feasibility study and other economic/financial analyses must be completed and submitted with the proposal. Project proposals are submitted to the MOF, the Public Management Investment Directorate (PMID) in the budget office for review. Project plans are also integrated into the MTBP for the responsible ministry.

Box 4. **Baseline estimates in OECD countries**

OECD countries that work with expenditure frameworks produce and update multi-annual baseline estimates. Each programme has its own particular set of factors that will affect expenditures – for instance economic variables, demographic developments, price changes or participation rates. The baseline estimates capture the cost of current law and/or current policy over the medium term and are essential to ensure the consistency of current law or policy with the multi-annual ceilings. Best practice in OECD countries shows that baseline estimates are frequently updated to reflect any changes in the underlying variables (usually monthly or quarterly) and are prepared at a line item level (the same level of detail as the annual budget). They should be part of the annual budget proposal submitted to parliament (OECD, 2002). The baseline estimates should also be agreed between the line ministry and the Finance Ministry. The baseline estimates are an essential tool for budgetary discipline not only during budget formulation, but also during budget execution. During execution, they alert overspending at an early stage, which should immediately trigger corrective measures (not in the next budget).

Establishing the expenditure framework can be seen as a top-down process, and preparing budgetary and multi-annual estimates as a bottom-up process. In fact, the reconciliation of prescriptive targets or ceilings with descriptive line item estimates is central to a disciplined budget process.

Budget formulation for investment projects in Albania is a logically designed system. In recent years, budget retrenchment to adjust for unrealised revenues has restricted the public investment programme. The PEFA report noted that "[in]sufficient attention is being paid to implementation capacity, expenditure targets for investment program[me]s are being set at overly optimistic levels despite poor past performance" (Public Expenditure and Financial Accountability, 2012: 9). The PEFA report also found that investment fell short of the planned levels in the Ministries of Health and Defence but that the Ministries of Education and Science and Public Works, Transport and Telecommunications executed more or less at planned levels (Public Expenditure and Financial Accountability, 2012: 30). As noted in Section 4 of this report, project arrears have a direct effect on budget formulation for investment projects in Albania. Funding for prior commitments has pre-empted funding of new projects under in some areas.

2.5.4. Guarantees and loans and public-private partnerships

The Law on State Borrowing, State Debt and State's Guarantees in the Republic of Albania of 2006 sets the legal framework for debt transactions. It broadly defines financing transactions and requires proposals that obligate the state to a future payment to be submitted to the Minister of Finance for review and approval. The MBS Law subjects all local borrowing to review by the Ministry of Finance as well.

Public-private partnerships (PPPs) and concessions are co-ordinated by the Ministry of Economy, Trade and Energy in Albania. From an Internet review, it appears that the US Aid for International Development and the World Bank's International Finance Corporation (IFC) are supporting PPP development in Albania. It further appears that the objective of the concession agency is to promote more private investment in Albania.

The Law on State Borrowing reflects the OECD's view that transactions that obligate the state to future obligations should be subject to review by the MOF. The OECD team for this review did not have the opportunity to meet with the Ministry of Economy, Trade and Energy. However, experiences from OECD member countries show that it can be difficult to get value for money out of PPPs if government agencies are not equipped to manage them effectively. Moreover, PPPs can obscure real spending and make government actions non-transparent, using off-budget financing. This means PPPs are potentially risky for fiscal sustainability, possibly leading to credit rating downgrades as has happened in some OECD countries. PPPs should be recognised as potentially obligating the state to future costs and should be subject to review by the MOF. Albania is encouraged to consider the "OECD Recommendations on Principles for Public Governance of Public-Private Partnerships".

2.6. Documents and transparency

The annual budget submitted to the National Assembly consists of the "Annual Budget Law" and its annexed tables, which are enacted into law by the Assembly. The "Medium Term Budget Programme" and the updated Economic and Fiscal Program are also provided to the National Assembly for information.

The Annual Budget Law is a brief legal document. In 2011, it consisted of 20 articles, specifying budgetary levels for 2011 for revenues, expenditures and the deficit for: the aggregate budget, the State Budget, the Local Budget and social insurance. The social insurance budget is further divided among the Scheme for Compulsory Social Insurance, the Supplementary Insurance Scheme, Health Insurance, and the Budget for Ex-Owners. The Annual Budget Law also specifies the total number of government employees, the salary of the President of the Republic, the Council of Minister's Reserve Fund, and the Judiciary Budget. It defines the formula for the allocation of unconditional transfers to local government by community population. Finally, the Annual Budget Law specifies funding levels for ministries and investment projects by reference to budget annexes and sets limits on state debt and guarantees.

The annexes to the Annual Budget Law, enacted by reference are:

- employees by budgetary institution;
- State Budget by ministry and independent budget institutions and major programme – divided between current and capital expenditure;
- unconditional transfers by region;
- unconditional transfers by municipality and commune;
- Council of Minister's Reserve Fund and contingency allocated among ten categories.

Requirements for the contents of the MTBP are set out in Article 29 of the MBS Law. For each central government unit, the annual budget shall include: the mission or goals of the central government unit; a description of its programmes and activities; a presentation of the programmatic policies, goals and policy objectives; an explanation of how each programme's outputs contribute to the achievement of the goals; the actual indicators for the two previous years, budgetary funds planned for the current year, and the Medium Term Budget Programme allocated to each programme for the next three years; a list of capital projects for each programme; an explanation of quasi fiscal activities; and a tax expenditure forecast.

The MTBP was not available in English, but appeared to be the central focus of budget policy discussions. The Economic and Fiscal Program is a useful overview of the economy, macroeconomic policy and fiscal condition of the country. It presents a number of useful tables that provide information for four prior years, the budget year and three out-years.

As a general matter, many countries' detailed budget documents are not easily understood by parliamentarians or the general public. Significant effort is needed to limit information to what non-experts can understand and to present the information in simple enough language to clearly present relevant facts about the programmes. Albania's budget documents could be more useful by providing more budget relevant summary tables, for example historical presentations by economic classification, administrative unit, personnel and major programme. Summary tables should be reviewed and revised annually to provide information that will inform the budget debate.

2.7. Organisation of the Ministry of Finance

The Ministry of Finance is organised into six departments: General Directorates for Treasury, Budget, Macroeconomic and Fiscal Policy, Public Debt Management, Internal Audit, and Public Financial Inspection. The ministry has a number of other operational units, including its Central Harmonization Unit for Internal Audit, the Unit for Prevention of Money Laundering, the Unit for Gambling, the Agency for Management of Seized and Confiscated Assets, and the Agency for Audit of EU funds.

The General Directorate for Budget is responsible for the management of public expenditures with effectiveness, efficiency and economy. The main functions of the General Budget Directorate are:

- preparation and implementation of the Organic Budget Law;
- budget management and monitoring;
- public investment management;
- legal regulation of intergovernmental fiscal relations;
- classification and budgetary system;
- analysis and budget policy development;
- preparation of legal and sub-legal acts on public financial matters;
- planning and regulation of budget processes and systems.

The General Directorate for Budget is organised into four directorates and has a total of 31 staff. The directorates and their primary functions are:

- Budget Analysis, Policy and Programming Directorate (BAPPD) (one director, two unit heads and six specialists):
  - ❖ analysing budget policies to ensure fiscal stability;
  - ❖ allocating resources to reflect government policies and priorities;
  - ❖ proposing norms and standards for budget expenditures;
  - ❖ developing guidelines for the preparation of the budget;
  - ❖ drafting the MTBP;
  - ❖ preparing the budget;
  - ❖ reviewing laws and sub-legal acts to ensure efficient and effective management of public finances.

- Management and Budget Monitoring Directorate (MBMD) (one director, two unit heads and six specialists):
  - managing the implementation process of the State Budget;
  - monitoring the Medium Term Budget Programme and annual budget processes;
  - preparing the management, implementation and monitoring instruction for the annual budget and the MTBP;
  - reviewing laws and sub-legal acts to ensure efficient and effective management of the state budget;
  - analysing budget performance indicators to assess the performance of planned activities;
  - preparing sectoral analyses in order to improve the management of the sectors when corrective actions are needed;
  - analysing independent institutions' and entities' expenditure plans, which by law have to be approved by a CoM decision;
  - proposing amendments to the State Budget;
  - preparing periodic monitoring reports of budget output indicators and the performance of budget activities.
- Public Investment Directorate (PIMD) (one director and six specialists, although currently only four specialist positions are filled):
  - ensuring that public investment projects support the implementation of the NSDI;
  - managing the procedure for identifying and assessing public investment projects;
  - evaluating and improving public investment projects;
  - tracking the performance of planned public investments;
  - participating in the review and negotiation of programmes and projects financed by donors;
  - preparing annual summary reports on the progress of programme implementation.
- Intergovernmental Fiscal Relations Directorate (IFRD) (one director and three specialists):
  - proposing criteria for allocating transfers from the State Budget to local governments;
  - preparing the Annual Fiscal Package for Local Government;
  - analysing alternative approaches for increasing local revenue and using expenses effectively;
  - notifying local government units of the unconditional transfer of funds allocated under the formula;
  - preparing guidelines for the implementation of the budget for local government units.

The Macroeconomic and Fiscal Policy Directorate is responsible for developing the macroeconomic forecasts and fiscal forecast presented in the Macroeconomic and Fiscal Framework document, formulating recommendations on short-, medium- and long-term fiscal policy, designing tax policy and periodic macroeconomic and fiscal analysis.

For the most part, the organisation of the MOF seems to be well structured to carry out its functions. Consideration should be given to integrating the staff and functions with the

BAPPD and MBMD to encourage amalgamation on a programmatic basis rather than by economic classification of spending.

2.8. Conclusion

Budget formulation procedures in Albania are more effective than those of many countries. The process is organised to ensure that participants in the budget process have constructive roles. Decisions are based on programmatic information, tied to policy goals and integrated into programme planning. The form of the processes for the most part should be continued. Issues that remain are primarily to improve the quality of the budget analysis.

Albania should develop a policy neutral baseline. Macroeconomic and fiscal forecasts are prepared in a credible manner. Few budget offices have anticipated the severity and duration of the current economic downturn. Albania should continue to strengthen the accuracy and reliability of its economic forecasts. One specific improvement to consider is developing a policy neutral baseline and incorporating the results of the baseline in the Economic and Fiscal Program. Policy proposals and structural reforms should be treated separately from economic and technical factors.

Programme objectives should be refined to more clearly represent the basic nature of programmes and performance indicators should be better focused to reflect the critical policy-sensitive nature of programmes. Staff in the ministries need to refine their skills to plan and budget for programmes more effectively. Changes needed are improvements in the quality of review, not in the nature of the procedures undertaken. Continuing improvement to programme budget measures will require additional use of the MTBP procedures within ministries and in the local communities. The more the results of the reviews are recognised as influencing budget choices by government or public debate on programmes, the more the practice will improve. These efforts can receive feedback through the decision process, but could be facilitated by training within the ministries and/ or localities, by informing the public on the results and by translating the budget decisions into programme implementation.

The budget schedule should be reviewed periodically to confirm that the sequential review adds value to the decision-making process. The budget schedule defined by the MBS Law requires repetitive procedures that consume substantial human resources from the budget office, the ministry's authorising and executive officers. At a minimum, the National Assembly should have more time to review budget policy and a greater opportunity to affect budget allocation choices.

Budget documents should be reviewed on an ongoing basis to ensure that the budget is transparent. It should not require a budget expert to understand the policy presented in the budget. Comparisons over time (two prior years, the budget year and two out-years) are particularly effective in conveying an understanding of changing budget policies. The solution is frequently not more information, but information presented tables, graphs and displays. That are easy to understand Budget writing should also be simplified and made more direct. The readers of budget documents are almost certainly not going to have expertise in the content presented in budget documents. If the material is clearer, the public will support the budget policy more and have a better understanding of what their tax payments are purchasing.

Responsibility and accountability for budget formulation and management should be delegated to budget institutions and spending units. Programme budgeting is based on an assumption that budget responsibility is delegated to the extent possible. The MBS authority creating authorising officers may need to be clarified to ensure that lines of authority are clear and do not conflict with the broader goal of delegating programme accountability.

The Ministry of Finance should take an active role in reviewing all PPP proposals. Many countries have found that public interest is frequently not served by these arrangements. The OECD guidelines should be considered in developing PPP oversight and governance arrangements.

3. Role of the legislature

3.1. Legal framework

The Assembly of the Republic of Albania (*Kuvendi i Shqipërisë*) is the sole legislative body in Albania. It is a single-chamber parliament elected for four years under a closed-list proportional representation system. It consists of 140 deputies (Article 64 of the Constitution).[5] Its role in the budget process is defined in Article 158 of the Constitution. According to the Constitution, the Assembly approves the budget and makes the final decision on the budget's implementation after a hearing of the High State Control's report.

The budget system, including its structure, principles and the foundation of the budgetary process, as well as intergovernmental financial relations and responsibilities for the execution of the entire budgetary legislation, are defined in the Organic Budget Law. According to Article 13 of the Organic Budget Law, the budget year for all government units begins on 1 January and ends on 31 December. The Organic Budget Law also specifies the role of the Assembly (Article 14): "*The National Assembly, by a specific law, approves budgetary revenues and appropriations for the central government units, unconditional transfers for local government units and their special funds, through which it gives the right to undertake expenditures in exercising their functions, as well as the financing sources of the budget deficit*."

The Rules of Procedure of the Assembly of the Republic of Albania ("Rules of Procedure") further specify the procedures and processes of the Assembly. A chapter of the Rules of Procedure is dedicated to the budget process and the role of the Committee on Economy and Finance.[6]

3.2. The Committee on Economy and Finance

The Assembly has a standing Committee on Economy and Finance. Included within its purview are: economic policy, the state budget, the supervision of its implementation, public finances, privatisation and the banking system.[7] The Committee on Economy and Finance leads budget discussions and the approval process according to the Parliamentary rules and the Organic Budget Law. It is composed of 23 members: 13 are from the majority party and 10 are from the opposition.

According to Article 79 of the Rules of Procedure, one of the main tasks of the Committee on Economy and Finance is to lead the budget approval process, including budget discussions. Article 158 (V) of the Constitution mandates that after hearing the High State Control's report, the Assembly should debate and vote on the implementation of the previous year's budget. The Committee on Economy and Finance is also involved in this process since there is no separate committee for public accounts.

The Assembly does not have a budget office responsible for carrying out budget analysis. Attempts to establish a non-partisan budget office have been unsuccessful. There is a trend in OECD countries to establish specialised units to assist with budget-related research and analysis (e.g. Australia, Austria, Korea and the United Kingdom have established parliamentary budget offices) (OECD, 2011a: 5). Parliamentary budget offices may have greater scope to act independently by setting their own research agendas and issuing their own reports (Schick, 2009). In Albania, the committee is supported by three economists and one lawyer. Individual members of the committee have the right to request help from the support staff. However, the minority party members of the committee do not believe they have equal use of the analytical capacity of technical staff. Technical expertise is provided by the Ministry of Finance at the request of the committee. The executive branch, often represented by the Minister of Finance, participates in most committee sessions in order to directly respond to committee requests.

Article 78 (I) of the Constitution stipulates that meetings of the Assembly be open. The Rules of Procedure specify that committee meetings are generally open to the media, interest groups and visitors. Committees also have the right to decide to close or partially close their meetings, although in practice, committee meetings are usually open to the public.[8] Open proceedings increase the likelihood of the publication of media reports on parliamentary debates and committee or member views, as well as assure the transparency and accountability of the parliament for voters. Especially in countries like Albania, which face new budget constraints, it is important that the public fully understands the difficult trade-offs associated with budgetary decisions (OECD, 2011b: 9). However, it has been suggested by the minority that information about the exact date and time of sessions is not adequately published, so that only a few of the committee's meetings are attended by the public or media. The majority, on the other hand, stated the media is present at all meetings of the committee and that the minutes of the committee's discussions are published on a regular basis on the Assembly's website and are sent in electronic form to all committee members.

3.3. Parliamentary budget procedure

3.3.1. Budget approval

The Constitution {Article 158 (III)} stipulates that on behalf of the Council of Ministers, the Prime Minister presents the Assembly with a draft budget law during the autumn session. The Organic Budget Law further specifies 1 November as the deadline for submission of the proposed annual budget to the Assembly (Article 29).

The annual budget law approved by the Assembly contains:

- revenues;
- annual budget funds for central government institutions;
- unconditional transfers for local government units;
- special funds;
- sources to finance the budget deficit and authorisation to borrow.

According to Article 25 of the Organic Budget Law, in July of each year, the Minister of Finance must provide the Assembly with a copy of the Medium Term Budget Programme (MTBP) approved by the Council of Ministers and must answer questions about it upon request of the Assembly commission responsible for public finances. However, approval by the Assembly is not foreseen. The MTBP is attached to the annual budget for informational purposes. The debate in the Assembly mainly focuses on the budget, paying little attention to the changes to the MTBP between the draft annual budget and the MTBP forecasts for the upcoming year.

Once the annual budget is approved, the principal authorising officer consolidates any changes in the MTBP (Article 31 of the Organic Budget Law). The MTBP, revised and approved by the Council of Ministers, is then submitted, usually in January, by the Minister of Finance to the Assembly for information purposes.

The deadline for approval of the annual budget is 31 December according to the MBS Law. This allows the Assembly approximately two months for the approval process. Thus, there is only limited time allotted to the annual budget discussion in the Assembly. The OECD's "Best Practices for Budget Transparency" recommend that parliament be provided at least three months to review the budget. However, the Assembly usually takes no more than four or five weeks to approve the budget. The Constitution provides guidelines for budget execution in case the annual budget is not approved until the beginning of the next financial year. However, this has yet to occur. The article by article discussions take place based on a schedule by the committee. Hearings usually take place in the month of November so that the timeframe for parliamentary budget approval is not fully utilised. The annual budget is usually approved by the beginning of December.

The Assembly's budget approval process is fully elaborated in the Rules of Procedure (Articles 78-85). Once the annual budget has been submitted, it is immediately announced by the Speaker of the Assembly. The draft budget is then debated according to a specific approved calendar in the standing parliamentary commissions and the Assembly's plenary sessions. The first plenary review is primarily a political discussion about the macroeconomic and fiscal aspects of the fiscal framework, and generally takes place within a single day.[9] Next, the budget is approved in principle, meaning that it votes on the total amount of expenditure, adopting policies and priorities that the government aims to realise across the economic branches and sectors for the budget year. Within two days of the budget's submission to the Assembly, the Speaker convenes a meeting of the chairpersons of all standing committees in which the Minister of Finance introduces the budget and related financial bills.[10] Finally, a schedule of in-depth committee hearings and plenary sittings is planned and presented to the plenary.

Each standing committee holds hearings on matters within its jurisdiction and has the right to invite institutions, civil society or private sector representatives, as well as other relevant bodies within the scope of its authority. Ministers may be required to report to the Assembly on specific issues. Furthermore, committees may organise public hearings in order to gather opinions and comments from institutions, persons or interested groups.[11] Based on these hearings, the standing committees formulate recommendations or amendment proposals to the Committee of Economy and Finance. A consolidated report is then prepared and submitted to the plenary for a second reading and final vote (Public Expenditure and Financial Accountability, 2012: 110).The Rules of Procedure specify the required content of this report.[12]

While the process of hearings is generally well regulated and organised, doubts about the quality of the debate have been raised by the minority. Concerns have been expressed that individual debate sessions in the Committee on Economy and Finance are too short to allow for in-depth discussion. Analytical support from the committee's support structure may not be as fully available to the minority as to the majority, leading to a lack of understanding of the budget's implications and thus, influencing the quality of debate.

The regulatory framework does not explicitly foresee amendment powers of the Assembly at the budget approval stage. The former Organic Budget Law[13] stipulated in Article 22 (IV) states that the Assembly may make changes to the proposed state budget under specific conditions defined in the law, e.g. when the main indicators of revenues change, when expenditures are above a certain limit, and when the deficit or other financial conditions change. However, this law has been abrogated by Article 75 of the Law on Management of Budgetary System in the Republic of Albania. The current Organic Budget Law does not include a comparable provision for the approval stage of the budget. However, a common practice in accordance with legal provisions is for the Assembly to request amendments to the Council of Ministers during the approval phase of the budget. The requested amendment must entail a proposition on how to balance the additional costs. The Committee on Economy and Finance reports having proposed changes to programmes and line ministries' spending each year without changing the total spending. However, it was the OECD's impression that changes are only being made on a small scale and that the minority's requests are not being responded to systematically.

Throughout the financial year, according to Article 160 of the Constitution, the Assembly is fully empowered to make changes to the budget based on the defined procedures for drafting and approving it. The Assembly must submit the requests for changes to the annual budget law to the Council of Ministers with an accompanying explanation as to why the requested changes could not have been forecasted in the proposed budget (see Article 46 of the Organic Budget Law). If the Council of Ministers decides to change the annual budget law, approval by the Assembly is necessary.

The annual budget law provides appropriation totals for expenditures, revenues and deficit, specified on state and local governments and special funds (social insurance, health insurance and ex-owners contribution). The budget law also provides some appropriation specifications, namely the composition of state revenues (grants, taxes and non-tax revenues) and the composition of state expenditures (current, capital and special fund expenditures). The state's current and capital expenditures are furthermore specified for line ministries and other central government budget institutions and their programmes. Employment ceilings are specified for all central government budget institutions. The state's unconditional transfers to local and regional governments are also detailed in the law. In addition, the total expenditures (state, local and special funds) are specified in a table showing COFOG functions and economical classifications.

3.3.2. Budget monitoring

The Assembly monitors the budget's execution during the fiscal year through quarterly and yearly reports presented by the Ministry of Finance. Budget execution and monitoring reports are prepared by the authorising officer of general government units no fewer than four times per year (Article 65, Organic Budget Law). Within one month after the end of the reporting period, the Minister of Finance presents the budget monitoring and implementation reports to the Council of Ministers and the Assembly. These reports are performance based and consist of:

- the financial performance of each programme;
- the products produced by each programme;

- the objectives achieved by each programme.

Based on these reports, the Assembly has the right to examine the budget's implementation. Individual MPs can request hearings with government representatives and call for debates in the standing committees or the plenary. MPs also have the right to ask for hearings with the Prime Minister, with or without a debate, regarding issues of budget implementation. Changes to the budget law must be approved by parliament (see Section 3.3.1 on budget approval). The committee reported that it receives quarterly reports in a timely and adequate manner. However, debate seems to be limited to the discussion of the consolidated budget implementation report. A lack of capacity for analysing these reports in the Assembly seems to be a major obstacle to the exertion of the monitoring rights.

Supplementary budget requests under the state budget reserve fund may be approved by the Council of Ministers and do not require consultation with the Assembly. However, the Minister of Finance shall periodically inform the Assembly, in writing, of supplementary budget requests and if requested, provide answers to related questions from the Committee on Economy and Finance (Article 45 of the Organic Budget Law).

Article 63 of the Organic Budget Law foresees the submission of a consolidated budget implementation report by the Council of Ministers to the Assembly for approval in the month of June.[14] This report is discussed by the Committee on Economy and Finance together with the High State Control's report. Usually, the Minister of Finance and the head of the High State Control participate in the meeting. MPs have the right to contact the institutions directly for more information; however, in practice, this right is not extensively exercised.

3.3.3. Budget control

As mentioned previously, the Committee on Economy and Finance also fulfils the task of legislative scrutiny by discussing and taking a final decision on the implementation of the previous year's budget based on the High State Control's report.

Article 164 of the Constitution stipulates that the High State Control present to the Assembly:

- the report on the implementation of the state budget;
- an opinion on the report of the Council of Ministers for the expenses of the previous financial year, before it is approved by the Assembly;
- upon request, information about audit results and reviews.

While the Constitution mandates the Assembly to take the final decision on the budget's implementation, it does not establish deadlines for review of the audit reports. However, parliamentary examination of the audit reports generally takes one to two months (Public Expenditure and Financial Accountability, 2012: 112).

The approval process for the High State Control's report follows the same procedure as the budget approval, but with fewer opportunities for input from the public. While parliamentary groups have the right to call for sessions with the government including the Prime Minister, ministers are unlikely to participate in the hearings unless there is a political issue (Public Expenditure and Financial Accountability, 2012: 112). Since the committee in charge of budget approval and budget oversight is chaired by an MP of the majority party, the minority does not have much influence on budget oversight. In the

United Kingdom, a separate Public Accounts Committee, chaired by the opposition leader, is responsible for holding the government to account for its use of public resources. This model aims at assuring that party membership does not impede parliamentary control.

The Committee on Economy and Finance formulates its recommendations based on the findings of the High State Control's report. These recommendations, once approved by the plenary, are legally binding.

Table 4. **Parliamentary budget calendar**

1 January	Beginning of the fiscal year
June	Submission of a consolidated budget implementation report by the Council of Ministers to the Assembly
July	Minister of Finance presents the Medium Term Budget Programme to the Assembly
1 November	Submission of the budget to parliament Revised Medium Term Budget Programme approved by the Council of Ministers is submitted to the Assembly for information by the Minister of Finance
31 December	Deadline for the approval of the annual budget and end of the fiscal year
January of the following year	Revised Medium Term Budget Programme approved by the Council of Ministers is submitted to the Assembly for information by the Minister of Finance

3.4. Conclusion

The parliamentary budget process in Albania is regulated by a comprehensive legal framework. Most crucial parliamentary rights are granted by the Organic Budget Law. Although the current Organic Budget Law does not explicitly foresee amendment powers at the budget approval stage, in practice, the Assembly regularly exercises this right. However, the OECD review team had the impression that the Assembly generally makes limited amendments and that the minority's requests are not taken up systematically. Amending the Organic Budget Law to reflect this practice would eliminate doubts about the Assembly's rights and assure that the opposition's requests are responded to in a regulated procedure.

The schedule and procedures of budget approval in the Assembly should be revised to provide the Assembly with more time to debate the budget. While the legislative framework foresees an active role of the Assembly, the Committee of Finance and Economy, in practice, does not make extensive use of it. While the Assembly theoretically has two months to discuss the budget, it takes usually no more than four to five weeks, limiting the possibilities for in-depth discussions in the relevant committees. The Assembly could put more effort into the approval process under the existing timeframe and revise its procedures to expand the budget hearings and budget debate to increase its impact on budget deliberations. The three-year MTBPs are the major strategic policy documents on which the government bases its annual budget. The MTBP is submitted to the Assembly every June for informational purposes. Considering the importance of the MTBP document, the Assembly should be granted the right to review and approve the medium-term financial strategy during the budget process, e.g. together with the annual budget.

The Albanian Assembly should reconsider establishing a non-partisan budget office in order to address the lack of independent analytical capacity for MPs. A major obstacle to the quality of the parliamentarian budget discussions is the lack of non-partisan analytical capacity in the Assembly. The committee is supported by a limited number of technical experts; however, the minority raised concerns about the availability of existing support staff for the Committee on Economy and Finance for all MPs, including the minority MPs.

The Assembly, and especially the Committee on Economy and Finance, should ensure that the majority of hearing sessions are open to the public and that information on the sessions is adequately published. Concerns about the publicity of parliamentary hearings (including those of the Committee on Economy and Finance) should be taken seriously. While the Albanian regulatory framework for the budget process includes all of the necessary provisions to guarantee full transparency of the content of the Assembly's session, in practice, publicity of the hearings is contested.

With regard to budget oversight, the role of the Committee on Economy and Finance could be significantly enhanced with a more prominent role for the opposition. Since the tasks of budget approval and budget oversight are both carried out by the Committee on Economy and Finance, the minority raised concerns about its role in controlling budget execution. As a means to minimise changes to the existing system, the German or the British model would be suitable for the Albanian Assembly. While the German Budget Committee also exerts both functions of budget approval and oversight, a sub-committee on public accounts, usually led by the minority, has been established. In the United Kingdom, the oversight committee on public accounts is led by the minority. A corresponding model could be established in Albania, thus providing a major role for the minority in the sub-committee.

4. Budget execution

The systems and procedures for budget execution in Albania have evolved substantially over the last two decades as an outcome of a series of structural reforms. The Organic Budget Law, Chapter V, set out the main legal framework for budget execution. This section reviews the implementation of the budget in eight sub-sections: overview of budget execution, cash and debt management, reallocations and carry-overs, budget monitoring, the structure of service delivery, the public enterprise sector, fiscal relations across levels of government, public employment and the civil service, and public procurement. Conclusions of the assessment and recommendations for further actions are provided at the end of this section.

4.1. Basis for budget execution

This sub-section provides a short overview of the basis for the annual budget execution, like the structure of budget allocations and the control regime. Details are discussed in the following sub-sections.

The funds approved in the annual budget law are the upper limits of expenditure within which the Council of Ministers is authorised to undertake commitments and make expenditures. The government has the authority to cut spending up to 10% of the appropriated funds once the budget has been approved by the parliament. The Council of Ministers exercises the authority to make expenditure through the Minister of Finance.

In January, the Ministry of Finance consolidates any changes in the annual budget and in the MTBP (3rd round of the MTBP) stemming from the parliamentary budget adoption and publishes both documents. Following the adoption of the budget by the parliament, the MOF issues budget implementation instructions comprising budget execution procedures and specific deadlines. At the same time, the MOF allocates a budget to each central and local government institution within the total appropriations in the budget law. The MOF's budget allocations for each general government unit are split by programme and economical classification, in line with Article 42 of the Organic Budget Law and the structure documented in Table 2 of this report.

In recent years (since 2005) changes to the financial control system have been adopted in line with the principles of the EU Public Internal Financial Control system, legislated in the Organic Budget Law. Managers in budget units are now responsible for maintaining effective internal controls, with internal auditors advising how to improve the controls. This change of internal control environment still requires a cultural change before the controls are fully implemented (see Section 5).

Controls on non-payroll expenditure are primarily *ex ante* voucher checking. There is very little internal audit functionality at the *ex post* stage as required by international best practices. Other financial controls follow international practice and are generally complied with.

As the budget is being implemented, Treasury monitors the staffing levels with respect to a ceiling of authorised positions. The financial resources and controls in place are based on this ceiling, not on the actual number of staff employed. Inevitable staffing lags result in an underutilised salary budget.

All government expenditure, central as well as local, is executed through the Treasury Single Account system (TSA). The system rejects any spending for which there are inadequate allocations. Controls are exercised by budget programme, institution and economic classification regarding the yearly budget allocations.

Budget institutions receive invoices from suppliers and prepare expenditure documents and perform *ex ante* controls. As many budget institutions do not have access to the Treasury system, they send expenditure documents to the relevant Treasury district office that records and performs an additional *ex ante* control before payment. If complete documents are not available, the district office sends them back to the budget institution. Final documents are also sent back to the budget institutions for archiving. Through this practice, the Ministry of Finance keeps a strong central control on budget execution, unlike in many OECD countries. In a number of OECD countries, the responsibility for spending in compliance with the approved budget is transferred to a large degree to the line ministries. However, such an arrangement is dependent on strong financial management of the spending units, clearly defined and accepted roles, rights and obligations of the budget institutions, and politically supported arrangements on violations of the rules of budgetary discipline.

4.2. Cash and debt management

4.2.1. Cash management

The system. Treasury maintains central control over cash. In 2011, the new cash management system (Oracle) was implemented, provided for by an Instrument for Pre-Assession Assistance (IPA) grant and Austrian support (the SETS project). There are a gradually expanding number of users of the Treasury system. Cash planning is based on the appropriations, the allocations by the MOF and the cash flow plans from the budget institutions in accordance with the provisions in the Organic Budget Law.

The TSA system covers all general government entities, managed by the Treasury Directorate, including all general government expenditures and revenues. These include

Box 5. **The Treasury Department**

The Treasury Department administers a set of rules and procedures for budget implementation, handles the Treasury Single Account (TSA) system, manages liquidities and keeps the accounts and financial reporting of the general government. The Treasury Department consists of the Central Treasury in the Ministry of Finance and 36 Treasury district offices. The Treasury deals with the line ministries and 41 individual institutions, 30 of which are central government institutions. There are about 2 000 spending units, including local governments, special funds and sub-units.

The **Central Treasury** consists of one general director and two departments:

- The Operational Department has one director and 30 staff in four sections: cash forecasts, financial reporting (expenditure and revenue), electronic payments, and TSA management and foreign financing. In addition, the 36 district Treasury offices around the country serve the general government (central government, local governments and special funds). Altogether there are 220 staff in the department and the district offices.
- The Government **Financial Information System Administration Department** has one director and seven specialists.

ministries, departments and agencies, regional and local government units and special funds. State-owned enterprises are outside general government and exclusively utilise commercial banks for their financial operations. The TSA is kept in Albanian lek (ALL) and two foreign currencies: euros (EUR) and US dollars (USD).

The Treasury accounts are maintained at the central bank, which has established a sub-account ledger that includes a revenue account and an expenditure account for each budget institution. Fifteen commercial banks (36 bank district offices) are involved in collecting tax/customs revenue, for which revenue balances are transferred to the central bank on a daily basis. The central bank's daily report summarises the activity in each ledger account to allow Treasury to know the source of financial transactions. The balances of these sub-accounts are swept daily into the TSA by the central bank.

A limited number of bank accounts are maintained outside the TSA mechanism, most notably some project accounts that have external funding. These project bank accounts are maintained in the central bank outside of the Treasury's control. However, the project accounts are recorded in the General Ledger. The bank reconciliations are performed by the central bank and its monthly financial summaries are sent to the MOF's General Account Directorate for incorporation into the monthly financial accounts.

The process. The spending units submit a breakdown of the budget allocation to the MOF (cash flow plans with a monthly payment schedule) in accordance with the MOF's instructions. In practice, these cash flow plans distribute the allocated ceilings over months without a strict planning of the payments' due date. The MOF approves and records the annual budget allocation in the Treasury System. The Ministry of Finance may hold back a portion of the funds appropriated by the Parliament. Controls by the Treasury are based on the limit set by the total annual budget allocation, not by month.

In practice, the Treasury bases the cash management on the actual cash level and its own aggregate forecasts based on a three-year historical cash flow pattern. The MOF (principal authorising officer) revises the cash flow plans during the budget year with or without a proposal from the budget institutions, based on continuous monitoring of the execution of the cash flow plan and cash management policies. Two problem areas are important for future improvements. First, the over-optimistic revenue forecasts influence cash planning and have forced the Ministry of Finance to revise the annual budget in recent years and to strongly prioritise payments. Second, the budget institutions' monthly cash flow schedules are of a poor quality for cash management and are not recorded in the Treasury system. Because of the frequent need to make changes to the Treasury's cash flow plans, the Debt Department's auction schedule is disturbed and changed and temporary cash surpluses arise, hampering one of the objectives of cash management: maintaining a relatively constant cash balance over time.

Cash overspending cannot occur because each transaction is checked against the appropriations/allocations. If the cash resources allocated to the account are insufficient, the transaction has to be rejected by the Treasury district office's expenses specialist. The Treasury executes payment when cash is available, in general within one month.

The right to make expenditures within the limit of approved funds expires on the last day of the budget year. For important multi-year contracts, this right is prolonged beyond the end of the budget year, but not for more than three years, subject to specific approval by contracts and deadlines in the annual budget law.

The parliament receives the Treasury performance information (fiscal table) on an annual basis and it is approved as a part of the next year's draft budget.

Arrears. There is an acknowledged "arrears" problem in the construction sector (primarily roads and water supply, less dominant for school and health buildings) but the size of the arrears is disputed. The Ministry of Transport explained this practice by asserting that contractors continue building on multi-year projects from their own expense above the limit of the annual budget, which creates claims on the following years' budgets (although they do not have any contractual rights and there are not formally any arrears). Multi-year commitments are not regulated in the Organic Budget Law and the practice of making informal commitments arises from a technical issue related to the costs of discontinuing the projects, a political issue from pressure to expand development and a procedural issue as contractors cannot apply for new projects unless they have finished 70% of old project contracts. As a result of these unauthorised commitments or "arrears", the Ministry of Transport's budget for 2012 and 2013 only encompasses ongoing investment projects, and the 2013 budget for the Ministry of Education did not have any space for new projects, only for the existing commitments.

The Treasury has launched an initiative to close the "arrears" problem by documenting pending contracted payments. The Treasury system has the capacity to register contractual payment dates for future payments at the time the contract is registered. The Treasury is collecting old contracts to ensure that all commitments are recorded by 2013. No spending will be allowed unless commitments have been recorded in the system and the system will not allow a payment to a contractor on a new contract before the old ones are paid. Historical data will look back three years. Through this effort the Treasury expects to be able to document any unknown arrears.

Starting in 2013, the Treasury will register the invoice due date in the Treasury system. Previously, there was uncertainty about whether the budget institutions withheld invoices when the limit of the budget allocation approached. According to the interlocutors the government does not spend much on interest on overdue payments, which may indicate that there are no substantial arrears. On the other hand, since spending units are already required to submit contract commitments to the Treasury for registration, the continuing problem with arrears suggests that the obligation to submit contract commitments is not being met in many cases. The due date registration will be a partial solution to eliminate arrears – stronger commitment control could eliminate the problem entirely. Therefore, the government should establish better commitment control where spending units are effectively submitting commitments to the Treasury system when a contract is signed (before an invoice arrives).

4.2.2. Debt management

The core legislation for debt-related activities is the Law on State Borrowing, State Debt and Guarantees of the Republic of Albania (Law 9665/2006) covering state borrowing activities, complemented by the Law on Local Borrowing (Law 9869/2008) for municipalities, only a few of which have incurred debt. The Minister of Finance has an exclusive authority to contract loans and issue guarantees as defined by the Law on State Borrowing.[15] The Directorate of Debt Management in the MOF follows an annual debt strategy that is approved by the Council of Ministers, working through the Central Bank of Albania as its fiscal agent for treasury bills and government bonds.

The Directorate of Debt Management employs its Debt Management Financial Analysis System for all external debt and uses stand-alone Excel spreadsheets for managing domestic debt and guarantees. Reconciliations of domestic debt are performed on a monthly basis, while external debt can take up to two months to be reconciled. The delay of an additional month for some external debt reflects the fact that some line ministries bypass the General Directorate and deal directly with “direct payment” applications from World Bank loans or other International Financial Institutions (IFI) credits. As a result, information on disbursements can take up to two months to reach the department and to be recorded in the system.

Quarterly and annual debt bulletins contain domestic and foreign borrowing of all general government and government guarantees. They are posted on the MOF’s website. External debt is broken down by maturity (long-term or short-term), currency, types of creditor and interest rates. Domestic debt is broken down by maturity, types of interest rates and holders of debt. For guarantees, only aggregate external and domestic stocks are outlined. The Minister of Finance’s annual report on the state budget presents the performance of the government’s debt management activities.

The Directorate of Debt Management updates data and notifies the Treasury after auctions that take place twice a week (3-, 6- and 12-month bonds). The Treasury purchases euros by auctions; eight auctions were held in 2012.

4.3. Reallocations and carry-overs

4.3.1. Reallocations

The legal arrangement for the reallocation of funds during the budget year is as follows:

- up to 10% among programmes, if approved by the Council of Ministers;
- between economic articles within a programme and an expenditure category (current expenditure and capital expenditure), if approved by the principal authorising officer in the MOF;

- between spending units within a programme and a current expenditure item, if approved by the authorising officer of the central government unit superior to the spending units;
- no reallocations can take place after 15 November;
- no shifts between investment and current expenditures.

When assessing the justification for reallocations the MOF (BDMM) focuses on why the need for reallocation was not foreseen in the original budget and why the line ministry found free funds. Reallocations are formally carried out through the supplementary budgets, first in the Supplementary Budget tabled in parliament mid-year (when deemed necessary) and then in the "Normative Budget" tabled in parliament at year-end.

Reallocation between the accounts within a budget programme occurs formally twice a month.

4.3.2. Supplementary budgets

In recent years the macro assumptions and revenue forecasts have been overly optimistic and the Council of Ministers has cut expenditures (not personnel) in the middle of the budget year, mostly budgeted capital spending (which dropped from 8.8% of GDP in 2009 to 5.8% of GDP in 2010), administration expenditures and expenditures of low priority sectors. By mid-year, substantial budget revisions had been made in 2010 and 2011, but the government succeeded keeping the public debt below the previous legislative limit of 60% of GDP.

Following the bi-annual revision of the macroeconomic assumptions and revenue forecasts, the Council of Ministers assesses the need for a supplementary budget (normally in June). Since the present government took office in 2005, there have been supplementary budgets almost every year (except in 2012).

4.3.3. Reserve fund and contingency fund

According to the Organic Budget Law, the budget includes a reserve fund and a contingency fund, of up to 3% of the total budget funds. The reserve fund can be used for unforeseen events, unlike in some other countries, while the contingency fund may be used if the performance of revenues is less than planned.

To receive additional funds from the reserve funds, a general government unit may apply to the MOF with a justification of why the expenditures were not foreseen in the annual budget, how the planned outputs contribute to policy objectives and why it could not be financed within the allocated funds. The Minister of Finance recommends and the Council of Minister approves the use of the reserve fund. The Minister of Finance informs the Assembly periodically on the use of the reserve fund.

4.3.4. Carry-overs

There is a very strict carry-over regime. All spending is limited to the calendar year unless explicitly allowed by the parliament in the annual budget law. Borrowing against future appropriations is prohibited. The only exception is that line ministries have the right to carry over the unused funds of multi-year investment contracts, but not for more than three years, provided *ex ante* approval by the Assembly.

Table 5 shows that most OECD countries allow carry-overs under certain conditions, in general in order to: avoid hasty and inefficient spending in the last month of the year, avoid building up stocks of unspent resources and ensure budgetary discipline by compensation requirements in the next budget year.

Table 5. **Can ministries carry-over unused funds from one year to another?**

	Operating expenditure	Investment expenditure	Transfers and subsidies
Approval not required	8	12	8
Executive approval	17	16	16
Legislative approval	10	9	8
Not permitted	5	3	7

Source: OECD (2011b), "Budgeting Features that Strengthen Fiscal Policy in OECD Countries: Results from the OECD Budget Practises and Procedures Database – Draft Report", GOV/PGC/SBO(2011)11, OECD, Paris.

4.4. *Budget monitoring*

In accordance with the Organic Budget Law and the Budget Monitoring Instruction, sice 2006 when Albania introduced performance budgeting, all central government units submit quarterly budget execution and monitoring reports[16] to the MOF. The reports document units of output achieved, expenditure incurred and unit costs in comparisons with planned outputs, planned expenditures and planed cost/unit for each programme as specified in the first year of the final MTBP document. For example, the Ministry of Education submits quarterly reports (50 pages) to the MOF, based on hard copy reports from the regional offices and data from the Treasury. The reports are used within the line ministry to update the minister on the implementation of the budget. Government-wide there are around 700 performance targets, most of which are linked to a specific amount of expenditure at product level.

Evaluation of monitoring reports is a shared responsibility (see Box 6). Budget institutions monitor and report on the physical delivery of outputs and they have a responsibility to use that information pro-actively. If delivery of an output is off-track or over budget, it is the responsibility of the spending unit's Group of Management and Strategy (through the Programme Management Team) to determine the reasons behind the gap in performance in order to take remedial action and reallocate resources within the budget institution.

Based on the quarterly reports of the line ministries and other central budget institutions, the Ministry of Finance (the Budget Management and Monitoring Directorate Directorate, BMMD) prepares reports with comments on reallocations vs. the original budget, performance of outputs vs. the plan, deviations from Treasury's financial figures, and recommendations for follow-up issues. The BMMD also checks the line ministries' breakdown of the appropriations of the annual budget law. The MOF focuses on deviations, i.e. those outputs that are substantially off-track, expenditures that are over budget or with unusual data on actual unit cost, the reasons for deviations and the corrective actions. The BMMD undertakes more in-depth analyses where there are *variances* from budget or planned output:

- Ensure the Budget Department's Budget Management Team (BMT) is informed of potential problems that might (or are beginning to) emerge during budget execution and that may result in unplanned fiscal pressures building up and/or requests for budget transfers from budget institutions.

Box 6. **Government units involved in budget monitoring**

The process of monitoring the delivery of outputs is formally the responsibility of **the budget institutions**. While the various tasks associated with monitoring are delegated to heads of programme management teams within budget institutions, monitoring is the responsibility of the Group of Management and Strategy (GSM).

The **Budget Management and Monitoring Department** (BMMD) in the Ministry of Finance has a principal responsibility *for the monitoring process* – i.e. to review the monitoring reports prepared by budget institutions. The BMMD is organised into two sectors composed of the head of sector and three specialists each (total of 9 employees). The main functions of the department are: managing the implementation process of the budget; monitoring the medium-term programming and the annual budget process by analysing budget performance indicators in order to monitor the achievement of outputs and performance of planned activities; and preparation of laws and regulations and monitoring their implementation.

The **Directorate of Public Investment Management** in the Ministry of Finance follows the implementation of capital programmes and projects by sector aiming to improve the programming process and project cycle management. It currently has four experts; the position of head of department is vacant. The organisation is due for reconsideration.

The **Department for Strategy and Donor Co-ordination (DSDC)** at the Prime Minister's Office has a duty to warn the Council of Ministers if outputs to which the Council attaches great importance are at risk of non-delivery, delayed delivery or poor quality. The DSDC monitors the progress of programme policy objectives, high priority outputs and those outputs that are listed in the ministry's integrated plans. The DSDC discharges this responsibility by receiving the same reports on progress from line ministries as the Ministry of Finance as well as the ministry's annual reports.

The **Ministry of European Integration (MEI)** monitors EU integration-related objectives and outputs to the achievement of the European Partnership Action Plan (EPAP). The MEI advises the Council of Ministers and reports to the European Commission on progress in implementing the EPAP. The Ministry for European Integration discharges this responsibility by receiving the same reports on progress from line ministries as the Ministry of Finance and the DSDC.

Through the MTBP hearings, the Budget Management and Monitoring Department, in conjunction with the Department for Strategy and Donor Co-ordination and the Ministry of European Integration, assess under what circumstances it can take action as a result of monitoring information and what those actions could be.

- Provide the MOF's Department for Budget Analysis, Policy and Programming with information on potential weaknesses in the planning process within budget institutions so that this information can be used in part in the expenditure analysis process and in part in preparing appropriately for budget hearings with line ministries.
- Provide an "early warning" to the Strategic Planning Committee (via the BMT) where key outputs that are linked to major and high-profile government policies are beginning to run off-track.

Two specialists in the Capital Investment Department focus on budget monitoring. The general perception (see, for example, IMF, 2011) is that the MOF does very little review of investment project plans or cost-benefit analysis. It has little capacity to verify the accuracy of the assumptions and only monitor output.

Budget monitoring uses historical patterns as a benchmark for analysis of the budget – 15 years of historical data. The Minister of Finance submits the budget implementation and monitoring reports for information to the Council of Ministers as well as to the parliament for information, one month after the reporting date. The 2011 annual report had 86 pages. Officially the parliament receives the monitoring reports once a year through the annual budget reports which accompany the budget law. All of the monitoring reports prepared by the line ministries are available on their respective websites and all of the monitoring reports prepared by the Ministry of Finance are available on its website.

The Ministry of Finance recognises the need to strengthen budget monitoring to build a stronger foundation for the formulation and execution of the budget. The quality of the line ministries' reports has improved over the years but there is still a need for further improvements. Line ministries have viewed the monitoring reports as a product of the MOF and therefore the quality of reporting has not advanced sufficiently. According to the Central Harmonisation Unit for Financial Management and Control, internal reporting is mainly of financial nature and does not contain information necessary for performance management (CHU/FMC, 2012). One reason for this may be methodological deficiencies in developing performance indicators and unit cost calculations suited for operational management. This is a common international problem and is reflected by a recent shift in the use of performance budgeting techniques in OECD countries (see Section 2).

There is no electronic support system for the development and monitoring of performance and products, only for expenditures. A new IT system is under development, approved by a trust fund. Better system facilities may help to increase the quality of reporting. Better system support (the Oracle system) to register total investment project costs and remaining (outyear) expenditure requirements would also help to monitor the capital projects. The analytical capacity of the MOF is not adequate to challenge budget planning assumptions for capital projects, or to review project management.

Evaluations are not frequently or systematically used in Albania, although staff do prepare an evaluation report upon request from a minister. In-depth evaluations and analysis of performance deviations may also help the monitoring process.

4.5. Structure of public administration and service delivery

The Albanian central government has 14 line ministries,[17] subordinate agencies and some independent institutions (Table 6). For instance, the Ministry of Transport has subordinate agencies to implement road and water supply policies, which are involved at policy level, monitoring and follow up on reports from the agency head. Heads of programmes are from the ministry while deputy heads are from the agencies. Some programmes are administered directly by the ministry, e.g. road safety. The Ministry of Education and Science is the largest ministry with 39 000 employees, followed by the Ministry of Internal Affairs (13 400 employees) and the Ministry of Defence (11 700 employees). The Health Care Insurance Fund, the Social Insurance Fund and the Ex-owners Compensation Fund are special funds according to current legislation and operate as independent institutions.

Service delivery is shared between the central and local governments. The delivery of collective services such as defence, police, penitentiary services, road construction, forest administration, tax administration, higher education and research, inspectorates, etc. are all the main functionalities of the respective line ministries and are financed from the state budget. The central government is also involved in shared functions by providing funds and personnel.

Table 6. **Structure of the Albanian public sector**

Level of government		Number of budgetary institutions	Number of spending units	Employment
Central government	Ministries	14		84 558
	Central agencies sub-ordinate to line ministries and independent agencies	30		4 802
	Special funds	3		x
	Total central government	47		89 360
Region	Counties/regions	12	31	720
Local	Municipalities	65	214	6 251
	Communes	308	309	6 100
General government	Total	432	Ca. 1 500	102 431

Source: Data provided by the Ministry of Finance of Albania, Budget Law 2011.

Local government has a threefold responsibility: i) exclusive functions, such as water supply, public transport, public lighting and garbage collection; ii) shared functions, such as pre-school and pre-university education, priority health services and protection of public health, and social affairs; and iii) delegated functions (mandatory and non-mandatory functions). Delegated mandatory functions are: social protection, social assistance and poverty alleviation, civil office services, agricultural land administration, the National Registration Center and the National Licensing Center.

The Albanian public sector is rather centralised. There is an ongoing decentralisation process but it is proceeding slowly. Local budget expenditures in 2012 were estimated at ALL 29.5 billion (2.1% of GDP) which equal 7.4% of total consolidated general government expenditure (Ministry of Finance, 2012: 25). The public sector is small compared to other countries in the region, with public primary spending at about 28% of GDP.

Outsourcing is not forbidden by law but rarely used in practice. It may be allowed if the need for it is justified, mostly within legal and administrative services. PPPs are debated but are not yet being used.

4.6. Public enterprises

The Albanian public enterprise sector is small due to the privatisation process of the last two decades. The central government has remained present in public enterprises in the railroad, ports, energy and water supply sectors, associations of treatment of students, etc. In recent years some energy providers, the telecom company and a gas corporation have been (partly) privatised. The Albanian Post Service a.s is a self-financed public enterprise. Employment in the public enterprise sector has fallen from about 60 000 in 2000 to just below 37 000 in 2011 (INSTAT). The budget of the public enterprises is financed through subventions of the water company, railroads and food providers. Based on the Electricity Corporate's difficult financial situation, the government budget issues guaranties for this company in order to finance energy imports. In Table 4 of the 2011 annual budget law, there are specified subventions of ALL 1.7 billion (0.4% of total expenditures). The budget also specifies the annual increase of state guarantees to be ALL 7.4 billion.

The present government has an ongoing privatisation programme of some strategic companies, such as the Albanian Petrol Company, some state hydropower companies and some military properties. The government budget does not include revenues received from these privatisations. For example, Law No. 119/112 Article 9 declares that this privatisation receipt has to be used through the Council of Minister's order to increase capital expenditures and decrease borrowing. Quasi-fiscal activities in the enterprise sector are not clear. Contingent liabilities stemming from this sector are also not documented.

4.7. Fiscal relations across levels of governments

Local government is divided into 373 directly elected units made up of 65 municipalities in urban areas and 308 communes. Indirectly elected mayors and representatives of municipalities and communes govern 12 regions (counties) through regional councils. According to the legislation, the council of a region, as the second level of local government, mainly deals with the harmonisation of local development policies with regional and national ones in various fields and sectors.

Prefects of 12 administrative districts are appointed by central government to oversee the legality, efficacy and efficiency of local governments' operations but do not have a role in actual service delivery. Each prefecture has three or four districts under its jurisdiction, for a total of 36 districts. At the regional level there are also different de-concentrated agencies which deal exclusively with the implementation of the policies of ministries and central institutions.

Local governments follow the same budget calendar as the central government, according to the Organic Budget Law. Local governments submit a two-page summary of local budgets to the MOF which summarises local budgets, economic growth, inflation, allocation of formula transfers, income, revenue and expenditure for the locality. The unconditional grant to each local government is shown in an annex to the annual budget law. Local budgets are required to be balanced. However, local governments can borrow from the financial markets within the country and/or abroad to cover their short- or long-term needs to finance investments. Any local government borrowing shall be approved by the local council and is subject to preliminary approval by the Minister of Finance. The total local government debt is 0.03% of GDP (Ministry of Finance).

Local governments are highly dependent on the central government, as local revenues are low and infrastructure development depends on central government investments. Small local government units are, in many cases, not economically sustainable. The structure of local budget revenues has significantly changed since 2003. In 2012, 40% of local government functions were financed by own revenues, 41% from unconditional transfers and 19% from competitive grants. See Tables 7 and 8.

Local governments are entitled to levy local taxes and to determine the level of these local taxes within the limits defined by local tax laws. Local taxes include the small business tax and property tax. Some taxes are collected on a shared tax basis: the vehicle registration tax is shared, with 18% of the revenue allocated to the local government and 25% of the mining rent tax goes to the relevant local government.

The central government provides financial resources to the local governments (commune/municipality and regional council) through unconditional and conditional grants, prescribed by Law no. 8652 dated 30 July 2000 "For organisation and functioning of local government" that is administered by the MOF (Directorate of Public Investment Management). Local governments take part in financing the regional governments by transferring grants.

The unconditional grants (about 65% of total grants) have been a formula distribution since 2002, administered by the Ministry of Finance. Grants to municipalities and

Table 7. **Major categories of local government expenditures and revenues in Albania**

% of GDP

	2010	2011	2012
Revenues and grants			
Local shared taxes	0.0	0.1	0.1
Property tax	0.2	0.1	0.2
Small business tax	0.2	0.2	0.2
Other local taxes	0.6	0.5	0.4
Total local revenue	1.0	0.9	0.8
Unconditional grants	0.9	0.9	0.9
Competitive grants	0.7	0.4	0.4
Total grants	1.6	1.3	1.2
Total revenue and grants	2.5	2.2	2.1
Expenditures			
Personnel (600)	0.7	0.7	0.7
Operations and maintenance	0.8	0.6	0.7
Social insurance outlays (601)	0.1	0.1	0.1
Interest	0.0	0.0	0.0
Total current expenditure	1.6	1.5	1.5
Capital expenditure	0.9	0.7	0.5
Total spending	2.5	2.2	2.0
Overall balance	0.03	0.01	0.05
Nominal GDP (ALL million)	1 222 462	1 297 710	1 346 169

Source: Data provided by the Ministry of Finance, Albania.

Table 8. **Local government expenditures by programme in Albania**

% of GDP

	2010	2011	2012
Education	0.2	0.2	0.1
Transport	0.7	0.6	0.4
Water supply and sanitation programmes	0.1	0.1	0.1
Public services programmes	1.4	1.2	1.1
Cultural and sports programmes	0.1	0.1	0.1
Other programmes/functions	0.1	0.1	0.2
Total local expenditure	**2.5**	**2.2**	**2.0**

Source: Data provided by the Albanian Ministry of Finance.

communes are based on the population and relative geographical size of the communes. The formula for regions is based on an equal share for all regions, population, geographical indicators of counties (fields, hilly and mountainous), and length of rural roads. The total grant is tied to the growth of the economy. Through a relative complex mechanism, funds are reallocated between local governments according to fiscal capacity. Local governments at the receiving end are guaranteed a minimum transfer.

The remaining 35% of transfers are conditional grants comprised of competitive grants and earmarked grants. Since 2010, competitive grants are collected into one pool, the Regional Development Fund, that can finance: local infrastructure, basic education, health, cultural facilities, water and sanitation facilities, building agro-food markets, irrigation and drainage, and forestation. Co-ordination of the competitive grants has been transferred to the Council of Ministers. Local governments apply to line ministries for their programmes. Line ministers send their proposed allocations to the Council of Ministers which then co-ordinates funding for all ministries to localities.

Shared functions funded in part through conditional grants are education (salaries are central), healthcare and social welfare. Generally, local governments maintain buildings; central government provides investments and staff.

The PEFA report suggest that despite the formal allocation criteria, the actual allocation of the competitive grants under the Regional Development Fund has been criticised as a rather politicised process, tending to favour regions run by the majority party.

The budget notes presented to the parliament provide an explanation of the formula and the itemized allocation. The criteria are formally decided by the parliament, but there has not been any changes to the proposed criteria up to now.

The Treasury plans generally provide a transparent and reliable framework within which the local governments can execute their budget. However, when the government revises the budget ceilings downwards due to over-optimistic projections, this affects the local government budget execution because the local government's own revenue is included in the common cash pool, the TSA. This lack of control over the use of their own revenue in the local governments is reported to be a source of frustration.

The interlocutors at the municipal level, the Deputy Mayor for Tirana and Authorising Officer for the municipality, advocated that local governments need more flexibility in the planning and execution of their budgets, especially concerning approval of investment projects and reallocations. The local governments report both to the municipal councils and the Treasury.

4.8. *Public employment and the civil service*

Positions in ministries, from the Secretary General of the Council of Ministers and the highest level of civil servant (secretary general in ministries) to specialists in ministries and local self-government (lowest level), are considered civil servants. The management of these categories of employees is based on the provisions of the Law on the Status of Civil Servants. Other public employees, such as teachers, doctors and nurses, as well as support staff in central and local administrations, are considered to be public employees, and their management (human resources) is based on the provisions of the Labour Code. The Department of Public Administration (DoPA), under the Ministry of Internal Affairs, administers the legislative and institutional frameworks for public administration and the civil service.

About 89 400 public employees are civil servants (2011). In addition, there are some 22 800 army and police personnel (OECD, 2003: 49). In the third quarter of 2012, there were 164 400 employees in the public sector in Albania out of a total employment of 922 475 (INSTAT, Labour Market, QIII/2012). The rate of public employment (17.8%) is slightly above the OECD average of 15% but below that of other countries in the region. About 22% of public employment belongs to non-budgetary positions (public enterprises).

According to the World Bank's *Worldwide Governance Indicators*, government effectiveness[18] in Albania has improved substantially in recent years, from a score of 32.7 out of 100 in 2002 to 48.3 in 2011, although this is still among the weakest scores in the region (the average of Europe and Central Asia was 67.2).

There is a common comprehension that the legislative and institutional framework for public administration needs to be addressed with a view to strengthening professionalism, depoliticisation, meritocracy, transparency and accountability. The extensive use of temporary contracts to circumvent selection procedures should be avoided. The recently drafted amendments to the Civil Service Law of 1999 – approved by the Council of Ministers, but not adopted by the parliament – intend to prevent politicisation and to ensure equal opportunities, and stipulate open competition and a merit-based system for recruitment and career development. The implementation of the government's action plan for public administration reform in preparation of EU accession has, however, proceeded slowly.

Salaries for state bodies are set by the Department of Public Administration in conjunction with the MOF. Unions are invited to provide comments, but do not have a direct role. Under government policies, teachers' and healthcare workers' salaries were to be doubled from 2005 levels and is close to being achieved. The MOF sets the amount available for salaries. The DoPA and the MOF negotiate the mix of salaries.

The performance appraisal system is not effective. As a measure of the weakness of the performance appraisal system, 90% of employees were rated as outstanding. Under the prior scheme, outstanding employees were to be given three months' salary as a bonus, category 2 employees two months, and category 1 employees a one-month bonus. In 2008, bonuses were reduced to 1 month, 0.7 months and 0.5 months respectively.

There are applicants for all vacant government positions. One reason for this may be that the average monthly salary for public employees exceeds the average salary for all employees in Albania, following a real public wage increase over ten years (2001-11) by 122% (INSTAT, Earnings and Wages 2011). The hiring criteria are according to by-laws education for specialists and experience for others. There is mass recruitment for vacant civil servant positions (according to the Civil Service Law), except for teachers. The Department of Public Administration recommends the three best candidates to the line ministry, which is free to select one of them. Pension schemes for civil servants are regulated by the Social Insurance Fund.

Present systems involved in the determination and management of payroll are manual, stand-alone systems. Extensive manual reconciliations are therefore required. The government is gradually implementing a modern human resource management information system (HRMIS) to replace the current manual systems in each ministry but it is not yet fully operational. The HRMIS is supported by several donors such as the World Bank, the EU and the IPS trust Fund. Its first pilot phase, for making the salary module functional, was successfully concluded in five institutions in April 2012.

4.9. Public procurement

The government, assisted by donor partners and a twinning project with Poland and Romania, has created a modern public procurement framework in line with international norms. Competition is the dominant method of procurement, supported by the mandatory use of centralised electronic procurement by the 1 700 contracting authorities.

Prior to 2006, procurement was a major problem. The Law on Public Procurement, passed in 2006 and amended annually through 2010,[19] is closer to EU requirements and provides an appropriate legal basis. Since 2007, most procurement requirements have been published on a central website fostering transparency. Since 2009, most contracts are being competed through e-procurement (goods, services and works). All procurement greater than EUR 16 000 must be competitively tendered while procedures below EUR 3 000 are exempt from pre-publishing. All procurement between these two limits must be pre-published on the website and attract a minimum of five bidders. Defence is outside of the procurement procedures.

The Public Procurement Agency (PPA), under the Prime Minister's Office, has been restructured and administers the legislative and institutional framework for public procurement. It has a staff of 20.

A Public Procurement Commission (PPC), appointed by the Council of Ministers and reporting to the parliament, deals exclusively with the complaints of economic operators for procurement, concessions and public auctions procedures. It is a collegial review body composed of five members. The commission issues decisions which are administratively final, but may be appealed to the court. Before 2010, complaints were subject to a fee; they are now for free. Most cases concern the evaluation of criteria for entering into a contract. Approximately half of the complaints are upheld by the Public Procurement Commission. The PPC has 18 staff.

A Procurement Advocate reports to the Prime Minister. The Procurement Advocate may initiate and conduct its own investigation.

In 2010, 85% of all procurement was conducted using competitive procedures. Transparency in operations is a key attribute. The PPA website reports all procurement opportunities, makes available all standard bidding documents, requires e-filing of all bids and reports on the results of all procurement decisions. However, some 20% of the contracting authorities do not notify the PPA of their procurement plans and hence the PPA is not able to publish them.

The Albanian e-procurement system has been strongly endorsed by donors as a good practice example. Further improvements are anticipated, including the provision of enhanced security of access to the system and greater safeguards against collusion among suppliers. There is also some need for improvements in the legislative framework and a clearer division of roles between the PPC, the PPA and the Public Procurement Advocate (PPAd) in order to secure their administrative capacity and independence.

4.10. Conclusion

Broadly speaking, the government has established sound systems and procedures for budget execution, generally in line with practice in OECD countries, though there is still some way to go before all of the elements are fully implemented.

The Treasury system respects international best practice. Its proper implementation still needs to be addressed.

The government should establish better commitment control where spending units are required to register commitments in the Treasury system when a contract is signed (before an invoice arrives). There is an issue with invoices not being submitted to the Treasury when there are budget shortages, creating unrecorded arrears. The MOF is on the right track in planning to introduce a commitment module as of 2013. This applies primarily to investment contracts. In addition, the plan to register invoice due dates may help to analyse if the budget institutions keep invoices out of the control of the Treasury when there is shortage of budget resources. However, the government should establish a more comprehensive commitment control integrated with the Treasury system.

Box 7. **Public procurement procedures in Albania**

Open procedures are those procedures whereby any interested economic operator may submit a tender.

Restricted procedures are those procedures in which any economic operator may request to participate and whereby only those economic operators selected by the contracting authority may submit a tender.

Negotiated procedures are those procedures whereby the contracting authority consults the economic operators of its choice and negotiates the contract terms with one or more of these.

Request for proposals is a procedure without prior public notice, whereby the contracting authority may seek offers from a limited number of economic operators of its choice and compare them according to the criterion of price.

Source: Law on Public Procurement (10 309/2010); Public Expenditure and Financial Accountability (PEFA) (2012), *Albania, Public Expenditure and Financial Accountability Assessment (PEFA) 2011*, The World Bank, Washington, DC.

The MOF should consider an electronic link between the budget institutions' financial systems and the Treasury system in order to facilitate efficient payment execution and commitment control. This could increase the efficiency of the budget execution and help spending units to better plan the use of allocated resources. It would also give the Treasury a better basis for cash planning. Access to the Treasury system for all budget institutions would also help reconciliation and planning at the spending unit level. Full system integration is, however, not recommended. The more sophisticated the systems are, the more opportunities there are for a failure.

Over time, the government might consider allowing small carry-overs to the next budget year, in combination of a compensation strategy for next year's budget, in order to secure efficient use of resources over the year-end and to allow budget institutions to reallocate smaller amounts between programmes.

The government should consider reducing the reserve fund in order to increase budget discipline, even if at this stage of development it seems to be well suited for Albania to continue its limited right to exercise reallocations through a centralised procedure.

The MOF should emphasise monitoring actual expenditure against the budget and actual outputs against targets but have less focus on direct links to unit costs in the budget formulation and monitoring. Such an emphasis of performance budgeting would be in line with international best practice. The Albanian performance budgeting system represented by the MTBP and the budget monitoring process is broadly in line with practices in some OECD countries. However, recent international research described in Section 2 indicates that it is difficult to use non-financial performance as a direct tool for budgeting.

Line ministries should take a stronger responsibility of their own budget execution and use the MTBP pro-actively in management and as a basis for internal management and control. This will create better understanding of the interaction between inputs and outputs, better ownership of the results and better reports to the MOF. The management culture should be changed by structural reform and training, and the Civil Service Law should be amended to shift to a performance structure from position-based personnel controls.

The government should continue to pursue professionalism, depoliticisation, meritocracy, transparency and accountability and secure the implementation of approved legislative and institutional frameworks. The roles concerning the design of civil service wages policy and performance elements in wages should be reconsidered in order to allow the MOF a better opportunity to co-ordinate wages policy with fiscal policy. Public administration reform is one of the key measures that Albania has to encompass before EU candidate status is finally granted.

The government should continue to refine the legislative and institutional framework of public procurement and secure training and across-the-board implementation to secure the successful implementation of the modern ICT system for electronic procurement processing. Defence procurement outside the public procurement procedures is a potential major loophole in procurement procedures. In the present work on legislation for PPP and concessions, the MOF should be secured a decisive role to secure value for money while using such instruments.

5. Accountability, control and audit

Many steps have been taken in Albania in recent years to improve accounting and audit. The Organic Budget Law, the Law on the Management of the Budget System in the Republic of Albania 2008 (MBS), came into effect in 2009 and, among other things, provided for the basic organisational structures for a budget institution. These structures were then developed in more detail by the Law on Financial Management and Control 2010. 2010 also saw the introduction of the Law on Public Financial Inspection, which provided for the establishment of a financial inspection service. Also in 2010, the Law on Internal Audit was amended to separate inspection from internal audit and clarify the role of internal audit. As a result, the legal basis is in place for a well-functioning internal financial control system that supports managerial accountability. While putting the principles into practice is a more challenging task, good progress has been made, but much remains to be done. The implementation of these steps is considered in this section.

5.1. *Accounting basis and procedures*

Cash is the accounting basis for the government accounts, although the Treasury system is based on a unified accounting and budgeting classification system that observes GFS 2001 and COFOG classification standards and work is ongoing to adopt aspects of ESA 95. The consolidated report for the executed budget which is submitted to parliament by the Treasury General Directorate of the Ministry of Finance is on a cash basis only.

Throughout the administration, the focus on financial control is one of cash. The MBS makes no provision for any element of accrual accounting at the state level and it provides for the exercise of controls with reference to the cash position. Budgetary control is exerted on the basis of the availability of cash with the Treasury checking the availability of allocations within agreed budget cash limits. This has allowed significant arrears to build up, even though in recent years attempts have been made to record commitments in the Treasury as well. The matter of arrears is discussed in more detail in Section 4.

Steps are being taken to control the build-up in arrears by ensuring that all commitments are recorded in the Treasury system by the end of 2013 and by ensuring that in the future commitments will be recorded in the Treasury system at the initial contract stage. This is being done with the support of an EU-funded project "Support and Expansion of the Treasury System – Albania (SETS)". It remains to be seen how successful this will be in addressing the arrears problem.

However, the MBS provides for modified accruals at the level of the individual budget institutions, which are required to keep their own financial records in accordance with standards set by the Ministry of Finance, and to report them to the Treasury for the purposes of reconciliation. These reports are on a modified accrual basis with expenditures being recorded at the time that the invoice is received as opposed to when the payment is made and revenues being recorded only when they are actually received. The individual reports of the budget institutions are considered to be less accurate than the consolidated report for the executed budget produced by the Treasury.

Albania plans to change its accounting basis to accruals. In 2009, the government approved a policy paper for the gradual adoption of IPSAS over the period 2009-14. To this end, a pilot project involving 5 institutions is currently ongoing and it is planned to include 40 budget institutions by the end of 2014. However, the implementation of a full accrual system will require extending to the Treasury system recording all transactions on an accrual basis as well as on a cash one. It is unclear as to how this can be achieved. Furthermore, there is little evidence to show that even modified accruals information is being used by management in budget institutions to inform decision making. It would therefore be better to concentrate first on eliminating the problem of arrears before progressing to the introduction of full accruals, which is a challenging and complex system. Getting complete information on commitments in order to stop arrears is a higher priority than the adoption of full accruals in an administration which does not have the capacity to use the information a full accrual system provides.

5.2. Reporting

The Treasury is responsible for keeping the state accounts and for the preparation of periodic and annual budget execution reports through the Government Financial Information System (GFIS). Reporting tends to focus on budget accounting, which remains on a cash basis. The compilation methodology underlying the data for the consolidated budget is broadly consistent with the analytical framework of GFS 2001, but the presentation and classification of data are not in the GFS 2001 format.

The MBS Law provides that the annual consolidated budget execution report, approved by the parliament, will be published in the *Official Gazette* before the end of October each year. The law also provides that the report will contain information on the achievement of objectives, and the status of internal financial management control and internal audit. The law further requires for a copy of the report to be sent to the supreme audit institution, the High State Control, which audits the annual consolidated report between February and July.

The Treasury also provides a monthly consolidated fiscal indicators report and a quarterly general government fiscal statistics bulletin. Monthly and annual data on the consolidated budget are published in the quarterly *General Government Fiscal Statistics Bulletin*. Data cover the general government sector. The data are disseminated on the Ministry of Finance's website.

The MBS Law also stipulates that the Minister of Finance will provide the government with a mid-year report in June of each year which analyses the implementation of the State Budget. The analysis includes:

- an assessment of the macroeconomic situation and forecasts;
- a comparison between actual budget outturns and budget projections, with explanations on differences;
- if necessary, proposals for government decisions;
- if necessary, a proposal for a change in the original Budget, along with the rationale as to why the requested changes could not be forecasted in the proposed budget.

However, this report is for information only and is not published unless the government decides to change the original Budget. The production of the report is good practice, but the fact that is not automatically published is not in compliance with the OECD's "Best Practices for Budget Transparency" even though some of the information is published in the monthly "fiscal report" for the end of June.

The Treasury sends monthly budget execution reports to the budget institutions by the end of the first week after the end of the month. The actual budget utilisation is presented largely in the same format as the budget, using the budgeting classification system. General government monthly reports are submitted to the parliament and published preliminarily five days after the end of the month and finally 20 days after.

Although the Treasury system records monthly data for all budget institutions and local governments, it does not yet fulfil a management accounting role and thus provide deeper analysis for managerial purposes in the budget institutions. Budget institutions are still producing their own management accounting records on a largely manual basis, assisted by spreadsheet systems. The pilot project for the adoption of accruals does not make provision for a full financial management information system, which includes supporting management accounting and costing information systems.

5.3. *Public internal financial control*

The legal framework for the introduction of Public Internal Financial Control (PIFC) is set out in the MBS, the Law on Internal Audit 2007 and the Law on Financial Management and Control 2010. These laws provide an adequate legal framework for the implementation of the three pillars of PIFC, namely financial management and control (FMC), a functionally independent internal audit (IA) and a Central Harmonisation Unit (CHU) for developing methodologies and standards for FMC and IA. The key role and responsibility for the development and implementation of PIFC rests with the Ministry of Finance, which fulfils its role through the operations of the Central Harmonization Unit of Financial Management and Control (CHU/FMC), the Central Harmonization Unit of Internal Audit (CHU/IA) and the Financial Inspection Service in co-operation with units in the budget institutions.

5.3.1. *Financial management and control*

The CHU/FMC is separate from the CHU/IA. The CHU/FMC is a directorate consisting of a director and five specialists. It co-operates with the Treasury Department and the Budget department. It has prepared standards for budget preparation, budget execution, risk management, management of assets, and audit trails on public procurement. Its main functions are to:

- establish and co-ordinate laws, strategies and methodological guidelines for financial management and control (including accounting);
- provide training;
- monitor financial management and control in public sector bodies, as part of which it annually reviews the instructions for FMC.

The CHU/FMC has worked to develop a better understanding of the legislation and the principles of internal control throughout the administration. For instance, training in risk management was provided through a Twinning Project of 2008-10. Despite this work, however, the CHU/FMC identified many weaknesses in its Annual Report for 2011 on "Functioning of internal public financial control system at general governance units".

The report highlights the fact that there is only a narrow understanding in many institutions of the full implications of the introduction of FMC and the concept of managerial accountability. This narrow understanding reflects the traditional administrative arrangements in Albania where there has been little evidence of downward delegation of responsibility and authority. This narrow understanding impacts on the implementation of the internal control arrangements. For instance, the MBS Law provides for the appointment of an executing officer to whom the head of the budget unit delegates responsibility for the implementation of the financial management rules, for keeping the accounts and for the preparation of financial statements. However, in practice the decision-making responsibility remains largely with the head of the budget (authorising officer).

Furthermore, there is no finance director role as such in Albania and the responsibilities of that role are divided among several officials. The official responsible for the co-ordination of budget formulation and the executing officer are two different functions. Executing officers are usually only responsible for one part of a budget institution's activities and there is no overall executing officer responsible for the overall financial management and control of the whole organisation (i.e. covering both first- and second-level spending units). This is despite Article 20 of the MBS, which states that "the executing officer shall be designated by the authorising officer for the implementation of the financial management rules, keeping the accounts and for preparation of financial statements".

The focus of financial control is to ensure that spending does not exceed budgetary limits (and with those limits monthly cash flow limits agreed with the Treasury) rather than to achieve performance targets within the budget limits. Internal reporting is mainly financial and does not contain information about management performance.

The arrangements for control and accountability that should apply between first- and second-level spending units, regardless of the size of the second-level body, are not defined in the MBS or the FMC Law. The State Administration Law 2012 seeks to put a reporting structure in place for the administration but does not provide a satisfactory structure for FMC and managerial accountability between the first- and second-level budget institutions. Moreover, the MBS Law provides that the authorising officer in a municipality should be the mayor. It would be normal for the authorising officer in a municipality to be the most senior appointed official rather than the elected mayor – at least in the larger municipalities.

5.3.2. *Internal audit*

5.3.2.1. Central Harmonisation Unit/Internal Audit. The CHU/IA is a general directorate consisting of two directorates, one responsible for monitoring the quality of auditing in all budget institutions and the other responsible for the professional development and certification of qualifying auditors. The total number of staff is 12; one directorate is comprised of a director and six specialists and the other directorate consists of a director and four specialists.

The CHU/IA organises training and certifies auditors, and drafts instructions, manuals and methodologies for the budget institutions. For example, in 2010, with the assistance of an EU project, it produced the 183-page *Manual of Internal Audit*. This manual has helped to improve the quality of internal audit. It explains the importance of annual audit planning and explains that it should be based on risk so that the internal audit unit focuses its efforts on systems or areas where the greatest potential exists for things to go wrong. It also explains that risk assessment is carried out during the entire audit. It emphasises that the responsibility for setting the plan rests with the internal auditors. Nevertheless, the quality of IA still needs further improvement. The *Manual* has helped with regard to the methodological framework but it is still a general manual and IA units require practical guidance.

The CHU/IA is responsible for ensuring the quality of the budget institutions' internal audit function. After each monitoring assignment, it delivers a report which identifies areas for improvement in that unit. The CHU/IA prepares a consolidated annual report for all IA activity in the public sector and submits it to the nine-member Internal Audit Committee appointed by the Minister for Finance, which then submits it to the minister who in turn submits it to the government. The CHU/IA recognises that the external quality assessments which it carries out need to be brought into line with international professional standards and it is working to achieve this.

The Law on Internal Audit requires co-operation between internal audit and external audit to avoid duplication of responsibility. The law provides that the CHU/IA will collaborate and maintain continuous contact with the HSC with the objective of exchanging all relevant information relating to audit through annual reports and annual plans, and joint training for internal and external auditors. In order to increase the effectiveness of this co-operation, a formal agreement between the Minister of Finance and the HSC became effective in May 2012.

5.3.2.2. Internal audit in the budget institutions. Any budget institution with three or more spending units is required by law to have an internal audit function. Whether a second-level user has an internal audit function is based on a government decision. Although each ministry should have an internal audit function, small ministries – as well as independent organisations – may contract larger ministries for audit services. For example, the Ministry of Integration only has 50 staff and contracts with the Ministry of Finance for internal audit. In the case of entities contracting for internal audit, there is a legal requirement that each entity should be audited at least once every two years.

Internal audit units are expected to provide management with quarterly and annual summarised information, including explanations about audit assignments that have been completed in accordance with their annual plan. They should present conclusions on the internal control system with recommendations for improvement, as well as information about actions taken by management to implement previous recommendations, including the reasons why any recommendations were not implemented.

The internal audit area has benefitted from technical assistance training in recent years. The number of internal auditors that have been certified is 1 200, with 300 more in the process of certification. Not all, however, are practicing as internal auditors. There are 406 internal auditors in 124 internal audit units, including 13 of the 14 ministries. A new strategy for the training and certification of internal auditors is being developed by the CHU/IA with the support of SIGMA. This new strategy is expected to improve the system of certification and the training programme.

In accordance with the Law on Internal Audit, internal audit is an independent activity that is separate from the management role. Accordingly, it should be clear that the head of an IA unit should report directly to top management and should not be part of the management team. Also in accordance with the law, internal auditors in ministries or municipalities report directly to ministers or mayors respectively. In a second-level budget institution, the internal auditor reports to the top-level official of that body, and a copy of the report is sent to the management of the responsible first-level user.

Amendments in 2010 to the law and the new Law on Financial Inspection 2010, separating inspection from internal audit, have helped to clarify the role of internal audit as a support to management. There is more awareness among top officials of the purpose of internal audit. Although ministers and mayors are still asking IA units to carry out financial inspection-type activities despite the establishment of a specific financial inspection function in the Ministry of Finance, as awareness is raised it seems that these instances are declining.

5.3.3. *Financial inspection*

The Directorate of Public Financial Inspection was established under the provisions of the Law on Public Financial Inspection 2010. The focus of the directorate is on anti-corruption in all budget institutions. Under the law, the directorate is limited to a small co-ordinating team with the power to "call on" selected officials from other ministries on an ad hoc basis. It consists of a director and five staff. There are 125 inspectors throughout the administration who submit reports to the directorate, which is responsible for ensuring the quality of their work.

Inspections are usually carried out after a request from the authorising officer of a first-level budget institution in response to concerns about fraud, corruption or bad management. They can also be carried out through an impromptu investigation based on information from a member of the public or a whistle-blower, although anonymous requests are not acted upon. All budget institutions are subject to inspection and donor funds can also be inspected. Overall, the directorate has received about 150 requests for investigations since its establishment. It has considered 29 cases, completing 8 inspections and with 5 investigations still ongoing. It has not taken any action in 16 cases. It has proposed 33 disciplinary measures and 24 corrective actions to be taken.

The directorate produces an annual report which is not officially published but is made available on request. Results are reported to the supreme audit institution, the High State Control.

The directorate has two main problems with which to contend. The first is that the powers of the directorate under the Law on Financial Inspection are unclear, which hinders its ability to give guidance to inspectors and to comment on reports. The second relates to the powers of the Minister of Finance as set out in the law. It is unclear whether the minister is limited to only providing "advice" on the results of an inspection or whether he can take "decisions" as well. In order for the directorate to become more effective, clarifications in these areas are needed.

5.4. *External audit*

5.4.1. *Legal framework*

The legal framework for external audit is provided through Articles 162-165 of the Constitution and the Law on the High State Control 2000 which set out the legal basis for the mandate and organisation of the supreme audit institution, the High State Control (HSC). Under Article 164 of the Constitution, the HSC reports to the national parliament. The legal basis is generally sufficient to guarantee the independence of the HSC, which as well as auditing the consolidated report for the executed budget, may audit all public sector institutions without limit and carry out all types of audits. For instance, during 2011 the HSC carried out audits in the Ministry of Defence, the Ministry of the Interior and in the General Directorate of the State Police. In recent years, there have been suggestions that the Law on the High State Control be amended to allow for dismissal of a chairman before his or her term of office ends. Although this has not yet been submitted formally to the parliament for consideration, even the suggestion could potentially affect the independence of the Chairman, and the HSC in general.

The Law on the High State Control requires audited institutions to take necessary measures following the HSC's recommendations. Furthermore, an order of the Prime Minister from 2006 requires the budget institutions to implement the HSC's recommendations as soon as possible and in the event of non-compliance it directs that there shall be administrative sanctions.

5.4.2. *Role of the national parliament*

The HSC reports to the national parliament through the Parliamentary Committee on Economy and Finance. It submits two main reports:

- an annual report of its own activities, which is submitted within three months of year end;
- the Report on the Implementation of the State Budget, which is submitted within nine months of year end.

The Report on the State Budget is presented along with two associated reports, one containing the HSC's opinions on the government's report for expenditures of the previous year and the other reporting on FMC and IA. The Chairman of the HSC and the Minister of Finance appear before the parliamentary committee in October to discuss these reports. The committee has the power to:

- produce a draft Parliamentary Resolution on the HSC's annual report on its own activities that is debated and approved in plenary session;
- scrutinise the HSC's report on the execution of the State Budget before the government submits the draft law for the upcoming annual State Budget to parliament;
- consider particular audit reports on specific request from a member of parliament or the Prime Minister.

The HSC's relations with the Parliamentary Committee on Economy and Finance are limited to the discussion on the annual activity report of HSC and the annual report on the budget execution. The committee does not deal with individual audit reports, and ideas to establish a separate body or subcommittee to deal with those reports have not materialised. Furthermore, despite requests to do so from the Chairman of the HSC, neither the committee nor the parliament have appointed an independent body to audit the accounts of the HSC, as foreseen in the Law on the High State Control. Instead, the HSC's own internal auditors audit its accounts, which is not appropriate.

5.4.3. *Structure of the HSC*

The HSC currently has 156 staff, of which 110 are auditors. It has recently intensified its requests for additional funding in order to fill existing vacancies. In the past year, the development of the HSC has been more intense than the previous few years when the pace of development was slow. During that time, it proved to be a challenge to maintain the level of quality achieved after the 2007-08 twinning project, and even more to further develop audit quality and audit impact.

In 2012, the HSC was reorganised in order to better comply with INTOSAI standards. It has established a Performance Department; a Department of Research, Development and IT; and a Directorate of Audit of State Budget and of Public Financial Management. In order to carry out its mandate more effectively, it is trying to improve the quality of its auditors' work by way of internal training programmes and training offered by peer organisations and specialised training centres both within Albania and abroad. A comparison for the first nine months of 2012 shows that there was a sevenfold increase in training days over the same period in 2011. The HSC has benefited from support from SIGMA as well from the United Kingdom's National Audit Office and the Courts of Audit in Slovenia, Poland and the Netherlands.

5.4.4. *Audits carried out by the HSC*

The HSC carries out all of the main types of audit as defined in the INTOSAI standards, but the vast majority of its audits deal with the financial inspection type of regularity/ compliance issues. This is shown by Table 9, which shows details of audits carried out between 2010 and mid-2012.

Reports on compliance audits list non-compliance issues with all of the necessary details for the management of the entities to follow up on recommendations from the HSC. The impact of audit reports therefore depends on the reaction of the auditees. The percentage of the compliance-related recommendations implemented by auditees has

Table 9. **High State Control audits by type**

	2010	2011	1 January-30 June 2012
Performance audit	3	1	2
Financial audit	17	10	10
Compliance/regularity audit	128	132	73
Other	5	9	6
Total	**153**	**152**	**91**

increased over the years, demonstrating both a growing acceptance by auditees of the recommendations and the HSC's increased ability to provide them.

However, performance audit-related recommendations, which could increase the impact of the HSC, are still too low. Indeed, the development of performance auditing has stagnated in recent years. Performance audit was developed during a 2007-08 twinning project, when the number of performance audits carried out annually reached seven. The HSC recognises that further development of performance auditing is needed. However, despite a number of pilot performance audits being carried out in recent years, there is a lack of information that would enable performance audits to be carried out to required international standards. It is intended to conduct a pilot performance audit of the National Statistics Office that will comply with required standards and will develop a methodology that can be used more widely. The HSC wants to follow the process used in Slovenia where 60% of 80 performance audits were IT audits. With procurement being 100% IT based and with the Treasury system being IT centred, this is important and the HSC has been trying to develop skills in this area with the support of SIGMA, who has provided training on IT auditing.

In the area of financial audit, the audit activity has been limited since it is unclear as to whether the HSC can issue an opinion following the audit. The Constitution allows the HSC to give opinions as part of financial audits but the Law on HSC does not. The HSC was hoping that the law would be amended in early 2013 to provide such a power as it has auditors qualified to issue opinions and they have already been working on a pilot basis with some institutions in this field.

Since all public institutions and local governments, including all public enterprises or companies in which the state holds a majority interest, are subject to audit by the HSC, financial and compliance audits cannot be carried out on all subjects on an annual basis. Approximately 50% of all potential auditees are covered annually, representing around 70% of the public budget. The selection of auditees takes place on the basis of criteria covering the volume of budget, the number of employees, risk and results of previous audits, with the principle of covering each bigger entity at least every two years. The most recent audit on the execution of the State Budget used data from about 80 institutions out of a total of 153. Furthermore, about 60 audits of local governments are performed each year out of 65 municipalities and 308 communes. This approach is appropriate given the resources available to the HSC at the present time.

5.5. *Conclusion*

The adoption of a full accrual system of accounting is less important than controlling arrears and recording commitments. Getting complete information on commitments in order to put an end to arrears should be a higher priority than the adoption of full accruals in an administration that does not have the capacity to use the information a full accruals system provides.

More emphasis should be placed on practical improvements to the system of financial control and audit. While positive steps have been taken in these disciplines over the past few years, many of the steps have been in the field of legislation and regulation. This provides a basis for these disciplines but is not sufficient in itself to ensure successful implementation.

The Albanian authorities should aim to raise the level of understanding throughout the administration as to what financial management and control and managerial accountability actually mean. Despite a reasonable legal framework for the introduction of FMC and despite the efforts of the CHU/FMC in promoting the new FMC Law, there is a poor understanding in Albania of what FMC and managerial accountability mean in practice. Responsibility for decision making is mainly centred on the head of the budget institution with very little delegation of tasks. This is an issue which will take time to improve as the traditional administrative arrangements cannot be changed overnight.

One step towards developing more delegation would be that the official responsible for the overall financial management and control of the finances of the spending unit should be positioned at the highest levels of management and report directly to the authorising officer. This is what the FMC Law of 2010 requires, but it does not happen in practice. The solution to this problem may be a redefinition of the role of the executing officer.

There should also be emphasis on achieving performance targets within budget limits in the budget institutions. This does not happen currently since the focus of reporting is mainly financial and does not contain information about management performance. Despite the work that has been invested in improving the Treasury system over the past decade, it continues to exist as an accounting system for transaction control, cash-flow management, and formal accounting and budget reporting purposes.

In the field of internal audit, the internal audit units need more practical guidance to perform their work more effectively. Therefore, the formal co-operation agreement between the Minister of Finance and the HSC, which became effective in May 2012, and the strategy for the training and certification of internal auditors that is currently being developed by the CHU/IA with the support of SIGMA, are both positive developments. However, these are both at the early stage and it is too early to say how effective they will be. Furthermore, the CHU/IA could ensure that the implications of internal audit for financial management and control policy are reflected in the training of internal auditors, as this is not already being done.

The law should be amended to clarify the role of the Directorate of Public Financial Inspection and the Minister of Finance with regard to financial inspections. Despite the likelihood that the establishment of the directorate should see a reduction in the cases of internal audit units being asked to carry out financial inspection type activities (especially as it becomes more well-known), there are still cases where this is happening. This should be investigated and the directorate and the CHU/IA, if necessary, should put an emphasis on training the top management of public institutions such as ministers, general secretaries and their deputies, directors of agencies, heads of directorates and heads of departments, in the objectives of internal audit. Managers should be aware as to the difference between an internal audit unit providing top management with advice about corrective actions and the top management taking responsibility for ensuring that the necessary corrective action is implemented.

The HSC should move beyond a concentration on regularity/compliance audit. The HSC recognises this and is taking steps to improve its capacity for performance audit, but it eventually will need to save resources on compliance audit by reducing the audit procedures and applying professional audit sampling techniques.

Finally, an independent body to audit the HSC's accounts should be appointed by the parliament as foreseen in the Law on HSC.

Notes

1. The percentages are estimates made by CIA (2012); there are no available current statistics on religious affiliation; all mosques and churches were closed in 1967 and religious observances prohibited; in November 1990, Albania began allowing private religious practice.
2. Under the United Nations Security Council Resolution 1244/99.
3. The EU *acquis* is the accumulated legislation, legal acts and court decisions that constitute the body of European Union law.
4. IMF Article IV Consultation, October 2011. See Box 3 "Public Finance Sustainability and Options for Fiscal Rules in Albania".
5. *www.osce.org/albania/41888*, 1998 Constitution of the Republic of Albania, text approved by referendum on 22 November 1998 and amended on 13 January 2007; translated under the auspices of OSCE–Albania.
6. Chapter III, "Consideration of Budget Bill and Financial Law".
7. Article 19, Rules of Procedure of the Republic of Albania.
8. Article 35, Rules of Procedure of the Republic of Albania.
9. See Public Expenditure and Financial Accountability (2012: 109-10).
10. According to Article 29 of the Organic Budget Law, the Minister of Finance must provide a statement to the Assembly, including a list of spending units according to the general government units to which they depend; respecting and implementing correctly the principles described in Article 4 of this law by the annual budget and the Medium Term Budget Programme; harmonisation of debt stock and forecasts with the objective of fiscal stability; fiscal risks and measures of protection; contingent liabilities of the general government and the probability of becoming liabilities in the following budget year.
11. Article 80, Rules of Procedure of the Republic of Albania.
12. Article 81 (IV), Rules of Procedure of the Republic of Albania says that the report must contain a complete evaluation of the entire structure of the bill like the macroeconomic indicators, the main indicators, the incomes and planned expenses, financing and their accomplishment according to the programme of the Council of Ministers.
13. Organic Budget Law, No. 8379 of 29 July 1998 on the Preparation and Execution of the State Budget of the Republic of Albania; *www1.worldbank.org/publicsector/pe/BudgetLaws/AlbaniaOrganicBudget1998.pdf*.
14. It contains: annual consolidated accounts for state financial transactions; a report on the implementation of the annual budget according to approved funds; a report on public debt and its composition; a report on the use of the reserve and contingency funds; information on the achievement of objectives, status of financial management and internal control; as well as an internal audit.
15. Law on State Borrowing, State Debt and State's Loan Guarantees in the Republic of Albania (No. 9665/2006) and on the Management of Foreign Financing in the Republic of Albania (No. 775/2010).
16. The monitoring reports include five different tables: factual programme expenditures reported by line item; outputs factual materialisation; factual expenditures of products; budget investments (projects); foreign investments (projects) factual expenditures; total factual expenditures by programme.
17. The line ministries in Albania are: Agriculture and Food; Defence; Economy, Trade and Energy; Education and Science; Environment and Water; European Integration; Finance; Foreign Affairs; Health; Internal Affairs; Justice; Labour and Equal Opportunities; Public Works, Transport and Telecommunications; Tourism, Culture, Youth and Sport.
18. The government effectiveness indicator captures perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies. The *Worldwide Governance Indicators* (WGI) are a research dataset summarising the views on the quality of governance provided by a large number of enterprise, citizen and expert survey respondents in industrial and developing countries.

19. The legal foundation for public procurement in Albania is the Law on Public Procurement (LPP) No. 9643 of 2006, with two amendments in 2007 and one in 2009, culminating with amendment No. 10309 of July 2010.

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ANNEX A

Summary of recent reviews of Albania

Debt Management Performance Assessment (DeMPA), Albania, June 2011

A World Bank team conducted an assessment of Albania's debt management performance in November 2010. It found in summary that "Albania stands out as one of the few (countries) which has sound debt management practices in the largest number of areas defined by the DeMPA methodology". Debt management is particularly strong in the areas of governance, strategy development, co-ordination with fiscal and monetary policy and domestic market borrowing. Areas for improvement are external borrowing and some parts of the operational risk management framework. There is no systematic tracking of foreign holding of the government securities issued in the domestic market.

Albania 2012 Progress Report, European Commission Staff Working Paper, October 2012

In October 2010 the European Commission adopted a progress report on enlargement of the EU. The EC recommended that Albania be granted EU candidate status subject to completion of key measures in the areas of judicial and public administration reforms and the revision of parliamentary rules of procedure. The report further found that Albania needed to develop tools to fight against tax evasion and fraud. Overall, it viewed Albania's financial and budgetary provisions to be at an early stage.

Public Expenditure and Financial Accountability Assessment (PEFA), January 2012

The PEFA report is the second PEFA assessment of Albania's public finances; the first was carried out in 2006. The assessment found that "The government of Albania had made significant progress across a wide range of the performance indicators since the 2006 assessment". Highlights of the findings include:

- *Credibility of the budget:* GDP and revenue forecasts have been consistently overly optimistic. Differences between budgeted and actual expenditures were rated as "A"; differences between budgeted and actual revenue as "D". Revenue estimates were not credible, anecdotal evidence of arrears.
- *Comprehensiveness and transparency:* budget information is not sequenced well to support parliament.
- *Policy-based budget:* the Albanian government has made considerable efforts to integrate planning and budget processes, which have been undermined by external shocks and

the government's response to the shocks. Expenditure targets for investment programmes have been set at overly optimistic levels despite past poor performance.

- *Predictability and control in budget execution:* substantial improvements in revenue collection, controls on non-payroll expenditures are primarily *ex ante* voucher checking with little internal audit, procurement has been fundamentally altered since the 2006 assessment. Internal control and internal audit require time and patience to improve.

2011 Article IV Consultation, Albania – IMF Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Albania

The August 2011 IMF staff report found that Albania required more realistic budgeting and recommended an expenditure-based fiscal rule tied to public debt reduction over the medium term.

Improving and Integrating Cash and Debt Management, IMF, Fiscal Affairs Department, December 2012

Albania has taken several steps to improve its cash and debt management. The credibility of the annual budget is particularly hampered by an optimistic bias in the revenue assumptions. Commitments that are not covered by appropriations lead to arrears that distort cash management. At present, no effective cash plans are produced by Treasury to assist in cash management. Revenue agencies must be encouraged to provide realistic cash plans. The Ministry of Finance should ensure that line ministries develop reliable baseline estimates and present consistent baseline estimates in the medium-term budget documents.

Support for Improvement in Governance and Management: OECD SIGMA Assessment, March 2012

The basic administrative legal framework and civil service system are in place, but have many shortcomings, among them:

- *The organisation of the central administration is too fragmented*. The current Civil Service Law does not promote a merit system.
- The Integrated Planning System at the heart of the public expenditure management is complex, but in practice inefficient. The planning system leads to a lot of paperwork and may overtax the limited staff available.
- *The difference between baselines and ceilings is not understood*. Baselines should be empirical estimates of the future costs of current policy and ceilings should be normative constraints on future expenditures. There is a lack of control of baseline estimates both inside line ministries and in the Ministry of Finance.
- *A legal framework for public internal financial control is in place.* Internal audit is separated from financial inspection, but ministers and mayors still request confuse the two functions.

Abbreviations and acronyms

ALL	Albanian lek
AMOFTS	Albania Ministry of Finance Treasury System
AO	Authorising officer
BAPPD	Budget Analysis, Policy and Programming Directorate
BMMD	Budget Management and Monitoring Directorate
BoA	Bank of Albania
CHU	Central Harmonisation Unit
CoM	Council of Ministers
DoPA	Department of Public Administration
DP	Democratic Party
DSDC	Department for Strategy and Donor Co-ordination
EFP	Economic and Fiscal Program
EPAP	European Partnership Action Plan
EU	European Union
FAO	First Authorising Officer
FDI	Foreign direct investment
FMC	Financial management and control
GDP	Gross domestic product
GFIS	Government Financial Information System
IA	Internal audit
IFC	International Finance Corporation
IFRD	Intergovernmental Fiscal Relations Division
IPA	Instrument for Pre-Accession Assistance
IPS	Integrated Planning System
LGU	Local government unit
MBMD	Management and Budget Monitoring Division
MBS	Management of Budget System Law
MFPD	Macroeconomic and Fiscal Policy Department
MEI	Ministry of European Integration
MFF	Macroeconomic Fiscal Framework
MOF	Ministry of Finance
MTBP	Medium Term Budget Programme
MTEFP	Medium Term Economic and Fiscal Programme
NSDI	National Strategy for Development and Integration
OECD	Organisation for Economic Co-operation and Development
PEFA	Public Expenditure and Financial Accountability Assessment
PEIP	Programme expenditure and investment planning
PEM	Public expenditure management

PFS	Public Finance Strategy
PIMD	Public Investment Management Directorate
PMT	Programme Management Team
PPP	Public-private partnership
PPR	Programme Policy Review
PPS	Purchasing power standards
RMBEF	Report on Macroeconomic and Budgetary Assessment and Forecast
SAA	Stabilization and Association Agreement
SAI	Supreme audit institution
SIGMA	Support for Improvement in Governance and Management
SMG	Strategic Management Group
SMI	Socialist Movement for Integration
SP	Socialist Party
SPC	Strategic Planning Committee
TSA	Treasury Single Account

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