Chapter 2

Budgeting as a tool for strategic agility

One of the pillars of strategic agility is resource flexibility; that is, the ability to quickly and flexibly reallocate resources from one area to another when priorities or needs change. The overall trend in recent years has been to decentralize budgets and give more freedom to line ministries in managing their resources; this can create "information gaps" that may hinder resource flexibility for the whole of government. There are several mechanisms that can be used to introduce more flexibility, including top-down budgeting, spending reviews, performance budgeting and automatic cuts of productivity dividends. The 2008 financial crisis created a need for urgent action on fiscal consolidation in many countries, leading governments to re-centralise or fast-track, at least temporarily, some budgetary decisions. This chapter looks at lessons learned from the crisis in terms of budgeting, as well as the use of the above-mentioned mechanisms and their potential for increasing strategic agility.

Introduction

In order to put strategic agility into practice, governments need to be able to quickly and flexibly reallocate resources from one priority to another. This chapter will address this particular dimension of agility, from managing the reallocation of resources in the public sector through the use of budgetary tools. While this chapter encompasses broad strategies of readjustment, it does not address how to increase the share of spending over which governments have discretionary spending authority (i.e. excluding entitlement expenditures).[1] Many governments have already greatly increased budget flexibility in recent years by decentralising the budget process and giving line ministries more freedom to manage their own resources. This practice provides line ministries with the means to reallocate resources between programmes under their sectoral responsibility. This decentralisation of responsibility has helped to align the incentives for ministries to better manage their budgets and to innovate in order to make the best use of limited resources. Across government, however, it can actually reduce strategic agility as it limits central budget authorities' (CBA) knowledge of the different programmes and therefore their ability to make reallocation decisions between sectors and ministries in line with changes in policy objectives or context.

The CBA, as the chief executive's or Cabinet's financial secretariat, is responsible for ensuring budget or resource agility in support of strategic agility. To this end, it must be able to ensure that budget processes are linked to the mechanisms for setting priorities, clarifying objectives, ensuring accountability for the use of resources, and collecting information on the extent to which programmes support intended objectives. The question therefore is: how can this be done?

The role of budgeting procedures and tools to strengthen public sector agility

Various budgeting procedures and supportive budgeting mechanisms are being used to foster budget agility, which in turn supports overall public sector agility. It is important, especially in a crisis situation, to distinguish between the short- and the medium-term challenges that need to be addressed. In the short term, immediate measures are needed to adapt the level of spending to reduced revenue, shrink budget deficits and curb government debt. On the other hand, there is always a medium- and long-term challenge in budgeting to sustainably create "fiscal space" for new policy initiatives, for strategic changes of policy and for accommodating the increasing demands of society. Table 2.1 presents the different budgeting measures that a CBA may use to reallocate resources and to keep the budget agile.

Table 2.1. **Summary of budgeting mechanisms for strategic agility**

Budget measure	Perspective of budget agility		
	Short-term challenges	Medium-term challenges	Long-term challenges
1. Top-down spending cuts	A very relevant measure for immediate budget cuts	A relevant measure for sizeable budget cuts in out-years	A less-relevant measure for sustained spending cuts
2. Spending reviews	Strategic spending reviews may provide directions for cuts	Efficiency spending reviews provide useful guidance for cuts and reallocations	Both strategic and efficiency spending reviews are relevant
3. Performance budgeting	Performance data may guide the strategic orientation of spending cuts	Output and outcome data are useful for the governance of agencies, but used less for resource allocation	Outcome data may guide long-term programme developments
4. Automatic cuts in productivity dividends	Not relevant for sizeable, immediate spending cuts	A relevant measure for limited annual reallocation	A very relevant measure for ongoing focus on reallocation

When using **top-down spending cuts**, the Ministry of Finance, acting on a mandate from the chief executive or Cabinet, allocates a reduced (compared to the baseline) budget allocation without the conventional participation of and negotiations with line ministries. This is a budgeting mechanism ideally suited to overcome short- to medium-term fiscal challenges. Experience from the financial crisis shows that, in dire situations with large fiscal deficits and rapidly mounting public debt, decisions may need to be made quickly in order to react to market pressures, changing macroeconomic conditions, public opinion or the general credibility of fiscal policy. Top-down spending cuts are in a sense used for short-term emergencies, while other tools such as spending reviews or performance budgeting can be used in the medium or long term. Most OECD countries that have introduced substantial fiscal consolidation measures have extended their austerity policy into the medium term (OECD, 2012c).

However, imposed top-down spending cuts may not be a viable mechanism for resource allocation in the long run in a decentralised. To ensure that all relevant information is taken into account before allocating resources, a conventional budget procedure and a larger degree of collaboration between the CBA and the line ministries is required.

Spending reviews are 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. An efficiency review seeks to identify how an existing government service or programme can be delivered with fewer resources. Strategic reviews assess both the objectives of policies and programmes as well as the efficiency of spending. The ultimate objective of strategic reviews is to prioritise programmes on the basis of policy objectives and/or performance.

Spending reviews may be a viable budgeting mechanism in the short, medium and long term, but the emphasis differs in each case. Most governments that have introduced major fiscal consolidation have used spending reviews and expert groups to guide the directions of the austerity measures. Some countries also conduct spending reviews to develop options for a political change of direction (e.g. after elections). For short- and medium-term policy changes, a strategic review may provide important information for the future direction of fiscal consolidation. The short- and medium-term challenges for the government will be deciding which measures will contribute to budget cuts with minimal effects on economic growth and limited implications for employment and social equity. In such a situation, it may be important to study the strategic orientation of programmes before taking any decisions on cuts.

If budget cuts are to be sustainable in the long run, such information is even more essential. While spending reviews look at the performance of government programmes, they differ from the ordinary operation of performance budgeting systems in that they are more likely to use in-depth evaluation results rather than based only on indicators. This additional information on programmes allows efficiency reviews to identify efficiency gains and areas for institutional development, the adoption of information and communication technologies (ICT), process reengineering, etc., in order to achieve those gains. Such changes may take years to implement but could provide substantial fiscal space for reallocations down the road. Spending reviews are also tailored to a specific political need at a particular time, and usually have a limited time to produce operational recommendations. While spending reviews may be carried out regularly, of a particular area will usually not be reviewed c more than once every few years.

Performance budgeting focuses on how output and outcome information is used in budgeting for resource allocation. Performance budgeting is widely implemented in OECD countries, but there is currently no consensus how best to use it. The OECD has identified three broad categories of performance budgeting:

- presentational performance budgeting,
- performance-informed budgeting, and
- direct performance budgeting (formula-based budgeting).

Performance targets on output and outcome levels provide important information about the strategic direction of programmes. The results against such targets indicate whether or not and to what degree programmes are effective and efficient. Regular (annual) performance reports from programmes and government institutions as well as programme evaluations may provide important information to line ministries and the CBA that may be useful for centre-of-government discussions on long-term policy changes with implications for programmes. . Performance information on the strategic direction of programmes may also be one of the various inputs of spending reviews. However, country experiences so far indicate 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 by Ministries of Finance. For programme managers, spending unit heads and line ministries, performance information is important in both the short and the long run. It 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 accountability of the government.

Automatic productivity cuts or efficiency dividends are initiatives in which assumed productivity gains in the production of goods and services in kind are centrally deducted from line ministries' budget allocations. Normally, automatic productivity cuts/efficiency dividends apply to the operational expenditures of central government. The size of these automatic cuts is usually around 1-2% per year. This provides a rather limited amount for annual reallocation, around 0.5% of the total central government budget of a typical OECD country. However, in the longer term, the cumulative total of such cuts amount to substantial sums. In addition to providing medium- and long-term continuous funds for reallocation, the main advantage of automatic productivity cuts is that they make the spending units focus on efficiency and strive to continuously and systematically improve. The greatest potential for budget agility in governments over the medium- and long-term lies in well-designed spending reviews that draw on performance information and are supplemented by automatic productivity cuts. This, in turn, requires other standard budgetary institutions to be in place, such as top-down budgeting, medium-term expenditure frameworks (MTEF), a strong central budget authority, etc.

The following sections will address the lessons learnt from the use of the first three key tools from Table 2.1).

Top-down spending cuts and revenue enhancements: Lessons learnt from the financial crisis

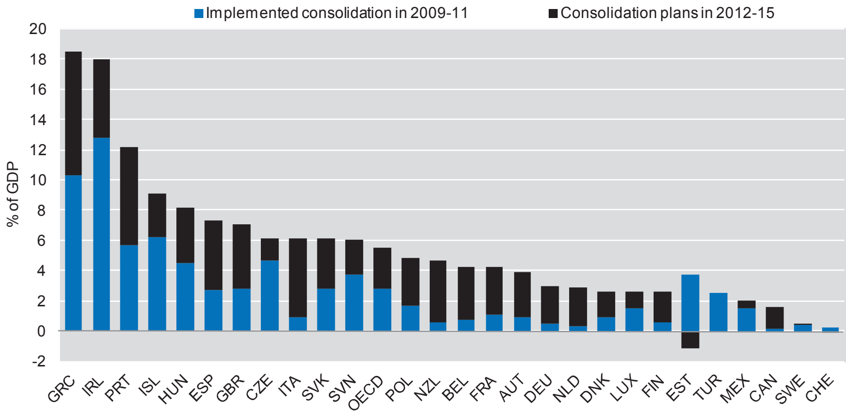
In the aftermath of the global financial crisis and the fiscal stimulus efforts that followed, most OECD countries have adopted fiscal consolidation programmes that reduce and reallocate expenditures both at the national and sub-national levels.

Central planning of fiscal consolidation

Between 2009 and 2011, OECD countries carried out fiscal consolidation of 2.8% of GDP and are planning an equally large effort of fiscal consolidation between 2012 and 2015 (Figure 2.1). Two-thirds of the fiscal consolidation is expenditure reductions; countries rely mostly on programme expenditure measures over operational ones in their efforts to reduce budget deficits and curb government debt. Welfare, healthcare, pensions and infrastructure are the four most frequently targeted programme areas for consolidation (OECD, 2012a).

The consolidation efforts that most OECD countries have planned and implemented since the financial crisis in 2008 five years ago have been decided under extraordinary circumstances. Such large expenditure reductions and reallocations often require the Ministry of Finance, Council of Ministers and parliament to take tough top-down decisions. For example, the Estonian government decided that the timeframe for taking decisions and making changes was very short. The Ministry of Finance prepared the consolidation plan and the main discussions were held in the Cabinet. Special working groups of academics were temporarily created to provide advice to the Cabinet. The Cabinet discussed the 2009 supplementary budget focusing on fiscal consolidation in a total of 37 meetings, and also discussed the 2010 budget and the 4-year medium-term budget strategy at the same time. The Parliament approved the consolidation measures during the process of approving annual/supplementary budgets. In addition, 29 laws were modified as part of the negative supplementary budget in 2009 (OECD, 2012b).

Figure 2.1. **Implemented (2009-11) and planned (2012-15) fiscal consolidation**



Notes: The data are the sum of annual incremental consolidation from 2009/10 until 2015 as reported by the national authorities.

Source: OECD (2012a), *Restoring Public Finances, 2012 Update*, OECD Publishing, Paris, http://dx.doi.org/10.1787/9789264179455-en.

One-third of OECD countries reported in the 2012 OECD Fiscal Consolidation Survey that they used expert committees in the process of planning fiscal consolidation measures. Expert committees may be academics (e.g. Estonia and Slovenia), experts from international organisations (e.g. Greece, Iceland and Portugal), civil servants (e.g. Hungary), an appointed commission (e.g. Italy) or an existing group that normally contributes to the budget formulation process (e.g. Belgium and Canada). Expert committees may be more *ad hoc* and differ from spending reviews (see next section) both in purpose, composition of members and timeframe, although some countries used their ordinary spending reviews to develop their fiscal consolidation packages (e.g. Ireland and the United Kingdom).

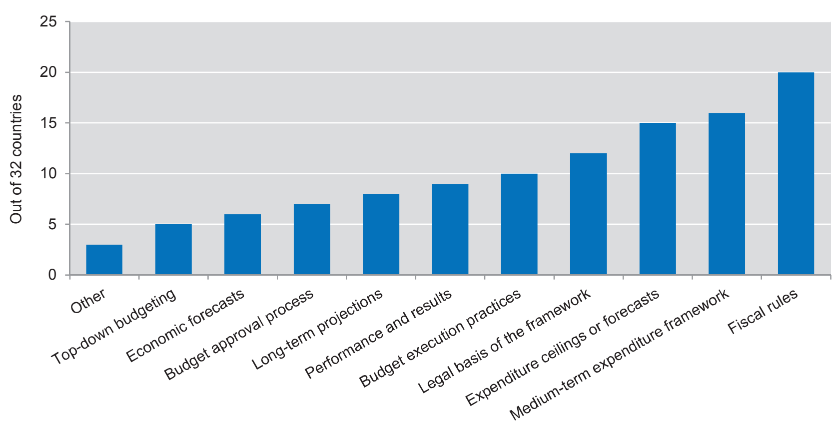
Three countries reported that the consolidation plan was based on a political agreement while one-fifth of countries indicated that they had followed a normal budget procedure while developing the fiscal consolidation plan. Nonetheless, the process of adopting and implementing fiscal consolidation plans resulted in a change of government in about one-third of the OECD countries (OECD, 2012b).

Taking the opportunity to change the institutional budgetary framework

Most OECD countries have taken the opportunity of the financial crisis to introduce changes in their institutional framework for budgeting. Twenty-seven countries reported such changes in one or more areas during 2008-12, and ten changed their framework in five or more areas. While many of these changes are designed to improve fiscal sustainability through greater budget discipline (e.g. fiscal rules, expenditure ceilings), others strengthen the central tools, information and processes that improve the CBAs' ability to support the strategic agility of government.

Twenty countries reported having changed their fiscal rules since 2008, 14 of which are members of the EU and are influenced by the ongoing process of renewed fiscal governance in the EU (Figure 2.2). Sixteen countries have made changes in their MTEF, and 15 have established expenditure ceilings. In addition, several countries are amending national laws, as well as constitutional laws, in order to regulate the new fiscal rules in the national legislation. This is a specific feature of the changes to the EU's fiscal governance (the so-called Fiscal Compact), and there may be more changes to budgetary frameworks in the next few years, partly because of ongoing efforts to strengthen the Stability and Growth Pact and establish the Fiscal Compact in the EU, and partly because of the exchange of experience during and after the financial crisis.

Figure 2.2. **Changed areas of budgetary institutional frameworks in OECD countries (2008-11)**



Source: OECD (2012b), "OECD 2012 Fiscal Consolidation Survey", OECD, Paris.

Schick comments that, during the financial crisis, the most affected countries bypassed conventional budget procedures and relied on *ad hoc* procedures to draft and adopt fiscal consolidation packages. Budget information and decisions have been tightly controlled by policy makers at the centre of government or the Finance Ministry. The crisis has concentrated budgeting in fewer hands, and, in some countries, given the Finance Ministry a disproportionate role in the process. He concludes that the concentration of information and power has reversed decades of progressive opening of the budget process through formal or informal consultations between government and stakeholders, and that sub-national governments and civil society have had little or no opportunity to influence the outcomes of the budget process during the worst of the crisis (Schick, 2013).

However, Schick does not expect the financial crisis's profound fiscal stress, intense conflict, concentrated power and political instability to be the template for budgeting's future. Although the crisis appears to have reversed the trend of incremental budgeting, the next generation of fiscal rules will likely push more governments to adopt top-down budgeting processes that set fiscal aggregates and sub-aggregates before bids are prepared by spending units and line ministries. This shift has already occurred in many countries that have made changes to the top-down budgeting practice during the years of the crisis. Top-down constraints are part of the process of transforming central budget offices from control agencies that oversee the details of expenditure to managers of fiscal policy that guard the country's fiscal position and analyse the budgetary impact of policy options.

Schick summarises the lessons learned from countries that have been able to preserve their fiscal balance that each country must summon the will to make and live by fiscal rules, to be fiscally prudent, to strive for results and to pay attention to programme effectiveness in spending public money. Outsiders can guide, but the most important success factor is for government leaders, programme managers and citizens to yearn to do the right thing.

While top-down budgeting is likely to improve budget discipline, it can also reinforce budget "silos", and so other budget mechanisms are needed to balance incentives for efficient budget management with the ability to prioritise and reallocate spending across government. The remainder of this chapter will discuss the general mechanisms that governments are using to create fiscal space for reallocations and consolidation under normal economic cycles and downturns. These mechanisms include spending reviews, performance budgeting and automatic cuts of productivity dividends.

Spending reviews may indicate areas to be cut and provide space for reallocation

Spending reviews are another major tool for fiscal reform. Typically, spending reviews are used to create fiscal space by reducing and/or (re)allocating budgetary expenditures due to a change in political priorities, a change in the demand for a service or the need to enhance efficiency. Spending reviews became a part of mainstream budget reforms in the 1990s, but have existed for much longer. Examples include the UK Public Expenditure Survey in the 1960s and the Australian Portfolio Management and Budgeting reform initiatives in the 1980s. According to the 2011 OECD Survey on Performance Budgeting, 16 countries out of the 32 that responded to the question used spending reviews in various forms.[2]

There are many different kinds of spending review, and the roles the institutional actors play also vary across countries and over time. A characteristic of a well-functioning spending review process is perhaps that it is continuously adapted to respond to current challenges. In the United Kingdom, spending reviews support the biennial revision of the expenditure framework and ministerial expenditure ceilings. The UK Treasury decides on the terms of reference, methodology and scope. Multi-institutional working groups draft the reviews, supported by line ministries. The reviews are approved by the Prime Minister and the Chancellor of the Exchequer. International organisations also use spending reviews in various forms. Both the OECD and the IMF (Robinson and Duncan, 2009) refer to spending reviews as a component of performance-based budgeting, which continuously reviews the appropriateness and effectiveness of existing programmes and uses performance information to identify programmes that can be cut, thus creating fiscal space. The World Bank[3] conducts "public expenditure reviews" of its borrower countries. These are meant to establish effective and transparent mechanisms for countries to allocate and use available public resources in a way that promotes economic growth and helps reduce poverty.

The OECD has emphasised three characteristics that differentiate spending reviews from other types of evaluation (OECD, 2011a):

- spending reviews not only look at programme effectiveness and efficiency under current funding levels, but also examine the consequences for outputs and outcomes of alternative funding levels
- the review procedure is under the responsibility of either the Ministry of Finance or the Prime Minister's or President's Office
- the follow-up to spending reviews is primarily decided as part of the budget process.

Spending reviews can be further sub-divided by their assessment criteria (Table 2.2). An efficiency review looks at inputs and processes to identify how an existing government service or programme can be delivered with fewer resources. Efficiency reviews can be applied to individual or multiple programmes or to an organisation or set of organisations to make operations more efficient and/or eliminate duplication. This type of review is meant to improve efficiency without calling into question the justification for the programme or organization itself. For example, Finland introduced the Productivity Programme in 2004 to maintain pressure to achieve public sector efficiencies. It included measures for improving government administrative structures, exploiting ICT and enhancing central government processes, as well as permanently reducing the number of government staff.

Table 2.2. **Typology of spending reviews and performance evaluation**

Primary objective		
Analysis: analyse management, structures and/or policy to improve efficiency and effectiveness	Create fiscal space: reallocate and/or reduce government expenditure for programmes or organisations	
Performance evaluation (programme, policy or organisational evaluation)	Spending reviews	
	Efficiency reviews	Strategic reviews
	Primary criteria: efficiency – identify how the existing policies can be conducted with less resources	Primary criteria: efficiency and prioritisation – identify what the government should or should not do
	Examples: – Finland: "Productivity Programme"(2005-15) – Korea: "Self-Assessment of the Budgetary Programme" (2005-)	Examples: – Australia: "comprehensive expenditure reviews"; "strategic reviews" (2007) – Canada: "programme reviews"(1994); "strategic reviews" (2009) – Denmark: "spending reviews" (ongoing) – Netherlands: "interdepartmental – policy review" (1982; 2009-present) – United Kingdom: "spending reviews"(1998-present)

As mentioned above, strategic reviews also assess the resource use. The objective of such an exercise is to prioritise programmes on the basis of policy objectives and performance. This will entail involving the political level of government – either throughout the review process or when key decisions must be taken. An example of a strategic review is the Canadian program review, from 1994 to 1999, in which each department of the Canadian government was required to review its programmes and activities and identify the role of the government, the effectiveness and affordability of the programmes. These proposals were then reviewed by a steering committee of deputy ministers, a special Cabinet committee of ministers, and finally by the full Cabinet for decision making (Bourgon, 2009; Blöndal, 2001).

While both efficiency and strategic reviews look at programme efficiency, only strategic reviews compare the programmes' objectives (and the effectiveness in meeting them) against the changing priorities of the government, including a changing fiscal environment. When the savings to be achieved through efficiencies alone are insufficient, strategic reviews may propose solutions such as changes in service levels, programme terminations or restructuring to achieve fiscal goals and increase budgetary agility.

Preconditions for an effective spending review[4]

Political will is necessary to set the mandate and take the decision

Creating an effective spending review process requires a clear political mandate at the level of chief executive. Spending reviews must be seen as a solution to a political problem, rather than a technical bureaucratic exercise. The mandate should be to identify options for reducing baseline spending, reallocating spending and, if relevant, enhancing revenue in order to create fiscal space for new priority spending. 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. In these cases, revenue measures can be relevant to include in the spending review.

The options proposed should be generated on the basis of sound research, but ultimately decided upon by the chief executive/Cabinet or another politically delegated entity (e.g. a ministerial committee) during the budget process.

Efficiency reviews should include reviews of issues that cut across policy areas, such as the organisation of support services, the use of ICT or procurement practices. Efficiency reviews should actively benchmark agencies and public institutions against each other and relevant private sector entities and similar institutions in other countries. A note of caution should be voiced with regards to relying too greatly on generating fiscal space through efficiency measures. In order to secure results on the ground, the government should avoid the illusion that efficiency improvements alone will be sufficient to create substantial fiscal space in the short term. If significant fiscal space is to be created, it is essential to be willing to reduce or reallocate programme expenditure.

There is always the political danger that spending review will be attacked as a "small government" exercise. It is, of course, an essential tool for any government that wishes to reduce the size of the public sector. However, assuming that this is not the government's goal, it should be stressed publicly that the objective is to reallocate rather than to reduce aggregate government expenditure.

The review team must have the necessary political and technical capacity to produce the necessary recommendations

Spending reviews involve the creation of a spending review team which is explicitly responsible for putting forward options for cuts to baseline expenditure for consideration by the political leadership during the preparation of the annual budget. Experience from countries such as Australia and the United Kingdom seem to indicate that it is best to create spending reviews as a function within (not outside) the civil service. *Ad hoc* external reviews (e.g. conducted by notable businessmen) have often not been successful.

The spending review team usually draws on raw data, ordinary performance reports, evaluations and efficiency reviews (as well as the views of budget analysts from the Ministry of Finance). In some cases, the review team will be large enough to conduct the analysis on its own; in other cases it will rely on existing analysis or will commission data collection and analysis from the Ministry of Finance, line ministries, management consulting firms, think tanks, etc.

Options for identifying fiscal space usually come in four forms: savings from measures to improve efficiency; eliminating programmes (or elements of programmes) which are ineffective and cannot readily be reformed to become effective; eliminating programmes which are politically a low priority; revenue enhancement measures (usually non-tax revenue).

The need for the spending review team to focus on priorities in addition to efficiency and effectiveness makes it important for the review team to be not only technically competent, but to also be sensitive to the priorities of the government of the day. It may, therefore, be useful for the team to include specialists in public policy as well as persons with the ability to gauge political reactions. Recognising that spending review is not a purely technical function, it should be under the direction of politically appointed officials who are sensitive to the priorities of the chief executive/Cabinet.

Government organisations must be obliged to provide the information requested by the spending review team. Some government organisations may resist such disclosure as it lays bare the inner workings of the organisation and undermines the information asymmetry on which it depends. Spending reviews are whole-of-government exercises, but bundling issues may provide better results. While it may be tempting to select programmes for review that look like potential candidates for budget cuts, this has to be weighed against the fact that such reviews may be met with strong resistance by the ministry under review. Thus, selection should be balanced and perhaps also include programmes for which there is some expectation that more funds will be allocated or for which a review will protect from additional cuts. This may make the ministry concerned more interested in participating.

The performance budgeting system should support spending review to the extent possible

The success of spending review in identifying options for cuts depends critically on ensuring that the officials who have responsibility for conducting the spending review have access to the performance information that is generated, including performance evaluations and performance indicators and reports.

Programme evaluations, which are part of the usual work of line ministries and focus on improving outcomes rather than reducing costs, should provide some information that hint at whether the programme is relevant for a spending review. In order to more clearly identify programmes or elements of programmes which can be reduced or reallocated, the standard terms of reference of programme evaluations should be required to include the cost of improving programmes, which, as presently designed, are ineffective. This includes an assessment of the probable cost of fixing the programme. Value for money audits carried out by the supreme audit institution may also be useful.

Performance indicators and reports are often part of the annual performance management framework. Experience shows that they are usually the most useful to the implementing agencies in their work and in their reporting. However, many OECD countries experience difficulties in generating key indicators that can be used to compare the efficiency and effectiveness of the operation and delivery of government services. There is no easy solution to this conundrum. Performance information should first be useful to those that generate it, otherwise it risks becoming an empty paper exercise where the data generated is neither accurate nor useful. The Ministry of Finance may be able to design a performance management system capable of providing some initial information in areas where efficiency and effectiveness are lacking.

Spending reviews have the most impact when change is necessary but effects may take a few years to emerge – links to the medium-term framework is important

Because cuts to existing programmes usually create some political resistance, the best time to carry out a spending review with a substantial impact may be when there is a change in leadership, which is often, but not necessarily, related to an election. In times of crisis, the purely political prioritisation strategic review is the most relevant as it basically becomes an exercise in reducing government expenditure. The impact of reviews concentrating on creating efficiency savings or changes in user behaviour leading to savings may not be seen until they have been in place for a few years. It thus becomes crucial that the effects of the spending review are built into the annual ceilings for each line ministry as per the medium-term framework. Without such a framework, the effects of the spending review may have to be renegotiated as part of every budget process and their impact may consequently be limited.

Consideration should be given to the appropriate frequency of spending review, and in particular to whether it should be an annual process. One possible approach would be to have periodic, in-depth spending reviews, and then a lighter spending review on an annual basis in between.

Spending reviews are part of the toolbox that enhances budgetary agility, as discussed at the beginning of this chapter. The preconditions discussed above thus form part of the foundation for budgetary agility.

Performance budgeting is a vital, but imperfect, tool

The public sector has traditionally been held to account for complying with rules and procedures. However, in the last 20 years, OECD countries have increasingly sought to develop a focus on the results achieved with the appropriations allocated through performance budgeting.

One of the challenges for performance budgeting is that it is expected to provide a great deal of information for different purposes, including:

- High-level outcome data that enables the executive leadership of government to pursue its strategic goals.
- Data on activities/processes, outputs and, most importantly, outcomes for parliament, the supreme audit institution and civil society that enables them to hold the government to account.
- Output and outcome data that can be linked with input data in a way that shows the efficiency and effectiveness of spending so the Ministry of Finance can monitor and steer the limited budgetary resources to where they matter most in a given political context.
- Input, process, output and outcome data for line ministers and their secretariats so that they can hold the executive agencies to account and have the ability to adjust policies in light of goals and actual developments.
- Input, process and output data that allows programme managers to adjust their operations so that services and programmes are delivered efficiently and effectively.

If the performance management system is consistently able to serve the needs of the various actors and deliver the specific information, the system should assure strategic agility, efficient and effective resource allocation as well as transparency and accountability. However, this is more easily said than done. In consequence, most systems have focused on gearing their performance management system towards the needs of selected actors.

Defining performance budgeting

The OECD identifies three broad categories of performance budgeting (Table 2.3):

- Presentational performance budgeting requires the publishing of performance information in budgets and other government documents (e.g. annual reports). The information can refer to targets, the results against them or both. While it serves to disseminate information for greater transparency and accountability of government operations, it is not intended to play an explicit role in decision making.

- Performance-informed budgeting takes presentational performance budgeting a step further and requires that either proposed future or past performance be used to inform the allocation of resources during the budget formulation. Performance information is used along with other information in the decision-making process.

- Direct (or formula) performance budgeting requires the allocation of resources to be based solely on proposed future or past performance. This form of performance budgeting is only used in specific sectors, such as education and health. For example, the number of students who graduate with a Master's degree, either in the current year, in the past or a combination of the two, will determine the following year's funding for the university running the programme (OECD, 2007).

Table 2.3. **Categories of performance budgeting**

Type of performance budgeting	Link between performance information and funding	Planned or actual performance	Main purpose in the budget process
Presentational performance budgeting	No link	Performance targets and/or performance results	Accountability
Performance-informed budgeting	Loose/indirect link	Performance targets and/or performance results	Planning and/or accountability
Direct/formula performance budgeting	Tight/direct link	Performance results	Resource allocation and accountability

These three categories are not intended to be exhaustive. Variations exist within government and within programmes. In general, although there is widespread use of performance information in the budgeting process, the overwhelming majority of countries use this performance information simply to inform budget negotiations (OECD, 2011b).

The innovative aspects of performance budgeting

Performance budgeting reflects a number of innovations with respect to budget and management institutions in various countries. These include:

- Changing the budget classification from inputs to programme: Under traditional (input) budgeting, parliament appropriates funding specified essentially by inputs (e.g. "salaries for a particular institution"). Performance budgeting entails government allocated funding to a political priority (e.g. "enhancing road safety"), which typically entails fewer line items.

- Reporting on non-financial performance information and lump-sum budgets: Traditionally, government accounts and audits focus on whether the appropriation was used lawfully. Performance budgeting reporting is meant to focus on outputs (e.g. the number of "drive safely" campaigns conducted) and outcomes (e.g. reduction in road fatalities). This enables an increased awareness of how much certain activities cost and what benefits they accrue. With more emphasis on what is delivered, a loosening of input control in favour of lump-sum budgeting is often used, and control of lawfulness rests with internal control procedures (Table 2.4). Lump sum refers to an appropriation of funds from parliament that is allocated to a particular agency or programme with few restrictions. This gives the head of the agency or programme flexibility in deciding the input mix – on what to spend the appropriation – which should increase efficiency.

- Using non-financial performance data as part of the management and/or budget process: This might take the form of performance-informed budgeting or formula budgeting; it might also take place in negotiations between the Ministry of Finance and the line ministries and/or between the line ministry and its executive units and agencies. There is great variation across OECD countries, but most commonly performance information is used by line ministries to manage executive unit's activities, possibly in the form performance contracts. These contracts are usually linked to the increased flexibility granted to these agencies in order for them to decide the appropriate mix of inputs that will achieve the desired outputs and outcomes. Lump-sum appropriations are one measure of flexibility. As can be seen in Table 2.4, approximately two-thirds of OECD countries use lump-sum appropriations, although the coverage of capital and operating expenditures vary.

- Tight monitoring of formula performance budgeting in order to maintain fiscal discipline. Performance budgeting does not imply that the centre of government abandons fiscal discipline. Even if additional flexibility is allowed and/or formula budgeting is used in certain sectors (e.g. health, education), overall spending ceilings – either at ministerial, programme or agency level – will be maintained by the Ministry of Finance.

- Use of medium-/long-term strategic plans and budgetary frameworks. As most policy outcomes can only be detected after a number of years, performance budgeting requires a medium-term perspective. For programming to be relevant, this also typically requires clear links between the government's electoral-cycle programming (for the parliamentary period or the life of the government, etc.) and its overall long-term strategic goals.

Table 2.4. **Do ministries/agencies receive lump-sum appropriations?**

	Number	Countries
For both operating and capital expenditures, without any sub-limits	3	Finland, Ireland, Switzerland[1]
For both operating and capital expenditures, with a sub-limit on wages	7	Czech Republic, Hungary, Italy,[2] Netherlands,[3] Portugal,[4] Slovak Republic, United Kingdom
Only for operating expenditures, without any sub-limits	4	Australia, Iceland, Norway, Sweden[5]
Only for operating expenditures, with a sub-limit on wages	3	Canada, Denmark, Poland[6]
No, detailed appropriations are set	13	Austria, Belgium, France,[7] Germany, Greece, Japan, Korea, Luxembourg,[8] Mexico, New Zealand, Spain,[9] Turkey, United States[10]

Notes: Based on *OECD Budgeting Practices and Procedures Database* Q. 49 "Do your agencies/executive organisations receive lump-sum appropriations?" and other data sources. 1. Switzerland: global budgets only exist for Management by Performance Mandate (MPM)-agencies, typically comprising of two lump sum appropriations (own operating and capital expenses). 2. Italy: some receive an amount as a percentage of tax revenues (e.g. revenue agency). 3. Netherlands: some agencies receive lump-sum appropriations covering operating expenditures; a large number of agencies are financed based on their output (i.e. formula budgets; price*quantity). 4. Portugal: typically receive lump-sum appropriations with two sub-limits for operating and capital expenditures. 5. Sweden: for smaller investment items (e.g. computers and office equipment) and larger items (e.g. software). Others with heavy investments (e.g. national road agency) receive one appropriation for the agency's operations and another for investments. 6. Poland: each agency receives a lump-sum appropriation covering expenditures linked to targets imposed by the central government. 7. France: appropriations are unrelated to the nature of the expenditure. 8. Luxembourg: appropriations are fixed on the basis of a detailed proposal provided by the agency. 9. Spain: depends on the agency/organisation and its expenditures. 10. United States: some small agencies receive lump-sum appropriations; Cabinet and major agencies do not.

Addressing the challenges of performance budgeting

A number of challenges need to be addressed when designing and using performance budgeting:

- What gets measured gets managed. Objectives and indicators have to therefore be comprehensive, reliable and measureable – easier said than done.
- Reforms need to be implemented at the agency/ministry level, which requires political buy-in and a willingness to change.
- Not all performance indicators are useful in the budget cycle. Legislators, ministers, policy analysts, service delivery professionals and concerned citizens are not necessarily interested in the same information at the same time; yet, all of them must be able to derive value from the system.
- Given the cross-government nature of some policy outcomes (e.g. child obesity), successful performance budgeting implies substantial, sustained cross-ministerial co-operation.

While there is great variation in the performance targets used by governments, many limit their number to prevent information overload. For instance, the United States has 3 700 performance targets followed by the Slovak Republic (1 641) and Korea (1 033). France, Japan and New Zealand have between 500 and 600 targets each and Sweden only has 48.[5],[6] The performance measures fall into a number of broad categories (Table 2.5).

Table 2.5. **Types of performance measures**

Performance measures	Input measures	What resources are used?
	Output measures	What products and services are delivered? What is the quality of these products and services?
	Outcome measures	Intermediate: What are the direct consequences of the output? Final: What outcomes have been achieved that are significantly attributable to the output?
	Contextual measures	What are the contextual factors that influence the output (e.g. processes, antecedents and external developments)
Ratio indicators	Efficiency	Cost/output
	Productivity	Output/input
	Effectiveness	Output/outcome (intermediate or final)
	Cost-effectiveness	Input/outcome (intermediate or final)

Performance budgeting practices are widely implemented, but varied; while countries might face similar challenges and share a common need to focus on demonstrating the extent to which spending achieves policy outcomes, their performance budgeting system needs to be tailored to fit their particular circumstances.

No country directly links public expenditures to performance information. With the exception of a few areas (education and health, for instance), performance information is used to inform the budget, not determine it. Fiscal discipline is consequently not threatened with the introduction of performance budgeting.

Performance information is more commonly used for management and accountability purposes than for allocation of resources. Consequently, performance budgeting is generally decentralised within the central government (to line ministries and agencies), with the exception of spending reviews. There is generally no clear answer, however, to how government should react to poor performance.

While there is little doubt that performance budgeting information provides important input to all levels of government, it is difficult to apply it to a number of key steering tasks, particularly at the aggregate level. The second-best solution is to ensure that those who generate the most basic performance information – the executive agencies – gain value from the performance framework. This ensures it is relevant, truthful and contributes to policy implementation. A special and more tailored effort must then be set up to provide the remaining actors with their legitimate performance information needs, be it in the form of spending reviews, special evaluations or other focused information gathering and analysis efforts. The existence of relevant and high-quality performance information will be an important source of information for such tailored efforts as spending reviews and centrally governed top-down budgeting, thereby also providing a basis for budgeting agility and fiscal space.

Productivity cuts may provide some fiscal space for reallocation drawn on productivity gains

Definition of automatic cuts of productivity dividends[7]

When accompanied with budget flexibility at the organisational level, automatic cuts of productivity dividends (ACPD) can create pressure for ministries and agencies to work more innovatively and to reallocate resources within their administrative area in search of greater productivity and effectiveness. The ACPD procedures have the following characteristics:

- They are "automatic" in the sense that they are part of the regular budget process and that no special decision is needed from year to year as to their application.
- They are based on assumed productivity gains in the public production of goods and services in kind.
- In view of their rationale, they are at least applied to the operational expenditures of central government.

Productivity is generally defined as a measure of the amount of output generated per unit of input. Productivity growth can be achieved by a better combination of inputs (the allocative efficiency of production), better quality of inputs and better operational efficiency (changes in the production process). The main obstacle to output measurement in the public sector is the lack of market prices, but measurement is also affected by the difficulty of accounting for changes in the quality of services.

Which countries use automatic productivity cuts? What is their rationale and how have they been implemented?

The ACPD procedures are applied in several OECD countries. Their rationale – and reason they are accepted in the national discussion about fiscal institutions – is that there is productivity growth in the public sector, and that without these automatic cuts, productivity growth would lead to backdoor increases in service levels without explicit budgetary decisions. Table 2.6 present examples of the experience of using automatic cuts of productivity dividends in five OECD countries.

In principle, automatic cuts on productivity dividends are designed to be applicable to all operational costs of government. Operational costs include compensation of employment and intermediate consumption and investment.[8] However, the appropriateness of such a broad coverage has been questioned.

Experience with automatic cuts of productivity dividends

Empirical data suggests that the long-run public sector productivity growth is usually estimated to be below that of the private sector by 0.5-2% per year. This interval is consistent with the ACPD arrangements that countries like Australia (1.25%), New Zealand (0.8%) or Sweden (2%) have built into their budget procedures on a permanent basis.

Table 2.6. **Automatic productivity cuts in selected OECD countries**

Country	Terminology	Size	Coverage
Australia	Efficiency dividend	Applied at the rate of 1.25% per annum (varying over time 1.0%-1.5%). An additional one-off efficiency dividend of 2.5% was applied 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	From 2011, an increased focus is put on the effectiveness of government functions, the availability and quality of services, and human resources management. There is no current 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 between 2012-15.Between 2007-11, only half of the efficiency savings on staff costs were cut from the appropriations of administrative branches. From 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 these were proposed by ministries and negotiated between the Ministry of Finance and the line ministries, approved by the Cabinet.
New Zealand	Fixed nominal baselines and additional efficiency savings as of July 2012	Fixed nominal current operational expenditures are used as a baseline in the annual budget cycle. Inflation has to be absorbed. Given that the inflation rate has been around 2.5% for the last few years, ministries have 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 to the savings caused by the fixed nominal baselines. The size of the required savings is 3% for small agencies and 6% for larger agencies.	Fixed nominal baselines for operational expenditures are applied to 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.

Table 2.6. **Automatic productivity cuts in selected OECD countries** (*cont.*)

Country	Terminology	Size	Coverage
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 productivity gains in the public sector are assumed to be the same as in the private sector. The DPG is calculated as the average productivity growth in the public sector over the last ten years. Since its introduction, the DPG has remained 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). It applies to *ca*. 16% of the total budget (which is the base amount subject to the DPG, not the actual deduction resulting from application of the DPG). Cuts are applied to multi-annual estimates of the 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.

There is consensus that there is productivity growth in the public sector, and there are approximate insights in the order of average growth in the government sector as a whole. This is sufficient to establish an effective ACPD arrangement. However, policy makers should avoid a too- direct connection between the outcomes of productivity research and the parameters (cut rates) of an ACPD arrangement. A direct connection may lead to a permanent policy debate about the appropriate cut percentages in the various sectors of public service provision and a politicization of productivity research.

It appears from the literature reviewed by the OECD that small agencies and relatively labour-intensive government divisions and agencies may have more difficulty in realising uniform ACPD targets than large and less labour-intensive agencies. Without differentiating APCD targets, this problem can largely be solved by allowing the reallocation of savings targets within ministries or between ministries.

The size of the ACPD cuts is usually chosen below measured average productivity growth in the private sector, which contributes to political acceptability. There have been *ad hoc* and one-off increases of this percentage in some countries to solve budgetary problems in upcoming budget years. This may lead to politicization of the mechanism and may undermine its long-term sustainability.

A uniform cut percentage costs less to implement than a differentiated one, leads to less discussion and avoids the politicization of productivity research.

It has been argued that, given the lack of market incentives (competition, profit), at least a part of the savings should be used to reward the agencies that achieve productivity gains. The literature mentions advantages and disadvantages of ACPD arrangements that allow ministerial divisions and agencies to use part of the savings for investments that can lead to savings or improved levels of service.

Taking into account that cuts of productivity dividends provide a limited amount for annual reallocation due to the low percentage and the restricted coverage of cuts (normally on the operational expenditures of central government), automatic productivity cuts have a minor impact on budgetary agility in the short run. However, in the longer term the cumulative impact may create substantial fiscal space for the government. It should indeed also foster a culture of continuous innovation and a pursuit of savings.

Conclusion

This chapter has studied governments' capacity for resource agility – or the ability to flexibly reallocate resources to changing priorities and strategic changes of direction. It discussed the challenge of achieving resource agility by balancing budget discipline with information, incentives and flexibility. Four mechanisms were considered: top-down spending cuts, spending reviews, performance budgeting and automatic cuts of efficiency dividends. Although experience from governments' responses to the financial crisis has shown that OECD countries have gained from top-down spending cuts and revenue enhancements in the short and medium run, the greatest potential for budget agility in governments over the medium and long term lie in well-designed spending reviews drawing on performance information, supplemented by automatic productivity cuts.

Many countries have integrated top-down budgeting into the institutional framework for budgeting. This practice provides line ministries with the possibility to adjust budget allocations within their responsibility, but may leave the CBA with a need for other mechanisms to achieve long-term budget agility. During the financial crisis, some governments used top-down spending cuts and revenue enhancement – often leapfrogging the conventional budgeting procedures in governments. Top-down spending cuts and revenue enhancements are used for short- and medium-term adjustments of budget allocations, but may not be sustainable in the long run.

In many countries, however, one of the consequences of top-down budgeting is a diminished ability for the Ministry of Finance to create fiscal space as part of the annual budget process. The basic reason for this is that line ministers have been able to use the regular budget process to put forward new spending proposals, while minimising the chance of new savings proposals being applied to their portfolios. Ministries of Finance are faced with a quandary: the move towards top-down budgeting has given them better control over overall expenditure and helped to align incentives at the line ministry level so that they manage resources efficiently by acting as their own "Ministry of Finance". At the same time, however, decentralised control over budget decision making exacerbates information asymmetries in the budget process. Not only do Ministries of Finance generally know less now about individual programmes and organisational performance, but line ministries also have a diminished need to provide savings proposals that will reduce their budget allocation. In keeping with the nature of top-down budgeting, line ministries identify and reallocate efficiency gains within their own area of responsibility.

Performance budgeting has often been presented as a means of filling the "information gap" by providing a reporting mechanism between the Ministry of Finance and the line ministries/agencies covering inputs in the form of budget resources, institutional information, outputs and outcomes. The results, however, have been mixed in terms of providing clear, useable and timely information for Ministries of Finance to take informed budget decisions, in particular with regard to prioritisation across spending areas. Ministries of Finance have oftentimes found themselves overwhelmed with copious amounts of performance information of limited use to the budget process. There is also increasing awareness that performance information needs are different for the management of service delivery in executive agencies compared to budget (re)allocation functions in the Ministry of Finance. For instance, calculating impact and its cost is difficult, since attributing causal relations between societal outcomes and public sector outputs and processes is complex, difficult and prone to time lags. Information may be biased in favour of the agency generating the data and indicators may simply be chosen because they are measureable, rather than because they are meaningful. In addition, the political element of pursuing political programmes and the political impact of inputs plays a significant role in the calculus by which resource allocation decisions are made. Tying resources to performance indicators (i.e. performance budgeting) is therefore difficult and rarely done in OECD countries.

A spending review procedure is part of the institutional response to the above conundrum when there is a need to identify fiscal space and prioritise expenditure. Ideally, spending reviews will have a clear political mandate defined by the chief executive or Cabinet, thus making the spending review a whole-of-government effort and all ministerial portfolios legitimate targets of inquiry. Information asymmetry should also be mitigated by the reviews, since they are designed to collect data, analyse it and make recommendations for change. Spending reviews are becoming a more frequently used measure for budget agility in both the short and longer term. They may provide political options for cuts, reallocations and general fiscal space that would be sustainable over the medium or long term, focusing on efficiency and political strategic priorities (politically determined effectiveness).

Performance information still plays an important role in the budget process, however. It is widely used in OECD countries, and while its direct role for budget allocation seems to be in decline, it is a source of information in spending reviews and in developing long-term strategic directions for budget allocations. It also provides the legislature, the supreme audit institution and civil society with essential background for assessing accountability of the government.

Automatic cuts of efficiency dividends provide a rather limited source for reallocation in the short run due to their limited size as percent of the total budget. Such automatic cut schemes may, however, result in a culture of efficiency where managers and agency heads persistently focus on efficiency, perhaps providing more room for reallocation over the long run.

Notes

1. On these issues, related to the fiscal space available to a government for policy initiatives see the presentation given by Mario Marcel on "Budgeting for Results and Fiscal Space after the Big Recession", at the G20 seminar held in Mexico in September 2012, www.g20.org/en/financial-track/522-seminario-del-g20-sobre-retos-y-perspectivas-de-la-economia-global.

2. See the results of the "2012 OECD Survey on Performance Budgeting and Spending Reviews" presented at the annual meeting of the Network on Performance and Results, 26-27 November, Paris.

3. See http://wbi.worldbank.org/boost/tools-resources/public-expenditure-review.

4. This section draws on Hawkesworth et al. (2012).
5. OECD Budgeting Practices and Procedures Database (www.oecd.org/gov/budget/database) Q. 75.
6. Results of the "2012 OECD Survey on Performance Budgeting and Spending Reviews" presented at the annual meeting of the Network on Performance and Results, Paris 26-27 November.
7. This section is based on Luinaud and Wilhelmsson (2012).
8. Intermediate investment includes investment in support of government operations but not investment in final capital goods, such as infrastructure.

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