Chapter 7

Financial management

In this study finance is conceived as a support service, comparable to human resources, procurement, etc. This conception implies that sectoral policy has priority over budgetary policy and that the budget process must serve the policy process in the best possible way.

In the era of New Public Management, the budget process was sometimes seen as the principal policy making process in government, of which all sectoral policy depended. This led to a large extension of the task package of the Ministry of Finance at the expense of the line ministries. This conception of the budgeting process is gradually becoming less prominent or sometimes even abandoned implicitly or explicitly. In connection with this development there is a renewed focus on the classical functions of the budget, namely those of authorisation, macro-economic steering, allocation and operational control.

In the area of authorisation, parliamentarians and the public put more emphasis on transparency, which has consequences for reporting on current and new spending. In the area of macro-economic steering, more and more countries are adopting medium term expenditure frameworks (MTEFs) and are trying to keep them fixed from year to year. Some countries have introduced spending review procedures to support the decisions on the expenditure framework. As far as allocation is concerned many countries have reformed the budget classification, defined the line items mostly by programmes, and reduced the number of line items to 10-15 per ministry. As far as operational management is concerned the most important innovation is the introduction of automatic productivity cuts. The reforms presented in this chapter consist of best practice examples in each of these areas.

Introduction

Finance as a support service

In this study finance (including budgeting, accounting and cash and debt operations) is conceived as a support service, comparable to human resources and organisation, procurement, information and ICT, etc. This conception is not always seen as evident and it is useful to pay attention to the reasoning behind it.

In the era of New Public Management, budgeting was sometimes seen as the principal policy making process in government, of which all sectoral policy making depended. This led for instance to the conclusion that sectoral policies had mainly to be decided in the context of the budget process and that the Minister of Finance was responsible for reporting on sectoral policy results and taking action as sectoral policies did not have the expected results. This view had profound consequences for Ministries of Finance. Expenditure divisions were henceforth expected to assess the adequacy of performance indicators or even to take the lead in the development of such indicators, and they were supposed to analyse sectoral policies and come up with remedies if these policies were deficient. Obviously this led to an enormous expansion of the task package of the Ministries of Finance that they were often unable to handle.

In the Value for Money study, it has come to light that this conception of the budgeting process is gradually becoming less prominent, or sometimes even abandoned implicitly or explicitly. This seems a return to the past when the task of the Ministry of Finance was seen as one of recording the consequences of sectoral policies and when the emphasis of the work both in Ministries of Finance and in the finance divisions of line ministries was more on accounting than on budgeting. However, in other aspects of budgeting, there is no return to the past as the budgeting process in most central governments has become more complex and as important innovations have changed it beyond recognition over previous decades. Furthermore, the relation to sectoral planning is an important conceptual question that has consequences for the institutional design of the budget process.

The trend to focus the budget process on financial support and to leave sectoral policy making and execution to the line ministries and the government as a whole has two main consequences for the institutional design of the budget process: 1) sectoral policy has priority over budgetary policy, and 2) sectoral policy making cannot be forced into the requirements of the annual budget cycle and should be allowed to follow its own cycle of development, implementation and evaluation.

The priority of sectoral policy making

A large majority of OECD countries have over the last decade moved to a budget procedure based on Medium Term Expenditure Frameworks (MTEF's). The main advantages of such frameworks are that expenditure ceilings provide a stable framework for sectoral policy making, that they imply top-down budgetary decision-making as opposed to the incremental budgeting procedures prevailing in the past and that they may contribute to automatic macro-economic stabilisation, in particular if the frameworks are fixed (not adjustable from year to year) and for a relatively long period (3 or 4 years). However, countries that have moved to a framework procedure have not always taken into account that the institutional design of the resulting budget process has to respect the priority of sectoral policy making. Since expenditure frameworks have profound consequences for sectoral policies, it is important to take the requirements of sectoral policy making into account on penalty of the collapse of the frameworks at the first occasion that they clash with the demands of the latter. Unfortunately this has often happened, although the overrun of expenditures ceilings was for understandable reasons not always loudly proclaimed in the countries where it occurred.

If a country introduces an expenditure framework, it is important that this does not imply that line ministries are denied the opportunity to make request for resources to finance new policies. In other words, top-down budgeting, essential as it is, must not mean that line ministries can only ask for resources to finance new policies when it is too late, namely after their expenditure ceiling has been set. It must also not mean that henceforth they can only finance new policy initiatives if they provide compensation by reducing resources for current policy. Such implications would be irrational from the point of view of allocation and not resistant against the needs of political practice. Indeed, it belongs to the essence of budgeting since the French revolution, recognised in the principles of universalism and unity, that all expenditures are in the budget and that all trade-offs can be made between alternative spending options, regardless whether they resort under the same ministry, as well as between spending and tax relief. This implies that spending ceilings, both the overall ceiling and the ministerial ceilings can only be set after:

1. spending requests by line ministries have been made and savings options on current policies have been considered;
2. updated estimates of spending for current policies (baseline estimates) have become available;
3. tax receipts under existing legislation have become available;
4. a fiscal rule or objective for fiscal policy in the medium term to anchor the framework has been established; and
5. options for tax changes have been considered.

If the budget year coincides with the calendar year and the expenditure framework is set before the summer, this means a forward shift of the budget calendar with a few months.

The priority of sectoral policy making also implies that decision-making about sectoral policies cannot be forced into the alleged requirements of the annual budget cycle. In practice of course, it has never been in any country. Sectoral policies have their own cycle. They are developed, decided, implemented, evaluated and revised in response to the needs of each sector. Procurement of weapon systems for defence has a very long cycle of some ten years or more (fighter planes, navy ships) and so has road construction. Other policies have shorter cycles such as public housing or health care or education. For many sectoral policies it is also true that they are decided *ad hoc* in response to major events, for instance prison security if a dangerous criminal escapes, or dyke construction in case of flooding, or, for that matter, participation in bank shares if a major bank needs to be rescued. For the budget process this implies that budgets need to be flexible once they are adopted. Ministers must be able to reallocate resources within their portfolio by reordering of baselines, and as far as the current budget year is concerned by reordering appropriations within their ceilings, if necessary by supplementary budget laws, or ultimately by demanding reordering of their ceilings within the overall ceiling to be brokered by the Prime Minister. Attempts to introduce rigidities in the budget process that are not adapted to these exigencies of sectoral policy making are bound to fail, as experience in many OECD countries has shown.

New focus of financial management

The fact that in many countries fiscal policy is withdrawing from the area of sectoral policy does not mean that it has become less important. On the contrary, the current emphasis on in-kind service delivery, coinciding, for that matter, with the need for austerity occasioned by the global financial crisis and low GDP growth in many OECD countries, has led to numerous innovations and reforms, that have contributed to the relevance of the budget process, rather than diminishing it. However, it is characteristic of these innovations and reforms that they focus again on the basic roles of the budget as a tool of financial management, rather than as a tool of governmental policy making in general. These basic roles have not fundamentally changed over the previous decades and are recognised in every handbook on public finance. They include the "functions" of authorisation, macro-economic steering, allocation and operational control.

As far as authorisation is concerned there is a new emphasis on transparency. Parliament and the public at large must be able to understand what the implications of the budget are. This means among other things more emphasis on baseline reporting. Parliament must be informed about the changes in baselines both at the occasion of establishment of the expenditure framework and at the occasion of submission of the budget and of supplementary budgets. Which baselines have been increased or decreased? What are the underlying decisions on sectoral policies: which new policies are being financed, which cuts in existing policies have been decided? Parliament must also be able to understand the increase and decrease of baselines in the out-years after the budget year. What factors make policies more or less expensive in future years. Finally, it must be able to understand why baselines have changes since the previous (supplementary) budget: have any sectoral policies been changed or are changes based on updated estimates of the costs of current policies (windfalls and setbacks originating in unexpected demand for services or cost decreases or increasing in services). The reform on baselines (Reform 7.2) and the reform on the budget documentation (Reform 7.4) of this chapter describe recent innovations concerning transparency.

As far as macro-economic steering is concerned, the move towards expenditure frameworks is the most conspicuous trend in almost all OECD countries. Practices concerning such frameworks come in a large variety. They can be flexible or fixed (adjustable from year to year or non-adjustable). If they are fixed they can be fixed for a relatively short period (two years) or a relatively long period (three or four years). They can contain new spending or savings proposals for the out-years or not. Reform 7.3 describes these varieties as they are practiced in a number of OECD countries that are on the forefront of innovation in this area.

Furthermore the setting of expenditure frameworks can be supported by the development of savings options in spending review procedures. The need for such procedures stems from the fundamental asymmetry of the budget process. Line ministries have incentives to propose new spending proposals of high quality, because quality contributes to the chance of adoption. For the same reason however, they have little incentives to propose saving proposals of high quality, at least as long as the expenditure framework is not adopted. Therefore a number of countries has organised the exploration of savings options outside the regular budget process in special spending review procedures. Reform 7.6 describes these procedures.

As far as the function of allocation is concerned, the most important innovation is the programme classification of the budget. Many countries have revised the budget classification in terms of programmes or policy areas, which are characterised as bundles of policy instruments (grants, subsidies, social benefits, investments, etc.) with the same policy objective. This reclassification has often drastically reduced the number of line items (separate appropriations subject to parliamentary authorisation) of the budget, from many thousands of items to a few hundred. Introduction of a programme classification has sometimes already taken place in the 1990s or in the early 2000s as part of New Public Management agenda. In that period a programme classification was thought to be an essential ingredient of "performance budgeting" and more focus on results. However, apart from that aspect, a programme classification is an important prerequisite for focusing the budget debate on allocation and political priorities. It is therefore understandable that no country has gone back to a classification based on inputs, now the emphasis on performance and results has shifted from the budget process towards the sectoral policy process. Reform 7.1 describes the programme classification and the pitfalls and remedies associated with it.

Finally, as far as operational control is concerned, the most important innovation comes to the light in this study, concerns automatic cuts of productivity dividends. The scrutiny of the efficiency of government operations is recognised as a task of the Ministry of Finance in the Budget Code of most OECD countries. However, Ministries of Finance have always been struggling with the question how to perform this task in an effective way. It often came down to advising the Minister of Finance on possible efficiency gains at the occasion of new spending initiatives of line ministries or at occasions when savings had to be inventoried. There are no good examples of systematic scrutiny of current spending programmes. Spending review (Reform 7.6) is a part of the solution. In countries were spending review has been institutionalised, these reviews typically not only look at options for savings by cutting current service levels, but also at savings options by more efficiency. This can imply using other policy instruments (allocational efficiency) or reducing the costs of current instruments (operational efficiency). This can mean for instance stricter eligibility rules or increasing private contributions, so that social services become more focused on low income households, or it can mean performing government tasks in the areas of administration or in-kind service delivery at lower costs. Automatic cuts of productivity dividends are another means to perform this function. There are several OECD countries that have institutionalised this reform. This is not an easy reform, and there are many precautions that have to be taken in order to implement it in a successful way. Reform 7.6 describes this institutional change in the countries where it occurred and analyses the experiences thus far.

Reform 7.1. Programme classification of the budget

Characteristics of the reform

This reform consists in reclassifying the central government budget according to programmes (or policy areas) in order to focus more on results of public expenditures. A programme – based classification allows more result-oriented decision-making process and a better assessment of trade-offs between expenditures for different policy areas and between expenditures and revenues.

Frequently occurring features of a programme classification are:

- a limited number of line items (not more than 500);
- breakdown by expenditure groups or programmes;
- multi- annual baseline estimates provided in the same classification;
- a separate single line item for each line ministry for current operational expenditure of the core ministry and for each agency under the ministry (compensation of employees plus intermediate consumption).

Where did it occur?

In the last two decades, a number of OECD countries have reclassified their central government budget for the purpose of authorisation: Australia, Canada, Finland, France, the Netherlands and Sweden offer good examples of reclassified budgets based on programmatic criteria.

The number of line items in the classifications of the countries that have implemented this reform ranges from 100 to 500. In 2007 the programme-based budget classification of Australia included 175 line items, of Canada 200 line items, of Finland 476 line items, of France 130 line items[1], of the Netherlands 200 line items[2] and of Sweden 500 line items (OECD, 2013).

Analysis

The classification design

The reform focuses on the classification that is used for the authorisation of the budget in appropriations laws and defines the line items of the budget.[3] Each country can only have a single line items classification that is typically based on a mixture of institutional[4,] economic[5] and functional[6] criteria.

A line-item classification is programmatic if it is based on outputs: goods and services in kind produced, cash transfers delivered and regulations executed. A programmatic classification is considered to be more supportive of the allocative, macroeconomic and managerial functions of the budget than a classification which is based on inputs. These are the advantages:

- Considering that programmatic line items are characterised by related objectives ("outcome" targets) or even a single ultimate objective of all expenditures financed by the line item, a programmatic classification is more supportive of the allocative (priority-setting) function of the budget.
- As to the macroeconomic function of the budget, the programmatic classification improves the steering of total expenditures and the maintenance of budget discipline. This requires however that line items not only contain estimates for the budget year but also estimates for the medium term: estimates for two, three or four years after the budget year. Steering of total expenditures necessarily requires a multi-annual perspective so that future problems can be timely identified and addressed. Multi-annual estimates are usually not authorised and have no legal status but are important for macro-budgetary planning. A programmatic line-item classification is important for the development of reliable multi-annual estimates because such estimates have to take into account the future

demand for outputs. Multi-annual estimates that do not take future outputs into account can only result from a mechanical extrapolation of the trends in input costs and will be intrinsically unreliable.

- A programmatic classification is also more supportive of the operational control function of the budget, which refers to the steering of the budget towards optimal operational efficiency (minimal costs per output). This is the case because the programmatic classification is based on policy area (groups of outputs). It stimulates the analysis of cost structures of production units such as hospitals, educational establishments or courts through comparisons over time (longitudinal comparisons) or across different regions (cross-sectional comparisons). This allows the steering of the budget towards minimal costs per output.

Reclassification according to output areas or programmes generally leads to a reduction of the number of line items. Since ministries are generally responsible for 5 to 20 programmes, and since the number of ministries ranges from 10 to 25, the number of line items in a programmatic classification ranges from 100 to 500.

With regard to the organisational structure of ministries and the division of tasks between ministries in the process of reclassification, it is advisable to stay as close as possible to existing organisational structures. If necessary the organisational structure should be changed first so that every Director General is made responsible for related programme line items and no overlapping responsibilities arise. Directors-General are thus made responsible for results as well as budgetary discipline for (each of) the programme(s) assigned to them. Overlapping responsibilities, in the sense that several Directors-General are responsible for the same programmes, inevitably lead to problems. Even more problematic are overlapping responsibilities between different line ministries. Therefore it is important to avoid such overlapping.

The relaxation of input control

Moving towards a programmatic line-item classification leads by definition to a certain relaxation of input controls and may thus be seen by the Ministry of Finance as a risky enterprise. Inputs are conceived in this connection as expenditures split according to the economic classification: compensation of employees, intermediate consumption, gross capital formation, etc. The ministry tends to put strict constraints on moves in this direction. Two basic conditions are:

- Budget estimates and multi-annual estimates should be well explained, preferably in terms of outputs and cost per unit.
- Strict rules of budgetary discipline should be put in place to guarantee that overspending on ministerial ceilings cannot occur.

Up to date and reliable baseline estimates (see Reform 7.2) is a necessary prerequisite of programme budgeting. The first condition mentioned above requires that these line-item estimates were well explained. Explanations in terms of outputs and costs per unit make it possible for the Ministry of Finance and Parliament to shift attention from inputs to outputs in the exercise of their supervisory tasks. It is necessary to limit these explanations to a rough summary of the actual financing rules, which allows the users (Ministry of Finance, Parliament, the public) to assess the plausibility and acceptability of the estimates. In any case, explanations of demand and price of outputs should reflect the financing rules actually used to finance the ministerial divisions and agencies that produce the outputs. It should be kept in mind that the essential aspect of programme budgeting is the discretionary authority of line ministers and budget holders over resources, in particular the possibility to shift resources between inputs. If outputs are not used to finance the divisions and agencies that produce the services and line items have to be explained in terms of inputs, it may be discovered at the end of the budget year that resources were used differently than described in the explanation of the line item in the budget documentation. That should not be a problem as long as the actual use of the resources is accounted for in the financial report of the budget year. Even in the case of input explanations, the programme classification can fulfil its role of allowing discretion to line ministries, without impairing the supervisory tasks of the Ministry of Finance and Parliament.

The second condition requires that line ministries accept the responsibility of not overspending their budgets. This is perhaps the most important message that must be communicated to everybody involved in the reclassification exercise: a programme classification is a contract between the Ministry of Finance and the line ministries in which discretion over inputs is exchanged for the acceptance of rules of budgetary discipline. This is not to say that, under a programme classification, reallocation of resources between line items should no longer be allowed. Even though the need for reallocation will automatically decrease when separate line items cover a larger part of ministerial resources, there will still be a need for reallocation between line items (programmes) in order to react to new circumstances, a change of political priorities or unexpected developments in the demand for services. This is true for the budget estimates, once they have been enacted in the budget laws, but even more so for the multi-annual estimates which cover a more distant and therefore more uncertain future. However, these reallocations should be subject to a strict regime of budgetary discipline that goes beyond the simple requirement that reallocations should be approved by the Ministry of Finance or authorised in supplementary budget laws. In particular, reallocations need to comply with compensation rules which raise high barriers against overspending on ministerial budgets.

Authorisation of administrative expenditure

A particular matter of concern for the Ministry of Finance and Parliament is the authorisation of administrative expenditures[7] of line ministries. These expenditures include the salaries of staff, and the procurement costs of goods and services of administrative units of core ministries and administrative agencies. A risk attached to the introduction of programme budgeting is that resources intended for subsidies to the private sector, cash transfers to citizens, and grants to local governments will instead be used for the recruitment of additional administrative staff, improvement of office buildings, etc. Even if strict rules of budgetary discipline have been put in place, this perceived risk may cause hesitations or resistance against the introduction of programme budgeting on the side of the Ministry of Finance and Parliament.

The risk of shifting resources from programme budgets to administrative budgets is compounded by the problem of splitting administrative expenditures into programme areas. For this reason, some governments (e.g. the Netherlands, Sweden, the United Kingdom) that have moved to a programme classification have maintained separate line items for administrative budgets (implying that current operational expenditures[8] of administrative units are not broken down by programmes). Administrative budgets usually represent only a small part of the overall budget (less than 10%). Keeping a separate line for administrative expenditures in each ministerial budget does not mean that ministers cannot reprioritise spending within this budget (for instance spend more on staff at the expense of procurement of goods and service) but that they cannot increase the administrative budget by moving programme resources (subsidies, cash transfers, grants, etc.) into administrative budgets.

In view of the previous considerations, a stylised format for a programme classification of a line ministry's budget could look like the example in the table below.

Table 7.1. Stylised budget classification

	Budget year (b)	b+1	b+2	b+3	b+4
Ministry I					
Administrative expenditure, core ministry					
Administrative expenditure, agency 1					
Administrative expenditure, agency 2					
Etc.					
Programme A					
Sub-programme A1					
Sub-programme A2					
Etc.					
Programme B					
Etc.					
Ministry II					
Administrative expenditure, core ministry					
Administrative expenditure, agency 1					
Administrative expenditure, agency 2					
Etc.					
Programme C					
Sub-programme C1					
Sub-programme C2					
Etc.					
Programme D					
Etc.					
Ministry III					
Etc.					

Feasibility of the reform

The development of a programme classification is an exercise that cannot be based on abstract reasoning about the responsibilities of ministries, but rather be guided by bottom-up reasoning based on the sectoral laws and_policy structures that are currently in place. Therefore this exercise can only be done in close co-operation with the line ministries. Moreover, the Parliament should be involved since the reform directly impacts on its authority over the budget. In the countries that have introduced a programme classification, it is generally done under the common responsibility of the line minister and the Minister of Finance and the resulting classification is approved by Parliament.

If the above-mentioned conditions with respect to the budget documentation and rules of budgetary discipline are met, the reform is feasible in all OECD countries.

Reform 7.2. Regular updating of baseline estimates

Characteristics of the reform

Baseline estimates are the estimates of the costs of current policies in future years. They present the implications of current policies for the most detailed expenditure groups (line-item level) in the budget year and in the two, three or four years following the budget year. The role of baseline estimates is threefold:

- They provide the basis for maintaining budget discipline;
- They provide the basis for multi-annual expenditure planning;
- They provide indispensable information for the setting of expenditure ceilings.

To fulfil these roles properly and provide a reliable picture of the future budgetary consequences of current laws and/or policies at any given point in time, baseline estimates must be regularly updated. The updates must be carefully checked by the Ministry of Finance and periodically reported to Parliament.

Where did it occur?

OECD countries have different cycles for internal updating of baseline estimates; for instance, the Netherlands updates 6 times a year (a two-monthly cycle), Denmark updates three times a year (a four-monthly cycle) and Sweden updates four times a year (a three-monthly cycle).

Some countries that do not use an expenditure framework still have a strong procedure of baseline updating as a basis of budgetary discipline: Australia, New Zealand, Norway have strong budgetary discipline, low deficits and low public debt. In this light it can be argued that strong baseline procedures are even more important for budgetary discipline than strong expenditure frameworks.

Analysis

Current policy and current law baselines

Multi-annual estimates can be established either on the basis of current law or on the basis of current policy. Current law estimates forecast the future expenditures flowing from substantive (non-budgetary) laws that are in force at that time of calculation. Current policy estimates forecast the future expenditures flowing from government policies that are presently in place. The difference between these two types of estimates is that current law estimates do not extrapolate budgetary estimates of previous years if expenditures are not based on substantive laws (hence only on budget laws). Thus, expenditures for infrastructure investments that are not based on substantive laws will not be included in current law estimates. The other difference is that current law estimates do not include expenditures which follow from approved policies, if these policies are not enshrined in substantive laws or if the laws are not yet enacted.

Budget discipline

In view of budget discipline, there are three reasons for regular updating of multi-annual estimates:

1. Under existing laws or policies, demand for services may be larger or smaller than foreseen at the time of budget approval both in the budget year and future years.
2. Cost per service may be larger or smaller than foreseen at the time of budget both in the budget year and future years.
3. Some policy changes cannot be postponed to the next budget year and they affect the current budget as well as future budgets.

In the budget year the appropriation approved by Parliament is a strict constraint on expenditures that may force the responsible minister to change policy during budget execution, but for the out-years there are no constraints at the line item level (in the case of an expenditure framework only at the level of total expenditures, possibly subdivided by ministries). Moreover, even for the budget year, a large proportion of expenditures is entirely determined by entitlement legislation that takes precedence over appropriations. In these cases (changes in the out-years, or changes as a consequence of entitlement legislation in the budget year) baseline updating can bring the threat of overspending to light and trigger corrective measures.

Inflation represents a special case regarding changes in costs per service. OECD countries that have moved to a programmatic classification use mainly two mechanisms for the compensation of cost inflation (wage costs and procurement costs). The first mechanism entails that budgetary and multi-annual estimates are stated in fixed prices of the previous year and that there is a separate line item for nominal compensation on the basis of multi-annual inflation forecasts. Compensation takes place by reallocation from this line item during the execution year on the basis of observed inflation. The second mechanism entails that inflation forecasts are built into budgetary and multi-annual estimates. In this case, inflation setbacks and windfalls are not automatically compensated but may, under certain conditions (large deviations, specific line items such as salaries), be compensated from a contingency fund. Whatever the mechanism, budgetary and multi-annual estimates should be updated as soon as new observations and forecasts become available.

The need for baselines is independent of the budget classification. Most countries that have adopted a programmatic budget classification prepare baseline estimates. However, up to date baseline estimates are also important for budget discipline in more traditional classifications (organisational, economic).

Multi annual expenditures planning

Many, indeed almost all, significant policy decisions have their most important impact after the upcoming budget year. New policies require time to phase in. Legislation has to be changed, executive agencies have to be reformed or built up, etc. This is true for new initiatives that require new spending as well as for new initiatives that lead to savings. Sectoral planning should therefore take into account the budgetary consequences for the medium term from the very start.

All policy decisions, submitted to government should therefore have an annex that spell out the budgetary consequences in the budget year and the out-years. Moreover, policies are not only decided during budget preparation, but during the entire year. Therefore, ministers should always be required to show how this will affect their budgets in the medium term and if there is an expenditure framework how this fits in their medium term ceiling, possibly after compensation on other line items.

Indispensable information for setting expenditure ceilings

The baseline estimates are indispensable for setting expenditure ceilings in countries that work with an expenditure framework (see Reform 7.3). The setting of ceilings requires availability of five kinds of information (see introduction to this chapter), including baseline estimates.

Without baseline estimates, ceilings cannot be set in a rational way. Indeed ceilings have to be based on a trade-off between revenues and expenditures (the ceiling for total expenditures), and between expenditures for separate sectors (the sub-ceilings for separate ministries and/or broad policy sectors). When they set ceilings policy makers have to know whether their decision imply more or less taxation or whether they imply room for new spending initiatives or savings in particular ministerial envelopes.

Responsibility for updating

The line ministries are responsible for regular updating of baseline estimates. However, updates should be checked by the Ministry of Finance. This is a technical, not a political matter. The central question is what the policy will cost if no measures are taken. In principle agreement should be reached at the level of policy experts of the line ministry and the Ministry of Finance. However, in case of a difference of opinion the matter should be decided at the level of senior civil servants of both ministries.

In many OECD countries, the largest part of the central government budget is determined by expenditures based on large demand-driven entitlement laws in the sphere of education, health, social security and grants to local governments. This implies that the reliability of baselines for these programmes is critical. These estimates are sometimes produced by forecasting models owned by the line ministries. These models can also simulate the budgetary consequences of changes in the entitlement laws. Given the importance of these forecasts for the macroeconomic steering of the budget, it is important that in these cases independent experts also look at these estimates. In countries where independent public forecasting bureaus exist (the Netherlands, the Nordic countries), these bureaus have a role in the updating or supervision of these estimates.

Transparency

Baselines are in the first place a means to ensure budgetary discipline and to facilitate multi-annual expenditure planning and the setting of ceilings within the government. However, the parliament should be informed, particularly at times when appropriations or supplementary appropriations are submitted for authorisation. This implies that (supplementary) budgets should always contain information about the baselines at the line item level, preferably in the body of the budget law (not in an annex). This does not mean that parliament should authorise the baselines. In almost all OECD countries parliament only authorises the estimates for the budget year. However, it means that parliament is informed about the multi-annual implications of the decision for the budget year and can exercise its power of the purse in the light of this information. Moreover, in order to understand the information about the baselines, this information should be explained in the budget documentation. In particular the budget documentation should contain a horizontal and vertical explanation of the baselines.

The horizontal explanation of the budgetary and multi-annual estimates

The horizontal explanation of the estimates has to provide a clear picture of the development of the estimates at the line-item level from the budget year until the last out-year. The explanation should look at developments in the demand for services and the costs of services under current policies. This explanation is called "horizontal" because it looks at the development of the estimates over time at a given moment in time.

The vertical explanation of the budgetary and multi-annual estimates

The budget documentation also has to explain how the line-item estimates have changed since the previous year. This explanation is called vertical because it looks at the change in the estimates at subsequent moments. In this respect, it is important to distinguish between policy changes and setbacks/windfalls under current policies. The setbacks and windfalls in the vertical explanation are the sum of all updates of the estimates during the previous year that do not arise from policy change, but rather from unexpected developments in the demand for services under current policies or in the costs of services. Policy measures have to be separated out, so that readers can understand the impact of separate measures that have been taken during the previous year.

Feasibility of the reform

Almost all OECD countries prepare base line estimates, but internal updating practices vary. The frequency of the updates varies from every three or four months to every year. Furthermore not all countries report baseline updates regularly to Parliament, including compensatory measures in case of overspending. The frequency of reporting to Parliament typically depends on the country's financial reporting procedures, because the baseline updates are usually integrated with financial reports. Parliament should be informed properly, including horizontal and vertical explanation. Many OECD countries can further improve their updating and reporting procedures.

Reform 7.3. Medium term expenditure framework

Characteristics of the reform

This reform consists in introducing or strengthening an expenditure framework that is a normative constraint on the total expenditures of central or general government over the medium term. The framework can be flexible (changeable from year to year) or fixed (not changeable). Countries that use a flexible framework often try to maintain their framework as constant as possible from year to year, although changes are possible under certain conditions; hence the difference between flexible and fixed frameworks may not be very large in practice.

Medium term expenditure planning implies that the budget documentation contains forward ceilings for central or general government as a whole and sometimes for ministries or broad expenditure groups for a period of 2 to 4 years after the upcoming budget year. The ceilings are decided at the beginning of the budget process (top-down budgeting) on the basis of macro-economic and revenue forecasts, costs of current and new programmes, fiscal rules or long term objectives and fiscal consequences of revenue options. In the budget process decisions are taken in order to make sure that the expenditure estimates for the upcoming budget year and for the following years at the line item level (baseline estimates) fit into the ceilings for those years. If there is room between the ceiling and the sum of the baseline estimates in any year, new spending initiatives can be allowed. If the sum of the baseline estimates exceeds the ceiling in any year cuts are required. Both baseline estimates and ceilings for the out-years are published in the budget documentation.

The reform also implies the establishment of strong rules of budgetary discipline that require immediate compensation by the line minister of any overspending on the ceilings of the budget year or the out-years during budget preparation and budget execution (until the next framework comes into force). For this purpose it is required that base line estimates are regularly updated (at least three times a year) and carefully checked by the Ministry of Finance.

Where did it occur?

Almost all OECD countries nowadays work with medium term expenditure frameworks (MTEFs), New Zealand being the notable exception. A large majority of the countries use flexible frameworks. A limited number of OECD countries use fixed expenditure frameworks in their budget process, notably: the Netherlands, Sweden, and the UK.

One of the differences between the fixed frameworks in use in the Netherlands, Sweden and the UK is the frequency of the framework's revision. The framework of the Netherlands is periodical in the sense that it is decided during the cabinet formation and covers the entire cabinet period. Ever since the introduction of the framework procedure in 1994, a new framework was decided at the beginning of each cabinet period for four years (but sometimes a cabinet fell before the four years were over, which led to a new framework of a new cabinet but again for four years). The framework of the UK has always been for three years since the introduction of the framework procedure in 1998. In Sweden the framework is on a rolling basis, every year one year is added at the end of the planning period.

However, the difference between the periodical frameworks in the UK and the Netherlands and the rolling framework in Sweden is not as large as it might seem. In the Netherlands the framework is in fact extended every year as well with one new out-year, but the ceilings in the out-years after the cabinet period cannot comprise new policies (either savings or new spending) to be implemented after the end of the cabinet period (in contrast to ceilings in the out-years during the cabinet period, which can comprise new policies to be implemented in out-years). This resembles the Swedish procedure, which excludes new policies to be implemented in all out-years (not only in the new cabinet period). Furthermore the Swedish procedure also allows for the revision of the entire framework at the start of a new cabinet period, if a new cabinet so decides. In the UK the framework is usually revised after two years, whereas the existing framework still contained a third year. The current framework established by the incumbent coalition government covers the period 2012-2014. In this light the procedures in the three countries are very similar as far as the frequency of revision is concerned.

Analysis

Fixed and flexible frameworks

The use of a flexible expenditure framework has important advantages compared to a budget process that does not start with ceilings or that focuses exclusively on the upcoming budget. Starting with a ceiling makes sure that there can be no creep in the total during budget preparation, as was usually the case in the era of "incremental budgeting", when the Ministry of Finance and line ministries started with their respective bids and the outcome ended up somewhere in between. The multi-annual perspective makes sure that future consequences of new spending initiatives are taken into account and have to be reconciled with future ceilings (constraining "camel noses"). Similarly it makes sure that savings that are necessary in future years are decided now. This implies a more structural approach to savings. This is particularly important because important savings usually require various years to phase in since they require changes of laws and reorganisations.

Compared to a flexible framework, a fixed framework has two additional advantages:

1. It leads to a strict separation of expenditure and revenue planning. Revenue windfalls cannot lead to more room for expenditures and revenue setbacks do not trigger consolidation. Expenditure frameworks lead therefore to automatic stabilisation. They are not anti-cyclical in the sense that windfalls lead to savings and setbacks to expansion, but a-cyclical, or neutral in the sense that revenue windfalls and setbacks do not affect expenditures. Automatic stabilisation is usually seen as more effective than anti-cyclical activism, because of timing problems (the recession is over when the stimulus phases in, the boom is over when the consolidation phases in) and the disruptive effect of activism on programme planning and the budget process in general[9].
2. The effect on budgetary discipline is substantially stronger: line ministers cannot hope to survive the current problems by *ad hoc* measures and accounting gimmicks and get more money in the next year. Even though reallocation between sub-ceilings is generally allowed during budget preparation, every line minister knows that reallocation in his/her favour is very difficult to bring about since it has necessarily to go at the cost of a colleague. This implies that every minister knows what he gets for the entire period of the framework. The effect of this arrangement is that line ministers start to behave as "their own minister of Finance". It also implies a considerable change in the task of the ministry of Finance. It does not negotiate anymore about allocation, but it monitors and enforces the rules of the game. These rules are the rules of budgetary discipline which tend to be quite extensive and elaborate under fixed frameworks. In addition the Ministry of Finance has to carefully supervise the regular updating and reliability of the base line estimates, because these estimates are the fundament of the budget process under a fixed expenditure framework. They trigger any savings decision to comply with the framework and they must permit any new spending initiative that respects the framework.

Expenditure frameworks and fiscal rules

An expenditure framework has to be anchored in a fiscal rule. This can be the deficit and debt rules of the European Union (a 3% headline deficit limit and a 60% headline debt limit) or the (structural) Medium-Term Objectives of the Stability and Growth Pact if a country exceeds the headline limits, but it is safer to steer on national fiscal rules that are stricter than the EU rules[10]. Many OECD countries anchor their expenditure framework in a structural balance rule (balance over the economic cycle). The estimation of the structural balance is a difficult exercise. It gives rise to deviating estimations and leads to a certain degree of arbitrariness. This problem occurs in all countries that anchor their framework in a structural balance rule (also if the framework is flexible), but it is mitigated to some extent if the framework is fixed, because in the latter case it only comes up when the framework is revised (or extended, but then only for the extension year at the end of the planning period).

Many OECD countries nowadays try to anchor their fiscal policy in long-term sustainability analysis. This requires that public debt does not exceed a certain percentage of GDP or gradually converges to a sustainable level if it is currently too high (for instance the 60% of the Growth and Stability Pact). In addition it requires that future demographic developments can be absorbed without pushing the public debt over its agreed limit. In case of an ageing population this usually means that public debt should be reduced well below the agreed limit in the coming decades in order to allow it to grow in the longer term until a demographic balance is reached. This in turn implies a substantial surplus target for the balance in future decades.

A particular feature of a fixed expenditure framework is that revenues and the headline deficit fluctuate according to the economic cycle without affecting expenditures. However, if the framework is anchored in a deficit rule, the revenue side of the budget has to be constrained as well. For this purpose it is necessary to fix tax policy at the same time as the expenditure framework for the same period. Subsequently, budgetary discipline at the revenue side has to be guaranteed equally by a compensation requirement. This can be called a “pay as you go” requirement using the terminology of the Budget Enforcement Act that was in force in the USA in the nineties of the previous century (abandoned in 2002). It requires that every enacted change in tax policy is fully compensated in other enacted changes at the tax side of the budget. For instance tax relief in the income tax has to be compensated by tax enhancement in indirect taxes or vice versa. It order not to affect the deficit, both tax relief and tax increases should be compensated. Note that the compensation requirement applies to the estimated change in the tax yield flowing from the enacted changes in the legislation. The compensation requirement does not apply to autonomous cyclical effects under current legislation (this is the essence of automatic stabilisation).

Countries that have constraints on the revenue side of the budget in place, usually have determined a band of fluctuation for the actual tax yield. If the boundaries of this band are exceeded, the underlying change in GDP is considered as structural. If tax revenue exceeds the upper boundary of the band a part of the growth is considered as structural and therefore available for tax relief (“return to the citizens”).[11] If, on the other hand, tax revenue falls short of the lower boundary of the band, this may require revision of the expenditure framework to restore the structural balance requirement in the medium term[12]. Under a fixed framework structural windfalls gives rise to tax relief whereas shortfalls may give rise to downward adjustment of the expenditure ceilings. This reflects the notion that deficit problems should in the first place be solved at the expenditure side whereas the benefits of buoyant growth should at least partly be given back to the citizens.

Coverage of the framework

The choice of coverage has to address two main questions:

1. Should mandatory expenditure be included?
2. Should interest on public debt be included?

In the UK the ceilings (“Departmental Expenditure Limits”, DEL) apply to discretionary spending and exclude mandatory expenditures, so called Annually Managed Expenditures (AME). This applies mostly to social security. However, education and health expenditures, that have in some countries the character of mandatory expenditures (because they are in those countries completely determined by law) are considered in the UK as discretionary and thus are included under the ceilings. DEL included around 60% of total spending and AME around 40%. DEL ceilings are set separately for current and capital budgets in order to protect investment (ministers cannot compensate setbacks on current spending by cutting investments). An argument for excluding AME expenditure is that some of it is cycle related, in particular unemployment benefits, so that exclusion may contribute to automatic stabilisation. In Sweden and the Netherlands, the ceilings include both discretionary and mandatory spending. The logic behind this is that the very reason for working with multi-annual frameworks is that setbacks on mandatory spending can often be anticipated years in advance so that timely measures can be taken to change the laws. Furthermore in Sweden and the Netherlands a larger share of expenditure is completely determined by law and thus mandatory (for instance education spending and all grants to local government in the Netherlands). Excluding mandatory spending would thus deprive the frameworks of their effectiveness. Finally, most mandatory spending is not cycle related, so that the automatic stabilisation argument is not very strong.

Interest payments on public debt are excluded from the ceilings in the UK and Sweden (in the UK because they are AME). The main argument is that these expenditures are accounted for on the budget of the Ministry of Finance and that ministry has little room for manoeuvre to compensate for large setbacks. In the Netherlands interest payments were under the ceiling from 1994 to 2008, then taken out from 2008 to 2011, then included, and since 2012 again taken out. The temporary exclusion from 2008 to 2011 was presented as a “stimulus measure” to the European Commission. There was not much else behind this measure. The current inclusion is mostly due to the pragmatic reason that public debt has risen substantially in current years, which makes it increasingly difficult for the Minister of Finance to find compensation for overspending in a relatively small budget.

Feasibility

When introducing or strengthening a MTEF, the authorities have to decide on the main features of the framework procedures and in particular on whether the framework will be fixed or flexible, on the anchoring of the framework in a fiscal rule, on the constraints at the revenue side of the budget and on the coverage of the framework.

Fixed framework has additional advantages compared to flexible frameworks but require relatively low volatility of GDP development and an extensive set of precise rules of budgetary discipline that should be subjected to explicit government approval.

Governments may consider anchoring the expenditure framework in a balance rule that is stricter than the EU deficit rule and that is based on long-term sustainability requirements. Governments are also advised to consider introducing a "pay-as-you-go" requirement on the revenue side of the budget that includes tax expenditures.

When introducing this reform, it is important to consider that the advantages flowing from the multi-annual perspective are only realised if the reconciliation requirement between base line estimates and ceilings in out-years is taken seriously, which requires reliable estimates, which are regularly updated and published in the budget or the budget documentation. It also requires that estimates for the out-years are carefully checked by the Ministry of Finance. In a budget process that is based on expenditure frameworks, line ministries have an interest in keeping base line estimates for the out-years low in order not to trigger savings decisions. If the problem arises a year later, it is often too late for structural measures, so that the line minister may hope to receive more resources for funding of ongoing programmes. In a flexible framework this hope is the more realistic because the framework can be changed from year to year. Paradoxically, the Ministry of Finance sees itself therefore often in a position to plead for higher base line estimates in out-years and this incentive is stronger to the extent that the framework is more flexible (in the sense that the budgetary culture is more permissive to annual change of the framework). It can also help to have a check on the base line estimates of major programmes with demographic components (education, social security, health, social services) by an independent forecasting institution.

Reform 7.4.Focusing the budget documentation on financial information

Characteristics of the reform

The reform consists in providing more concise information in the budget documentation focusing on the expenditures for policy instruments and administrative expenditures, while moving information on results to ministerial policy documents and evaluation reports.

The reform can lead to better readable budget documentation of smaller size that responds better to the needs of parliamentarians and the public.

The reform supposes that the budget is classified according to a programmatic classification (see Reform 7.1). The budget documentation provides information on the costs of separate policy instruments, in particular if the line item of the budget consists of various policy instruments, and on the administrative expenditures of the ministry, split out in expenditures of the core ministry and the various agencies, and, as far as the core ministry and the agencies are concerned, the main components of the administrative expenditures, such as salaries of civil servants and contract employees, procurement of goods and services and ICT.

Where did it occur?

Whereas in many countries reforms have taken place in the last few years that aim to improve the readability and relevance of the budget documentation to parliamentarians and the public, the Netherlands has implemented the most far reaching reform in this respect. The memorandum "Accountable Budgeting" submitted to Parliament in 2011 contained proposals to revise the budget documentation in order to implement this reform in two stages, the first in the budget 2012 and the second in the budget 2013. Currently the reform has mostly been carried out, although some aspects still have to be fine-tuned (Ministry of Finance of the Netherlands, 2011).

Analysis

Shortcomings in the informational content of the budget and the budget documentation

The New Public Management reforms of the 1990s have in many countries led to unexpected and unintended consequences, including a large extension of the budget documentation. In particular the budget documentation was often packed with performance information (information on outputs and outcomes) that obscured how public resources were actually used, that did little to clarify the responsibilities of the minister, and that, according to critics, sometimes had the character of "government propaganda" (see Chapter 1 for a general survey of the unexpected consequences of New Public Management").

In the Netherlands this led to complaints by Parliament. In particular parliamentarians noted that the reduction of the number of line items in the budget from 800 to 160 as a consequence of the introduction of a programme classification, had obscured insight on how public resources are actually used. Programme articles sometimes included a number of policy instruments, whereas the costs of each did not appear in the budget or the budget documentation. In addition most ministries had divided administrative expenditures over programme line items. Other ministries had a central line item for administrative expenditures but did not split it out over types of operational means, such as salaries and ICT expenditures. Moreover, output and outcome information did not make clear the responsibility of the minister and the extent to which the minister had control over outputs and outcomes or are achieved mainly by non-financial instruments such as legislation (outputs are often determined by entitlement legislation and outcomes are determined by many factors over which the minister has little control, for instance reduction of school drop-out or protection of human rights in foreign countries. In addition parliamentarians noted that it was often not clear what the policy consequences were of performance information and policy evaluations. In summary the virtual elimination of input information from the budget and the budget documentation, combined with the unfulfilled promise of performance accountability using output and outcome information, left parliament with a sense of loss of control. This was increasingly perceived as an accountability gap.

Complaints of a similar nature have been heard in several other countries that have been visited for the purpose of this study. The current reform seeks to address these problems by proposing a number of remedies concerning the budget documentation. They focus on 1) the content of the financial information to be included, 2) the content of the policy information to be included.

Financial information to be included in the budget documentation

The budget is a financial document. It fulfils several functions: allocational, macro-economic, managerial, but its first function is that of authorisation: it serves as a vehicle for Government and Parliament to decide on how public resources are spent. This has consequences for the budget classification and the budget documentation. The New Public Management School assumed that Government and Parliament were only interested in the realisation of policy aims, but this is not factually the case. Parliamentarians have interest in how resources are actually spent, and for good reasons that are explained in Chapter 1. This has two consequences for the budget classification and for the budget documentation. First, classification and documentation must specify the costs of separate policy instruments. Second, classification and documentation must specify administrative expenditures.

A programme classification is generally characterised by a limited number of line items (see Reform 7.1). Expenditures are divided on the basis of programmes with a common policy aim, sometimes split out in sub-programmes. However, it often occurs that under the same programmes or sub-programmes expenditures are authorised that cover the costs of several policy instruments. Policy instruments are conceived in this context as separate subsidies, social benefits, programme investments[13], transfers to local government and international organisations, etc. Some countries that have moved to a programme classification have split out expenditures for separate policy instruments in the budget documentation as "activities", for instance France. However, others have not. There is a trade-off between the number of line items and the degree of specification of the policy instruments. It can make sense to limit the detail in the classification, provided that the information on the separate policy instruments is still provided in the budget classification. The expenditures for the separate instruments are then not subject to parliamentary authorisation, but the Parliament can still exert its power of the purse by approving or amending the line items in light of the information provided in the budget documentation. This practice contributes to the conciseness and readability of the budget and reduces the need for supplementary budgets if government decides to reallocate resources between policy instruments after the budget has been approved. This requires of course regular reporting on budget execution (that is important for other reasons as well), so that parliament can intervene during the course of the execution year if resources are used for other purposes than it is willing to approve.

Parliamentarians also have an interest in administrative expenditures. In principle this information could be provided in the budget documentation as well, rather than through the budget classification, but in practice this solution leads to many difficulties. It requires that for the purpose of the budget classification, administrative expenditures are split among programmes. However, administrative expenditures cannot easily be split out in this way. Typically the core ministry divides its administrative resources over the programmes in a flexible way. Many officials, especially those that fulfil positions at the higher levels of the hierarchy work on several programmes and policy instruments simultaneously and the attention that they give to separate programmes and policy instruments differs from day to day and from period to period. This makes the splitting of administrative expenditures among programmes and policy instruments an arbitrary exercise. Moreover, many agencies carry out several programmes and policy instruments. One can think of agencies that execute subsidy programmes, or social benefits or grants to local governments. Splitting out the expenditures for separate programmes and policy instruments is then a similarly arbitrary endeavour. Experience shows that it leads to endless internal discussions and high administrative costs. Furthermore the significance of the line item estimates is obscured if they can contain administrative expenditures. Finally, including administrative expenditure in programmes can lead to leakage of programme expenditure into salaries and accommodation, which Parliamentarians want to prevent (see Reform 7.1).

In this light it is preferable to keep administrative expenditures apart from programme expenditures in the classification and to subject them to separate parliamentary authorisation (see also Reform 7.1).

Nevertheless, even if this is done, parliamentary interest in administrative expenditures usually goes further than the totals for the core ministry and the agencies.

Members of parliament are typically interested in civil service salaries, costs of contract employees, procurement of goods and services, costs of ICT, etc. Here the reasoning applies that this information can be given in the budget documentation without impairing the power of the purse, in a similar way as the information about separate policy instruments.

According to the Dutch reform the administrative expenditures of the core ministries will be authorised in a central article for operational expenditures ("*apparaatsuitgaven*", "apparatus expenditures"). Insight in the various types of operational expenditures of core ministries, in particular salaries, costs of contract employees, costs of ICT and costs of other procurement of other goods and services, will be provided in the budget documentation.

The budget will also provide an overview of the total operational costs of arm's length agencies (arm's length agencies have an accrual administration: hence costs instead of expenditures). The split in kinds of operational costs of arm's length agencies will be provided in separate agency articles of the budget.

The budget documentation will also provide an overview of the total operational costs of administrative independent agencies[14], but the overview will not present the split in kinds of operational costs of these agencies. This does not seem entirely consistent with the logic of the reform. The minister is accountable for the operational management of administrative independent agencies. These agencies have a special statute that prohibits government interference in their executive policy and decisions in individual cases, but the minister remains accountable for their operational management. It seems logical to split the operational costs of administrative independent agencies in a similar way as the operational costs of arm's length agencies in the budget documentation. Administrative independent agencies, even if they have legal personality, typically lack the internal procedures of efficiency scrutiny that are characteristic for public non-profit institutions tasked with service delivery (universities, cultural institutions such as museums, etc.)[15].

In spite of the fact that the total operational costs of the agencies are presented in the budget or the budget documentation, the public contributions to some arm's length agencies (the ones that are not shared service centres) and all independent agencies are authorised as programme expenditures. This seems unnecessarily complicated. It would be simpler to authorise all public contributions to the operational costs[16] of administrative agencies as administrative expenditure (next to the operational expenditure for the core ministry, see Reform 7.1 for how the budget classification would look like in that case).

A special problem concerns the operational expenditures of service delivery units such as the military and the police. As far as these units are concerned, the Dutch reform includes a rather complicated set of rules which imply that under certain conditions the expenditures on salaries and goods and services of these units can be authorised as programme expenditures and not included in the administrative expenditure article of the core ministry, nor in the survey of administrative expenditures in the budget documentation. The arrangement seems rather complicated and not entirely satisfactory since it does not apply to all service delivery units in the core ministry or the agencies. It would be simpler and more in line with the rationale of the split between programme expenditure and administrative expenditure to exclude all expenditure on salaries and goods and services of service delivery units inside the ministries and agencies from the definition of administrative expenditure, and thus from the survey of administrative expenditure in the budget documentation (see Table 2.1 in Chapter 2).

Furthermore, it deserves attention that in many counties educational establishments (which in the Netherlands are public non-profit institutions or municipal agencies) and care providers such as hospitals (which in the Netherlands do not belong to central or general government sector at all) belong also in this category of service delivery units without legal personality for which it is reasonable to specify their expenditures on salaries and goods and services as programme expenditures.

Policy information to be included in the budget documentation

If the focus of the budget documentation is put (again) on financial information, the question arises what policy information should remain. In this respect the Dutch example is illustrative.

In the Dutch reform it is emphasised that Parliament and the public are in the first place interested in what the responsible minister (and thus the government) wants to achieve and what she/he has done for that purpose. The budget documentation is not the place for extensive expositions of the aims and instruments of sectoral policies in general. This information should be provided in periodic sectoral documents (sectoral plans for the medium or long term, in some sectors with annual updates) and should not repeated from year to year in the budget documentation. Rather the line ministers should be invited to provide a short summary of what they intend to change during the upcoming budget year in her/his policy aims and policy instruments that will have budgetary consequences reflected in the budget and the baselines for future years.

As to policy information in the budget documentation, the Dutch reform emphasises the importance of policy evaluations. The line ministers are responsible for policy evaluations but before the reform the budget documentation gave at best a fragmented overview of these evaluations divided per line item. The reform includes the provision that the budget documentation should list all evaluations, that have taken place in the previous year (including publication references) and that are planned for the upcoming years (the budget memoranda contain a multi-year schedule for policy evaluations) per ministry, as well as the consequences drawn from the past evaluations for policy adjustments in the coming year, including the consequences for the upcoming budget and the baselines for future years.

As to performance indicators, the Dutch reform is based on the idea that indicators of processes, outputs and outcomes can be provided in the budget documentation if these results are measurable and the indicators make sense and can be influenced by the Minister. If this is not the case they should be omitted. This has led to a lively discussion between the Ministry of Finance and the line ministries on which indicators are worth to include in the budget documentation. Given that evaluation is seen as a responsibility of the line ministries and that evaluations must be published by the line ministries, it would have been more consistent to stipulate that performance information should be provided in sectoral policy documents and not at all in the budget documentation. Nonetheless, in the Netherlands, the number of indicators was roughly halved in comparison to the old budget memoranda.

Finally the Dutch reform includes a (strict-) limit on the number of pages of the budget documentation. This provision is important because it supports various other components of the reform, in particular the limitation of policy information to what the minister intends to change in the upcoming budget year and the provision that performance information should be limited to results that are measurable and indicators that make sense.

Feasibility of the reform

The reform is feasible in all OECD countries that have moved to a programme classification. The split of programme line items in separate policy instruments in the budget documentation is in particular important for countries that have reduced the number of programme articles to the extent that the line items authorises expenditures for more than a single policy instrument. The introduction of a central line item for administrative expenditures of each ministry is in particular important for countries that have tried to split administrative expenditures according to programmes.

In addition, the expectations of results accountability through performance information in budgets were not met. Putting more emphasis on the financial consequences of changes in policy aims and instruments can help produce more informative and transparent budgets.

Reform 7.5. Automatic cuts of productivity dividends

Characteristics of the reform

This reform consists of automatic, annual cuts of productivity dividends in appropriations, available for distribution to priority areas or for savings. The reform is based on the assumption that production of goods and services in the public sector leads to annual efficiency gains similarly as in the private sector. These annual dividends are a result of productivity growth and can be estimated. A corresponding reduction in appropriations (called here "cuts of productivity dividends") can thus be applied. If the efficiency gains are not taken into consideration, they can lead to backdoor increases in service levels. When taken into account, these productivity dividends can be subjected to annual mandatory cuts.

This reform has two essential characteristics: first, the cuts of productivity dividends are "automatic" in the sense that they are part of the regular budget process and do not require special decisions from year to year as to their application; and second, the cuts are at least applied to the operational expenditures[17] of central government.

Where did it occur?

Such cuts are applied in a number of countries participating in the Value for Money Study: Australia, Denmark, New Zealand, and Sweden. In Finland there is no practice of automatic cuts as such, but the programmes for Central Government Productivity (from 2007) and for Effectiveness and Productivity (from 2011), that were introduced as *ad hoc* saving operations in the country, have some characteristics that are similar to cuts of productivity dividends.

Analysis

Key features of the reform

The main argument for this reform is that the traditional assumption that in the public sector productivity growth is zero is not realistic. This conventional assumption has been reconsidered in the past years and some OECD countries have started exploring options for measuring the value for public outputs, thus accounting for productivity development, and applying automatic annual cuts to avoid backdoor increase in service levels.

The key features of the arrangements in these countries are summarised in Table 7.2 below.

Table 7.2. Key features of the arrangements of the reform

	Terminology	History	Baseline and size	Coverage
Australia	Efficiency Dividend	• Introduced in the 1987-1988 Budget. • A precursor to the efficiency dividend was introduced in the 1986-1987 Budget which aimed to achieve a general efficiency saving of 0.5% in salaries and 1% in administrative and operational expenditures.	• 1.25% per annum from 1987 • 1.0% from 1994 1.25% from 2005 (up to 2% in 2008-2009) • 1.5% from 2011 • 1.25% from 2013 • 1% from 2015	• A uniform percentage decided by the Government is applied to the operational expenditures of all ministries and agencies in the general government sector unless they are exempted by the Government.
Denmark	"Reprioritisation contribution"	• A uniform, automatic annual budget cut of 2 % was introduced in the mid-1980s. • From 1987 the cut rate varied form agency to agency on the basis of empirical productivity studies, but on average was about 2.5%. • The empirical estimates were not considered very reliable and were open to criticism. • In 1993 it was replaced by a uniform 2% cut.	• 2% cut is applied to the operational expenditure of central government in the last out-year of the four year budget forecast (baseline) that is part of each year's budget. • The base varies as different parts of central government are exempted depending on government priorities and special political agreements.	• Institutions and programmes subject to special political agreements are exempted from the cut.Exemptions on this ground account for approximately 1/3 of central government operating expenditure (the remaining 2/3 is subject to the cut), but the percentage varies from year to year.
Sweden	"Deduction in Productivity Growth (DPG)"	• From 1994 agencies were no longer automatically reimbursed for increased wage costs. The same wage index started to be applied later in the agencies to all agencies (if an agency's service output is kept unchanged, it is assumed to be able to produce this output with decreased wage resources because of the corresponding increase in the productivity of labour).	• The DPG is calculated as the average productivity growth in the private sector (1% - 2%). • Productivity is calculated by dividing the real contribution of the sector to GDP by the number of labour hours worked in the sector.	• The DPG applies to ca. 16% of the total budget (the percentage represents the base amount subject to DPG).

Table 7.2. Key features of the arrangements of the reform *(continued)*

	Terminology	History	Baseline and size	Coverage
New Zealand	"Fixed Nominal Baselines" and from 2012, an additional "efficiency savings" is applied.	• New Zealand has had Fixed Nominal Baselines since the early 1990s on all baselines excluding some specific items. • In addition, the Cabinet decided in April 2011 to implement efficiency savings on core governmental administration.	• Nominal current operational expenditures are used as baseline in the annual budget cycle meaning that inflation has to be absorbed. Given that the inflation rate has been around 2.5% for the last few years, ministries had to achieve a similar productivity gain in order to maintain their existing level of output. • The efficiency savings (3% for small agencies and 6% for larger agencies) are applied to agency component of the current operational expenditures (not to the core ministries).	• Fixed Nominal Baselines for operational expenditures are applied on the entire central government budget, without exception.
Finland	"Central Government Productivity Programme" (from 2007) "Programme for Effectiveness and Productivity" (from 2011)	• In the context of an ad hoc saving operation, productivity targets until the year 2015 (cuts in operational expenditure) have been decided.	• The cuts are based on increasing labour productivity and are implemented via four-year Spending Limit Decisions and annual budgets. • The annual percentage cut is differentiated between policy areas. The average requirement is a 1% cut for the government as a whole.	• All ministries were asked for productivity plans to increase productivity and these plans were then used to decide the size of the cuts. Targets for staff reductions were converted into targets for cuts of current operational expenditures by using roughly the average cost of person work-year within the central government.

Measuring productivity in the public sector

Measuring productivity is the key challenge in implementing this reform. Productivity is generally defined as a measure of the amount of output (services in kind and administrative services) generated per unit of input (labour and capital). Strictly speaking, this is the definition of average factor productivity, which stands in contrast to the definition of marginal factor productivity (the marginal addition to output as a consequence of a marginal addition to an input).

Operational (or technical) efficiency is a relative concept: it measures the relative productivity of a production process. It can be defined as the amount of input required to produce a unit of output compared to the amount of input required in the optimal production process.

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 measurement of the public sector output, is complicated by, first, the lack of market prices (the majority of public services are not sold in competitive markets), and second, the difficulty of accounting for changes in quality of services. Despite its importance, comprehensive measures of the public sector's productivity have not been developed even in the most advanced countries. In the past, public sector output was typically measured by inputs and activities (such as how many customers received services or how many students were taught). The outputs produced have not received sufficient attention. Moreover, in the national accounts it has been commonly assumed (although not prescribed) that in the government sector the value of inputs equals the value of outputs. This assumption has not been conducive to developing output measures.

However, this output = input convention has increasingly come under scrutiny in recent years. Many policy makers and academics consider this as a major shortcoming and some OECD countries have started exploring other options for measuring the value for public outputs, thus accounting for productivity development. Governments around the world have begun to carry out the research and policy analysis aiming to identify the multiple factors that drive productivity improvements in the public sector (such as labour skills, new technologies, improved managerial capabilities and service innovations), to measure the impact of those factors, and to identify ways to manage those factors to improve productivity.

In light of this measurement challenge, it would be difficult in this stage to state a conclusion about the best model for measuring productivity in the public sector. However country experiences provide arguments for the following valuable principles that can be considered in designing and implementing the reform:

1. Given widely different approaches to the measurement of productivity in the government sector, it seems prudent to avoid an overly direct connection between the outcomes of productivity research and the cut rates. A direct connection may lead to a permanent policy debate about the appropriate cut percentages in the various areas of public service provision and a politicisation of productivity research. There is consensus that there is productivity growth in the government sector and there are approximate insights in the order of average growth in the government sector as a whole. This is enough to establish an effective

arrangement of productivity dividend cuts, based on an undifferentiated annual cut percentage.

2. The overview of country examples shows that the cut rate varies from 1 to 2.5%. There are basically two approaches to the choice of the cut rate. The first is a political decision informed by national and international productivity research. The second approach is the Swedish one, which basically calculates government sector productivity growth as a ten year moving average of productivity growth in the private service sector. The cut percentage may change from year to year but the changes are very small in view of the use of a ten-year moving average. This approach may have the advantage that it is less vulnerable to short term political considerations and that it ensures equal treatment of the private and public service sectors.

Feasibility of the reform

The experience of Australia, Denmark, New Zealand, Sweden and in part of Finland shows that estimating productivity gains and redistributing them annually to priority areas is a feasible and operational practice. The main advantage mentioned by the countries that use them is that automatic cuts change the baseline of current policy that serves as the point of departure for the annual budget process. This is seen by finance ministries as a strategic advantage in budget negotiations.

The critical element in designing and implementing the reform is to establish a proper cut rate in the absence of reliable estimates of productivity growth at the sectoral level. There are two key approaches in defining the cut rate: first, differentiating the percentage on the basis of empirical productivity studies; and second, using a government-wide percentage based on a reasonable average.

At present countries do not use the first approach, because it does not provide for reliable estimates and is thus open to all kinds of criticism. The second approach is partly political and therefore the acceptance of the reform by ministries and by the public is challenging. Even in Sweden, where the model is the least politicised (the cut rate is linked to productivity development in the private sector and not established by government decision), it has been debated and criticised before being agreed upon by political parties and civil society. However, automatic cuts of productivity dividends do not mean that the budget of all line ministries is substantially reduced from year to year. First, the cuts only apply to current operational expenditures which are generally a small part of ministerial budgets. Second, most ministries annually have new spending initiatives which may be larger than the automatic cuts. These two factors can play a role in moderating resistance against the introduction of the reform.

Reform 7.6. Strong spending review procedure, anchored in law

Characteristics of the reform

Spending Review (SR) is a tool of financial management aiming at evaluation of current spending programmes, in order to identify and recommend savings options and to make room for new initiatives, hence supporting both fiscal discipline and enhanced Value for Money across government. It is an evidence based assessment of spending efficiency, and more broadly of the efficiency and effectiveness of public policies.

The introduction of SRs can provide, on the one hand, savings (a SR is aimed at the development of concrete spending options varying usually from 5% to 20% of spending) and, on the other hand, a quality improvement in public policy (a SR evaluates the efficiency and effectiveness of current programmes and puts forward options for programme improvements next to savings options).

In contrast to policy evaluations by line ministries (see Reform 2.5), a SR has a different aim and follows different procedural rules. These are the three main differences:

1. SRs not only look at the effectiveness and efficiency of programmes under current funding levels but also at the consequences for policy outputs and outcomes of alternative funding levels;
2. the Ministry of Finance holds final responsibility for the spending review procedure; and
3. the follow up of spending reviews is decided in the budget process, so there is a direct link between SRs and budgeting (OECD, 2010).

Where did it occur?

Conducting SRs is a widespread practice in the countries participating in the Value for Money Study. Australia, Canada, Denmark, the Netherlands, and the UK have integrated SRs in the budget cycle either on annual or multi-annual basis. The table below summarises the key features of these national practices. Finland, Ireland, Spain and Sweden have also reported to conduct SRs, however their experiences are either recent and relates to the post-crisis consolidation measures or are not established as a permanent component of the budget process.

Analysis

Key features of the reform

The key features of the arrangements in these countries are summarised in Table 7.3 below.

Table 7.3. Key features of national practices

Country	History	Review topics and coverage	Organisational set up and key actors	Number of SRs	Linkage with the budget
Australia	• Strategic reviews were introduced in 2007, replacing lapsing programme reviews. • A special Expenditure Review Taskforce (ERT) was established in the Department of Finance and Deregulation (DFD).	• Topics are identified by the Minister of Finance who then requests Cabinet to agree on the proposed reviews. • SR is not focused solely on operational efficiency, but has a whole-of-government focus, examining the alignment of programmes with government priorities, the effectiveness and the efficiency of programmes and potential budget savings.	• SRs are managed by the DFD (and Treasury in the case of tax expenditures) in close consultation with the responsible ministry. • Each review is conducted over 4 to 6 months by a team of 4 members led by a senior Finance officer or by an independent chairman who is either a former civil servant or an eminent person. The team is supported by a consultative group of representatives from relevant ministries and agencies, including the Department of the Treasury and the Department of the Prime Minister and Cabinet, which provides expert advice to the team. • Line ministries are invited to participate in the review via interviews or as part of a reference group, but they do not have any direct influence over the report or its recommendations. • Reports are presented to the Finance Minister who brings it to Cabinet who takes the final decisions on implementation of review recommendations. • There is a trend for these reports to be published.	• 12 SRs have been conducted since 2007.	• As the topics are selected at the start of the budget process, SRs assist the Cabinet to decide priorities in budget formulation. • SRs are usually conducted during the budget preparation process.

Table 7.3. Key features of national practices *(continued)*

Country	History	Review topics and coverage	Organisational set up and key actors	Number of SRs	Linkage with the budget
Canada	• SRs have been introduced in 2007.	• SRs are systematic and comprehensive assessments of all programme spending every 4 years, assessing how and whether the programmes are aligned with priorities, and whether they provide value for money. • SRs three key aims are: ○ to ensure the efficient and effective delivery of departmental programmes, ○ to ensure that departmental spending programmes are aligned with the federal government core responsibilities, and ○ to ensure that departmental spending is aligned with the government's key priorities. • All reviews must identify options for programme redesign, and at least 5% of total spending must be "freed-up" for reallocation from the "lowest priority, lowest performing" policies.	• Treasury Board (TB) leads the SR process and the Treasury Board Secretariat (TBS) provides advice and guidance on its conduct. The responsible Ministry conducts the review in accordance with the Terms of Reference. • Ministries are required to establish a Steering Committee, and establish under the committee their own "review teams" according to their assessment of how best to meet the requirements of the reviews. Ministries are required to engage an external expert to provide advice on their Strategic Reviews. • The Minister presents the findings and results of the reviews to TB. TB (supported by TBS) reviews all the Strategic Review recommendations presented by Ministers and makes recommendations on the reallocation and reinvestment proposals as input into the Budget planning process. The Minister of Finance reports annually on results of the reviews in the Budget. • The details of the reviews are Cabinet Confidences and are not published.	• In 2007 17 SRs took place, covering about 15% of total programme spending. • In 2008, 21 SRs took place covering about 27% of total programme spending. • In 2009 20 SRs took place covering around 23% of total programme spending. • In 2010, 12 SRs took place covering around 30% of total programme spending.	• The results of SRs are considered by Cabinet as part of Budget planning, feed into the annual budget process and are announced in the annual budget.

Table 7.3. Key features of national practices *(continued)*

Country	History	Review topics and coverage	Organisational set up and key actors	Number of SRs	Linkage with the budget
Denmark	• The SR practice was developed during the 80s' and 90's.	• Budget analysts identify subjects for SRs in an early stage of the budget preparation in view of upward pressure on spending ceilings and efficiency/effectiveness deficiencies. • After internal decision making in the MoF and dialogue with the concerned line ministries, the MoF proposes a list of SRs to the Economic Committee of the Cabinet to decide. • The reviews are conducted over a relatively short period of time (2-4 months)	• There is no standard framework and for each review the responsible unit and person in the MoF has a high degree of discretion on how conduct it. In practice similar procedures are applied from year to year to organise and conduct SRs. • For larger SRs external experts (consultants) are involved in the analysis and a steering committee with participation of the affected line ministry is set up. The line ministry contributes factual information and is involved in drawing conclusions from the review. The role of the MoF is to challenge established views and procedures. • For smaller reviews, the organisation and procedures are less formalised, and the review is conducted in bilateral contact with the relevant line ministry. • The Government's Steering Committee receives the recommendations and decides on proper reaction. • SR reports are sometimes published (or made available on the Internet) after the Government has decided upon recommendations.	• Over the last years, the number of SRs has been in the range 10-15 annually (except for one year with 34 reviews).	• Expenditure adjustments are incorporated in next year's budget.

Table 7.3. Key features of national practices *(continued)*

Country	History	Review topics and coverage	Organisational set up and key actors	Number of SRs	Linkage with the budget
The Netherlands	• SRs are conducted annually as from 1981. Recently the procedure moved partly to a more periodic and comprehensive schedule (a multi-year review cycle).	• The reviews must be primarily forward-looking and include reform options based on an evaluation of the current policy. • The reform options must lead to savings (in many years with a mandatory option leading to a spending reduction of 20%). • The procedure was invigorated during the fiscal crisis when a comprehensive review of all major spending programmes in the public sector took place (some 20 reviews). The current trend is to move to a multi-year review cycle in which all major spending programmes are reviewed in the year before elections (although *ad hoc* reviews during the cabinet period are not excluded).	• SRs are conducted by working parties of civil servants from several ministries and external experts under the chairmanship of a prominent person who does not bear responsibility for current policies. • All SRs are supported by a special unit in the MoF which provides the secretariat of all working groups. In the working parties there is no right to veto any policy option proposed. • The spending review procedure is supervised by a committee of high-level officials of the central ministries (including Prime Minister's Office, Finance, Economic Affairs, and Interior and Kingdom Relations). • The reports of all spending reviews are published and made available to the public and political parties. In review rounds preceding elections they are published before the start of electoral campaigns.	• 10 to 15 interdepartmental reviews undertaken each year (the number of reviews fell during the 2000s to 3-5 each year), but in 2010 some 30 SRs took place.	• Decision making on options described in the SR reports is integrated in the budget process. • The in-coming cabinet has used recommendations from the spending reviews as input for the government programme.

Table 7.3. Key features of national practices *(continued)*

Country	History	Review topics and coverage	Organisational set up and key actors	Number of SRs	Linkage with the budget
UK	• The SR practice was introduced in 1998.	• The SR process focuses on discretionary spending, which covers around 60% of total spending. This is the part of the budget that is subject to the fixed multi-annual ceilings ("Departmental Expenditure Limits, DEL). The remaining 40% is taken up by "Annually Managed Expenditure" (AME) which includes social security, interest, and other items of mandatory spending, and is allowed to fluctuate to provide for automatic stabilisation. • The aim of SRs is to support the biennial revision of the expenditure framework and ministerial ceilings. For that purpose the SRs are supposed to: ○ to reallocate money to key priorities, ○ change policies so that money is well spent, ○ ensure that departments work better together to improve services, and ○ weed out unnecessary and wasteful spending.	• SRs are produced by various types of working groups: some exclusively composed of Treasury officials, some of mixed composition. • External experts and prominent personalities from the public and private sector are often invited to participate or chair the working groups. • The completed reviews are discussed between the Chief Secretary of the Treasury (responsible for the budget) or the Chancellor of the Exchequer and the line minister.	• 6 rounds of SRs took place in the UK since the introduction of this practice in 1998.	• The SR process is explicitly linked to the setting of departmental expenditure limits on a periodic basis. • In 2010 the comprehensive SR was used to distribute large-scale expenditure reductions planned over a five-year period across the various ministries.

Rationale of the reform

A spending review (SR) is a mechanism that aims to overcome the fundamental asymmetry of the budget process. This asymmetry consists in the fact that line ministers have incentives for making good proposals for new spending (the better the proposals the larger the chance of adoption) but have no incentives to put forward good proposals for new savings (for the same reason: the better the proposals the higher the chance of adoption).

One method to overcome this asymmetry is to impose strict portfolio ceilings, which force line ministers to put forth good savings proposals to compensate for setbacks and new spending initiatives. However, this mechanism does not work at the time the ceilings are established or adjusted. So at these occasions there is a need to develop options for savings outside the regular budget process. A SR is a tool that provides for that need.

Spending reviews allow for developing saving options in co-operation with line ministries but without giving them a leading and decisive role. Therefore one of the key features of SRs is that this process is centralised, and that the Ministry of Finance (or Prime Minister's Office) holds final responsibility for the SR procedure.

Need for a comprehensive legal framework

In order to be an efficient tool of financial management and reallocation the SR practice needs to rest on a comprehensive regulatory framework. Formalising key features of the procedure provides it with the status of a regular foreseeable exercise and reduces the need for ministries of Finance to "reinvent" the procedure with each review (as is the case in Denmark).

It is also important to promote SRs as a focused process. It implies that a SR should lead to concrete, elaborated saving recommendations to be used in the budget process. It also means that the SR process and its outcomes should be embedded in the budget cycle. Without this link with budget formulation SRs cannot produce the expected impact on expenditures and programme efficiency and effectiveness. Options to increase expenditures should not be allowed in SRs. The required amount of savings to be developed by a SR must be fixed in the regulation.

To ensure the process is sustainable over time, and to avoid that the procedure will gradually fall victim to 'reform fatigue' (as has happened in Australia and Canada), SR exercises should be conducted on a prescribed periodic basis. This can be ensured in two ways. In view of the required link with the setting of expenditure ceilings, SRs may be set up as an annual or periodic exercise. If the expenditure ceilings are set or extended annually, as is the case in most OECD countries, SR can be conducted on a selective basis, so that every year a limited number of reviews are conducted. In this case it is important to ensure that all policy areas are reviewed at least once in every cabinet period. Alternatively, if the expenditure ceilings are set every two or three years or only once in every cabinet period, as is the case in the UK and the Netherlands[19], SR may be set up as a triannual or quadrennial exercise. In this case it has to be ensured that all policy areas are reviewed simultaneously. In both cases the effect is that each separate policy area is not reviewed more than once in every cabinet period.

Role of the ministry of Finance

Another important feature of the SR procedure is to promote pro-active participation of both the Ministry of Finance and of line ministries in the process. The experience of the Netherlands and the UK reflects a certain tendency to a wait and see attitude of Finance representatives which may diminish their impact on the SR reports.

To make the collaboration between the Ministry of Finance and line ministries more balanced, Ireland has introduced a "court like style" process in its one off spending review exercise of 2008. In this approach each line ministry was invited to submit an evaluation paper in advance of the meetings of the SR team. The purpose of the evaluation paper was to give line ministries an opportunity to outline possible savings options and the impacts on outputs and outcomes. In parallel with this process, the Ministry of Finance prepared their own evaluation papers with included options for expenditure and staff reductions. Both sets of evaluation papers were considered by the SR review team. Subsequently the team produced its own savings options, making use of all information thus obtained. This “accusatorial” rather than "inquisitorial" process puts responsibility on the Ministry of Finance to develop its own set of workable savings options, and allows them to include lessons from other government departments who have successfully cut operating costs or redesigned policies.

Feasibility of the reform

As there is no single blueprint for establishing a successful SR procedure and country models differ, many factors should be considered and tailored to the national institutional and regulatory context and established practices. In order to succeed, the key concern in institutionalising the SR procedure is to make SR as focused as possible, meaning that they must lead to concrete and elaborated saving options to be used in the budget process.

It is equally important to anchor in law the aims of a SR and a clear set of procedural instructions:

- mandatory savings options; prohibition of options leading to additional spending;
- participation in the review teams: experts from Ministry of Finance, line ministries, Prime minister’s Office and external experts;
- appointment of an independent chairperson (who do not carry responsibility for the policy area);
- establishment of a steering group of senior officials of central ministries tasked with supervision;
- the criteria for subject selection and the frequency of SRs;
- exclusion of a veto right on options to be introduced in the reports;
- publication of the terms of reference and of the reports, except in special cases (for instance reports on security organisations);

Anchoring these instructions in law is important for the effectiveness of SR and for the sustainability of the SR procedure over time. A strong SR practice may require creating a spending review unit within the Ministry of Finance to support the review process. It has to ensure that the reviews are conducted in a timely manner and that they remain focused on questions that lead to saving options that can be used in the budget process.

Notes

1. To be reduced to 120 in 2015.
2. Since 2007 reduced to 160 line items.
3. The term “line item” means here the lowest level of the budget classification that is used for authorisation purposes. From the legal perspective line items mean that ministers cannot shift resources from one line item to another or can only shift them under strict conditions described in the budgetary legislation. The term “appropriation” is used for the expenditures (outlays or commitments to incur obligations) that are authorised in the line item.
4. An institutional classification subdivides expenditures according to the organisational structure of the government and the ministries.
5. An economic subdivides sets expenditures according to economic character as defined in the national accounts, such as compensation of employees, intermediate consumption and subsidies.
6. A functional classification subdivides expenditures according to the purpose, such as defence, justice and public order, or social protection
7. See Chapter 2 and the Glossary for the distinction between administrative and programme expenditure.
8. Administrative budgets should in principle include administrative investments (investment in government buildings etc. as opposed to programme investment such as infrastructure). In practice, only current operational expenditures are kept separate in countries that have introduced a programme classification.
9. It is sometimes thought that a fixed expenditure framework resembles in this respect a (permanent) expenditure rule (as a fiscal rule), but this is not necessarily the case. Examples of expenditure rules are the requirement that total expenditures cannot increase from year to year by more than the GDP growth rate of (currently promoted by the EU) or that expenditures cannot exceed a certain percentage of GDP. Expenditure rules of these types do generally not lead to a strict separation of expenditures and revenues and are therefore less conducive to automatic stabilisation.
10. In countries that use an MTEF, the fiscal rule becomes irrelevant once the MTEF is decided. However, the EU rules have a supranational character. This is also true for the EU Medium Terms Objectives (MTO’s) that come into force if a country does not comply with the EU fiscal rules. In this situation two approaches are possible. In the Netherlands the MTEF is revised so that it complies with the EU rules or objectives. This happened several times in the years after the global financial crisis and implied deviations from the fixed character of the Dutch framework. In Sweden the MTEF remains in place, but EU fiscal rules may imply that the ceilings of the MTEF cannot fully be filled up with expenditures.
11. For instance in the Netherlands tax relief is possible under the current framework if the budget is expected to be in surplus in all years of the framework and moreover if the deficit and debt limits of the EU Stability and Growth Pact (SGP) are respected. If these conditions are met, one fourth of the excess tax yield over to the trend estimate can be given back in the form of tax relief (the rest being used for debt redemption).

12. In addition EU Stability and Growth Pact (DGP) requires Eurozone countries to revise their expenditure frameworks or tax policies in order to comply with the EMU deficit requirements of the GDP. The financial crisis has pushed many OECD countries over the GDP thresholds in the last few years. Many of these countries have now embarked on revision of their expenditure frameworks in order to restore their public finances.

13. For the analysis of budgetary decision-making it is important to distinguish between programme investment and administrative investment. Programme investment is aimed at the provision of capital goods that are used by the citizens: mostly infrastructure for transport and ICT. Administrative investment is aimed at the provision of capital goods that are used by government, mostly government accommodation and facilities.

14. Administrative independent agencies are known in the Netherlands as "*Zelfstandige Bestuursorganen*" ("Autonomous Government Organs"), see Reform 4.3.

15. It seems reasonable that the minister is not held accountable for the operational management of public non-profit institutions tasked with service delivery (universities, museums, etc.), since they have their own procedures of accountability and supervision.

16. In the Netherlands agencies have no other costs than operational costs. In other countries that is not the case (for instance in Sweden, see Reform 12.2).

17. The two main components of operational expenditures are wages and procurement of goods and services (see glossary).

19. The British SRs used to be undertaken periodically in line with the update of expenditure ceilings (every two or three years). The Dutch SRs used to be undertaken every year on a selective basis, but currently there is a tendency to limit the number of annual SRs and to organise a more comprehensive round of SRs prior to parliamentary elections.

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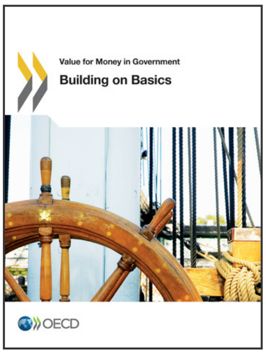

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