OECD Economics Department Working Papers No. 341

Managing Public Expenditure: The UK Approach

Paul van den Noord

https://dx.doi.org/10.1787/541200211154

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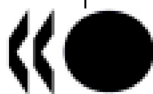

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Organisation for Economic Co-operation and Development

06-Sep-2002

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ECONOMICS DEPARTMENT

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By Paul van den Noord

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ABSTRACT/RÉSUMÉ

Managing public expenditure: the UK approach

The UK medium-term budgetary framework introduced in 1997 addressed a number of weaknesses of the former regime, notably a bias against capital expenditure and, more generally, poor conditions for longer-term planning adversely affecting central government spending departments, local authorities and public enterprises. Departmental spending was indeed characterised by pronounced swings and capital spending was squeezed to very low levels. These weaknesses are considered the major cause for the poor performance of crucial public services. The present paper discusses the new budgetary framework and examines the scope for further improvement.

JEL codes: E62, D61, H11, H40, H61.

Keywords: *Public sector efficiency, budget systems, fiscal policy.*

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La gestion des dépenses publique: l'approche du Royaume-Uni

Les prévisions de dépenses actuelles au Royaume-Uni s'inscrivent dans le cadre budgétaire à moyen terme mis en place en 1997 et a permis de remédier à un certain nombre de faiblesses du dispositif antérieur, notamment une distorsion à l'encontre des dépenses d'équipement et, d'une manière plus générale, des conditions peu propices à une planification à long terme, ayant une incidence négative sur les dépenses des ministères de l'administration centrale, des autorités locales et des entreprises publiques. Ces dépenses se caractérisaient en effet par de fortes fluctuations, et les dépenses d'équipement avaient été réduites à un très bas niveau. Ces faiblesses sont considérée comme la principale cause des mauvais résultats enregistrés par certains services publics essentiels. Ce document de travail discute le nouveau cadre de la politique budgétaire et examine les possibilités d'amélioration.

Classification JEL: E62, D61, H11, H40, H61.

Mots-clés: Efficacité du service public, systèmes budgétaires, politique fiscale.

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MANAGING PUBLIC EXPENDITURE: THE UK APPROACH*

Paul van den Noord

1. Currently, the UK's fiscal situation and outlook is better than for many years, with expenditure now financed without heavy recourse to borrowing. This has been the combined result of sustained fiscal rigour during much of the 1990s and a firm recovery from the recession that hit the economy at the beginning of the decade. The attention has now turned to consolidating this achievement while tackling with priority the sorely needed improvement in the quality of several key public services, such as education, health care and public transport. Traditionally, budget managers at all levels of the administration have had to grapple with strict top-down allocation of funding across spending departments, programmes and — importantly — public enterprises on an annual basis. This feature and decisions to consolidate the budget without raising taxes has led to a squeeze of discretionary investment spending over time and a deterioration of public service provision. The need to address these deficiencies motivated the present government, after it took office in 1997, to develop a new framework for fiscal management and to continue the emphasis on mobilising the private sector where this is expected to yield gains in operational efficiency.

2. In the light of these developments, this chapter examines key issues relating to the management of public expenditure in the United Kingdom. The chapter first analyses longer-term trends in public expenditure in the United Kingdom and their main determinants and future challenges. This is followed by three sections discussing, respectively, the new budgetary framework, the growing role of the private sector in the provision of public services and issues relating to fiscal federalism. It concludes with suggestions for further change.

Trends in public expenditure and forces shaping them

3. Public spending as a share of GDP rose sharply in the 1960s and 1970s, ratcheting up with each economic slowdown, as in most OECD countries (Figure 1).[1] However, while elsewhere this was generally followed by a stabilisation in the 1980s and some decline in the course of the 1990s, public spending restraint in the United Kingdom started much earlier and was much more pronounced. Aside from favourable cyclical developments, this reflected *inter alia* the privatisation of many state-owned enterprises and former public services, with the proceeds used to reduce debt and hence debt servicing cost. In addition, the United Kingdom went further than most OECD countries in cutting public transfers and/or converting them into tax credits and private insurance.[2] The new government entering office in 1997 initially stayed on a fiscal consolidation track, and public spending continued to decline sharply in the first half of its first term. As a result, by the end of the 1990s public outlays as a per cent of GDP had reached a historical low, close to their mid-1960s level. However, with the public sector accounts in comfortable surplus, spending cuts were partially reversed in the run up to the June 2001 elections and official projections are for further increases over the medium term.

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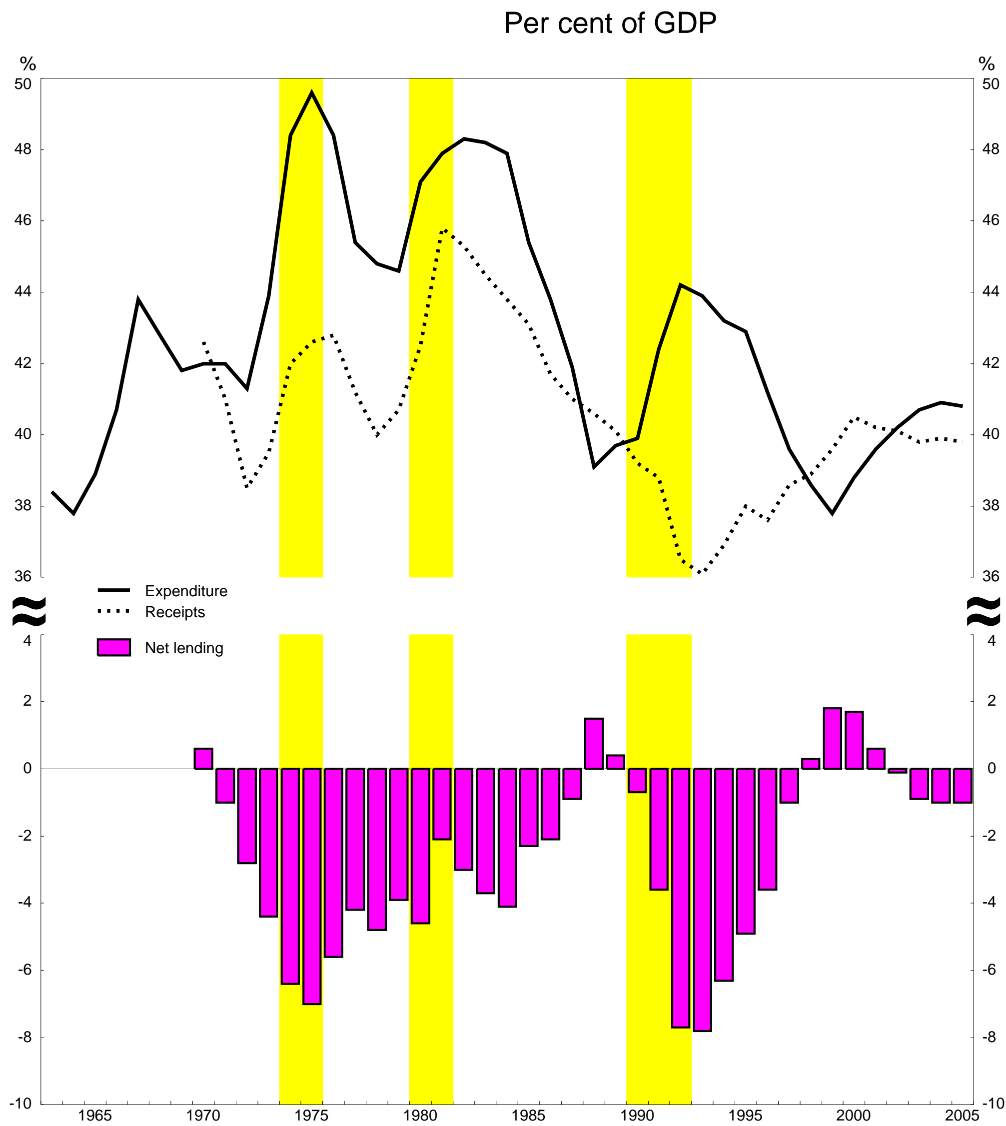
* This paper was originally produced for the *OECD Economic Survey* of the United Kingdom which was published in December 2001 under the authority of the Economic and Development Review Committee. Thanks go to Jens Lundsgaard for his contribution and Andrew Dean, Jørgen Elmeskov, Mike Feiner, Peter Hoeller and Vincent Koen for their comments. The author would also like to thank Desney Erb, Christine de la Maisonneuve and Nathalie Macle for technical support.

Figure 1. **Public sector expenditure, receipts and balance**[1]

Per cent of GDP



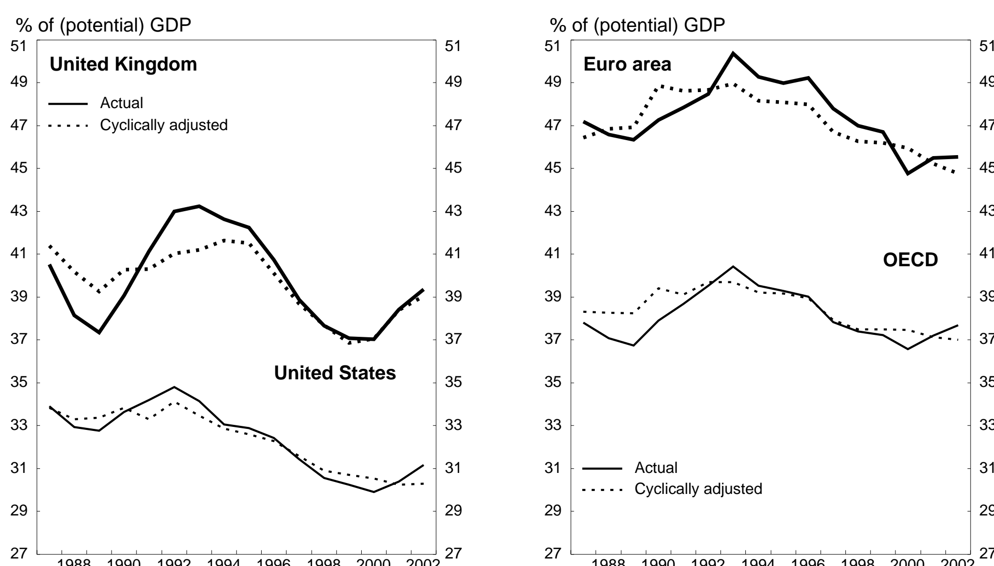
1. Shaded areas are recessions.

Source: HM Treasury and OECD.

4. Presently, public expenditure is roughly at a par with the OECD average of around 38 per cent of GDP, and practically halfway between the expenditure ratios in the United States (around 30 per cent of GDP) and the European Union (around 45 per cent of GDP).[3] This also holds broadly in cyclically-adjusted terms (Figure 2). Looking at expenditure by function (Tables 1[4] and 2), for which, unfortunately, internationally comparable National Accounts data stop in the mid-1990s, the United Kingdom's record is also more or less average, although differences with some other major OECD countries are striking:

- Expenditure on pure *public goods* (including justice and defence), at around 5 per cent of GDP, is similar to that in most other major OECD countries, although much lower than in the United States and France. It fell sharply in the first half of the 1990s with cuts in the defence budget as the Cold War unwound.
- The GDP share of expenditure on *merit goods* (education, health and social services), at around 11 per cent, is slightly below the EU average, and well below the expenditure shares in *e.g.* France and Germany (14 per cent). It has picked up more recently, however, reaching 12 per cent of GDP in 2000, and should rise further in the medium run.
- Spending on *income transfers*, at around 15 per cent of GDP, is again below the EU average (18 per cent), and well below that in the major European countries (between 18 and 20 per cent), but substantially above the United States (around 9 per cent). This spending category has been on a persistent downward path since the mid-1990s.
- Expenditure on *economic services* (transport infrastructure, housing, etc.) is a relatively small expenditure category in most OECD countries (4 per cent of GDP on average), but even more so in the United Kingdom (3 per cent of GDP). It has shown a long-lasting and significant decline relative to GDP, in part reflecting the privatisation of nationalised industries and public services and a fall in investment in the construction of public dwellings. Expenditure in this category has picked more recently, however.

Figure 2. **Actual and cyclically-adjusted general government expenditure**



Source: OECD.

Table 1. **Public sector outlays by function**

Per cent of potential GDP

		1989/90	1996/97	1999/00	2000/01	Changes		
						1989/90-1996/97	1996/97-1999/00	1999/00-2000/01
I.	**Public goods**	6.0	4.9	4.6	4.7	-1.2	-0.2	0.1
	Law and order	2.0	2.1	2.1	2.2	0.1	0.0	0.1
	Defence	4.1	2.8	2.5	2.5	-1.3	-0.3	0.0
II.	**Merit goods**	10.7	11.2	11.2	12.0	0.5	0.0	0.7
	Education	4.9	4.7	4.5	4.8	-0.2	-0.1	0.3
	Health	4.9	5.3	5.4	5.7	0.4	0.2	0.3
	Social services	0.9	1.3	1.3	1.4	0.4	0.0	0.1
III.	**Income transfers**	10.4	12.5	11.4	11.3	2.1	-1.1	-0.2
IV.	**Economic services**	4.5	3.9	2.7	3.2	-0.6	-1.2	0.5
	Transport	1.6	1.3	0.9	1.0	-0.3	-0.4	0.1
	Housing	1.0	0.6	0.3	0.4	-0.4	-0.3	0.1
	Trade and industry	1.5	1.2	1.0	1.2	-0.3	-0.2	0.2
	Agriculture	0.4	0.8	0.5	0.6	0.4	-0.3	0.1
V.	**Others**	5.3	4.9	5.0	5.2	-0.4	0.2	0.2
I-V.	**Total primary expenditure**	37.0	37.3	35.0	36.4	0.3	-2.3	1.4
VI.	**Debt interest**	4.2	3.7	2.8	2.8	-0.5	-0.9	0.0
I-VI.	**Total**	41.1	41.0	37.8	39.2	-0.1	-3.2	1.4

Source: HM Treasury submission and OECD.

5. In comparison with some major European countries public expenditure on merit goods like health care and education has been relatively low. This feature is often cited in the public debate as an indication of under-funding, the more so since headline indicators on outcomes do not paint a positive picture. Indeed, reflecting education and learning patterns over past decades, the spread of skill endowments is wider than in most OECD countries and has been associated with a comparably large incidence of open poverty. Moreover, as discussed in the special chapter on health care policies contained in the previous *Economic Survey*, the United Kingdom portrays mediocre scores on health status by international standards. However, the low level of *private* health and education spending in the United Kingdom is more marked than that of public spending, the latter being less out of line with other countries (Figure 3).[5] This reflects the universal public delivery of health care and education practically free of charge, which is unlikely to change fundamentally in the immediate future. The ongoing debate is centred on the issue of outsourcing the operation of hospitals and schools to the private sector via public-private partnerships in order to raise operational efficiency, and less on changing delivery and charging structures.

Table 2. **Structure of government outlays by function in OECD countries**

1995 or latest year available

As a per cent of	Public goods[1]		Merit goods[2]		Income transfers		Economic services		Public debt interest	
	GDP	Total outlays[3]	GDP	Total outlays[3]	GDP	Total outlays[3]	GDP	Total outlays[3]	GDP	Total outlays[3]
Australia	8.2	21.8	10.5	27.9	9.0	23.9	5.6	14.9	4.1	10.9
Austria	4.5	8.6	11.9	22.8	19.2	36.8	3.1	5.9	4.4	8.4
Canada	2.9	6.3	12.3	26.6	11.5	24.8	2.4	5.2	9.6	20.7
Denmark	6.0	10.0	16.5	27.5	20.8	34.7	5.6	9.3	6.4	10.7
Finland	3.3	6.1	15.2	28.0	22.5	41.4	1.1	2.0	4.0	7.4
France	9.2	16.6	14.1	25.5	20.9	37.7	3.1	5.6	3.5	6.3
Germany	5.2	10.5	13.9	28.0	18.2	38.6	4.5	9.1	3.7	7.4
Italy	6.5	12.5	10.2	19.5	17.9	34.3	4.6	8.8	11.5	22.0
Japan	4.5	12.3	10.1	27.7	12.8	35.1	5.3	14.5	3.8	10.4
Korea	5.7	29.7	5.6	29.2	1.8	9.4	3.7	19.3	0.5	2.6
Netherlands	11.6	22.2	12.0	23.0	19.2	36.8	6.4	12.3	5.9	11.3
New Zealand	5.3	13.6	10.6	27.2	13.5	34.7	..	..	4.8	12.3
Norway	6.3	12.1	18.4	35.4	15.9	30.6	7.2	13.8	2.8	5.4
Portugal	8.3	6.6	10.6	21.2	12.1	24.2	6.3	12.6	6.3	12.6
Spain	9.9	21.9	10.6	23.5	14.9	33.0	5.9	13.1	5.2	11.5
Sweden	5.9	8.4	17.2	26.7	21.2	32.9	3.4	5.0	6.8	10.5
United Kingdom	**5.4**	**12.4**	**11.5**	**26.4**	**15.6**	**35.8**	**3.3**	**7.6**	**3.6**	**8.3**
United States	9.2	26.8	11.9	34.7	9.4	27.4	2.8	8.2	4.8	14.0
European Union[4]	6.9	12.3	13.1	27.5	18.4	35.1	4.3	8.3	5.6	10.6
Average of countries above	**6.5**	**14.9**	**12.4**	**26.7**	**15.4**	**31.8**	**3.9**	**9.3**	**5.1**	**10.7**

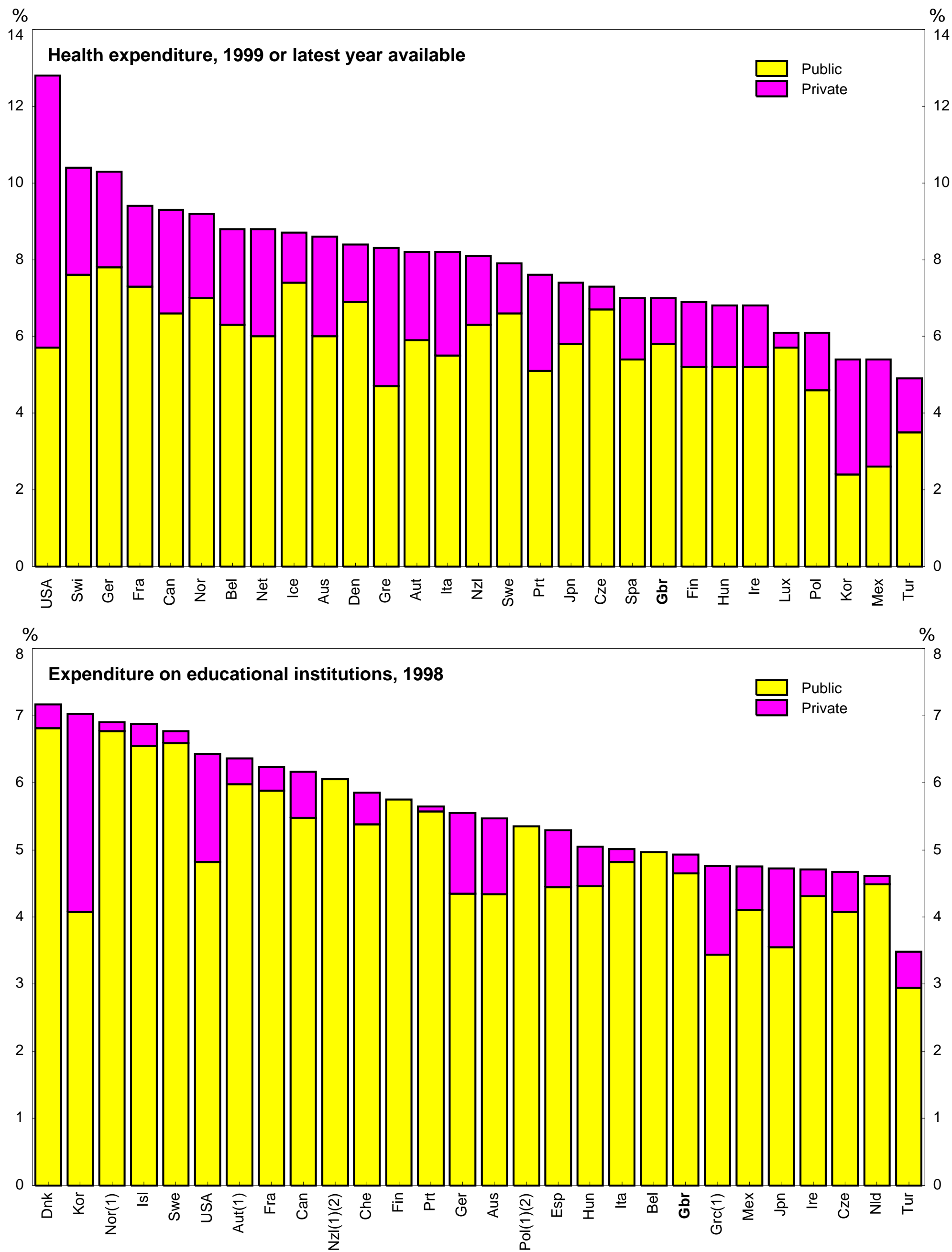
1. Defence, general public services and other functions.
2. Education, health and other social services.
3. Expenditure shares may not add up to 100 per cent as expenditure by function and total expenditure are derived from different sources.
4. Excluding Belgium, Greece, Ireland and Luxembourg.

Source: OECD.

6. A striking feature of public expenditure in the United Kingdom has been the persistent decline in public investment outlays. As a result, by 1999 its share of GDP was the lowest of a broad sample of OECD countries (Table 3 and Figure 4). To some extent this reflects the privatisation of state-owned companies and a shift toward privately funded public infrastructure investment under the Private Finance Initiative (PFI) adopted in the early 1990s — which in principle is not included in public sector investment (see below). However, the general picture holds also if adjustment is made for this factor. One area where the lack of public investment has been particularly detrimental is public transportation. Rail and metro networks are poorly maintained and commuter services, notably in and around the capital, are congested, unreliable and expensive. The deficiencies of commuter services have encouraged car use in large urban areas, which in turn leads to road congestion. The Government privatised British Rail, but the results so far do not seem to have been as beneficial as other privatisations and dissatisfaction with the rail network remains acute.[6]

Figure 3. **Health and education expenditure**

As a per cent of GDP



1. Public subsidies included in private funds.
2. Public expenditure only.

Source: *OECD Health Data 2001* and OECD, *Education at a glance 2001*.

Table 3. **Public sector outlays by economic category and sector**

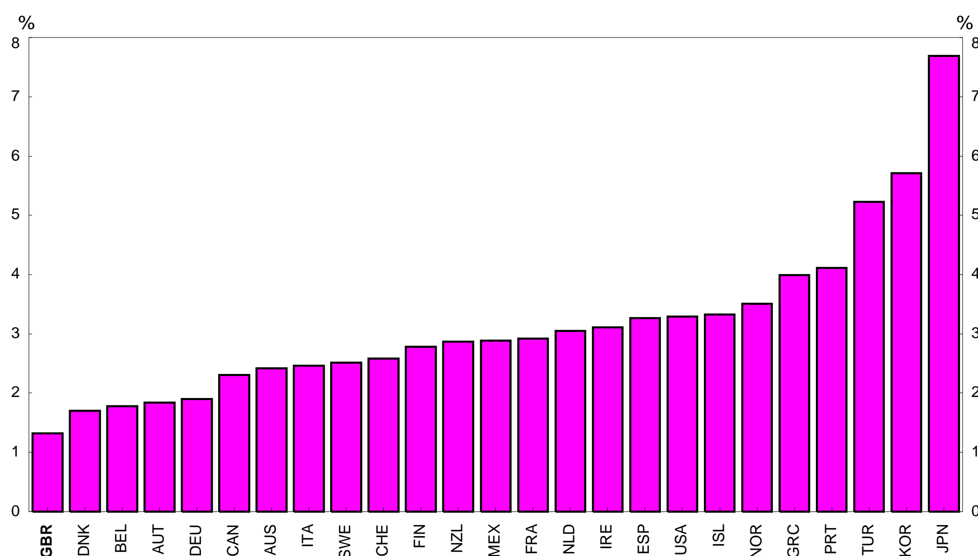
Per cent of potential GDP

	1989/90	1996/97	1999/00	2000/01	Changes 1989/90-1996/97	1996/97-1999/00	1999/00-2000/01
I. Current expenditure	37.2	38.5	35.9	36.8	1.3	-2.6	0.9
of which: Debt interest	4.2	3.7	2.8	2.8	-0.5	-0.9	0.0
II. Capital expenditure	4.2	2.4	2.0	2.4	-1.8	-0.4	0.4
Net investment	1.1	0.6	0.4	0.8	-0.5	-0.2	0.4
Depreciation	3.0	1.8	1.6	1.6	-1.2	-0.2	0.0
I + II. Total	41.3	40.9	37.9	39.2	-0.5	-3.0	1.3
Central government	29.5	30.4	28.1	29.1	0.9	-2.3	1.0
Local authorities	10.8	9.9	9.4	9.7	-0.9	-0.5	0.2
Public companies	1.0	0.6	0.4	0.4	-0.4	-0.2	0.0

Source: HM Treasury submission and OECD.

Figure 4. General government gross investment

1999, per cent of GDP



Source: OECD.

7. The authorities consider the fiscal framework in place prior to the 1997 reforms to have been at the root of the under-investment problem. Political imperatives implied that the public-sector borrowing requirement (PSBR) would be determined in relation to the macroeconomic environment and taxes set in relation to the longer term political and economic objectives of the government. While medium-term expenditure targets by department were set for a three year period, little attention was paid to them because the underlying economic and fiscal projections were not rooted in an estimate of the economy's potential and therefore constantly changed, and institutional short-termism became entrenched as a result.[7] These features, in combination with the system of cash accounting, which the United Kingdom until recently had in common with many other OECD countries, put a heavy strain on discretionary expenditure, and in particular public investment. Being subject to the annual budgeting cycle made it also very difficult for public corporations to operate within the public sector, as viable projects often could not go ahead because not enough cash was available within the fiscal year to fund them. This may help explain the drive for privatisation, to liberate investment in public services from the yoke of public borrowing constraints, and the UK's leading role in the implementation of full accrual budgeting and reporting.[8]

Implementing the new budgetary framework: progress to date

8. To address the above deficiencies, the Government adopted a medium-term framework for government spending when it entered office in 1997, building upon a set of relatively simple rules for fiscal policy. The sections below review this framework.

Aggregate fiscal management

9. The *Code for Fiscal Stability* created in 1997 commits the Government to: *i)* specify its principles of fiscal management and state the objectives of fiscal policy; *ii)* design an annual reporting cycle, including a Pre-Budget Report, an Economic and Fiscal Strategy Report and a Debt Management Report; and *iii)* adopt best practice accounting tools.[9] The Code thus aims at providing a transparent fiscal policy framework, to complement the framework adopted for monetary policy, but it has also important implications for public expenditure, notably for the mix of current and capital expenditure. Under the umbrella of the *Code*, the Government has defined the following fiscal rules:

- *The golden rule*, which stipulates that over the business cycle the Government will borrow only to invest and not fund current spending.[10]
- *The sustainable investment rule*, according to which net debt as a proportion to GDP will be held stable over the business cycle at a prudent level.

The Government will meet the golden rule if, on average over the business cycle, the current budget is in balance or surplus. Current expenditure is defined to include the consumption of fixed capital. As a result, borrowing is constrained to not exceed the amount of *net* investment over the business cycle. Consequent to the sustainable investment rule, borrowing is constrained to leave the ratio of net public debt to GDP below a prudent level of 40 per cent of GDP.

10. With the current budget in surplus and the ratio of net debt to GDP around 30 per cent, the Government is well on track to meet the two fiscal rules. This situation is officially projected to persist at least until 2006, notwithstanding a significant increase in net investment funded in part by government borrowing (Table 4).[11] In fact, as explained in the Annex, the rules seem to provide ample scope to ease fiscal policy, but that would risk being inconsistent with the requirements for macroeconomic stability.[12] The Annex also shows that, if ever the rules would become binding, they set a floor for net investment at close to 2 per cent of GDP on average over the business cycle, which roughly corresponds to the government's medium-term investment target.

Table 4. **Medium-term public sector finances**

	Definition	Outturn 1999/00	Estimate 2000/01	Projections				
				2001/02	2002/03	2003/04	2004/05	2005/06
Key assumptions								
Real GDP	% rate of change	2¾	3.0	2¼	2¼	2¼	2¼	2¼
GDP deflator	% rate of change	2½	1¾	2½	2½	2½	2½	2½
Output gap	% of potential GDP	0.2	0.6	0.5	0.3	0.2	0.1	0.0
Current budget								
Current receipts	% of GDP	39.6	40.5	40.2	40.1	39.8	39.9	39.8
Current expenditure[1]	% of GDP	37.5	38.2	38.7	38.8	39.0	39.0	39.0
Surplus on current budget	% of GDP	2.1	2.4	1.5	1.3	0.8	0.9	0.8
Cyclically adjusted surplus	% of potential GDP	1.9	2.1	1.4	1.1	0.6	0.7	0.7
Capital budget								
Gross investment	% of GDP	2.5	2.8	3.1	3.4	3.6	3.6	3.6
less asset sales	% of GDP	-0.5	-0.4	-0.4	-0.4	-0.3	-0.3	-0.3
less depreciation	% of GDP	-1.6	-1.6	-1.6	-1.5	-1.5	-1.5	-1.5
Net investment	% of GDP	0.4	0.8	1.1	1.5	1.7	1.8	1.8
Balances and debt								
Net lending	% of GDP	1.7	1.7	0.5	-0.1	-0.9	-0.9	-1.0
Cyclically adjusted net lending	% of potential GDP	1.6	1.4	0.3	-0.3	-1.1	-1.1	-1.1
Net debt	% of GDP	36.8	31.8	30.3	29.6	29.7	29.9	30.0
Memorandum item:								
Maastricht Treaty definitions								
General government net lending	% of GDP	1.7	1.7	0.5	-0.1	-0.9	-0.9	-1.0
General government gross debt	% of GDP	43.7	40.6	37.6	36.1	35.7	35.6	35.6

1. Including depreciation.

Source: HM Treasury, Budget 2001.

11. As formulated at present the fiscal rules have a number of advantages, but also entail some risks. The advantages form the main motivation for their adoption: they counteract the inherent bias against capital expenditure and ensure sound public finances. Although the fiscal rules do not imply any restrictions on overall expenditure *a priori*, they do imply that in the event of a permanent fall in government revenues, current, not capital expenditure would be affected. Moreover, since the rules apply on average over the cycle, a transitory decline in revenues would not affect discretionary expenditure — be it current or capital — at all. Therefore, the rules allow fiscal policy to be geared towards medium-term objectives while letting the automatic stabilisers work freely — both at the revenue and expenditure side — thus facilitating the operation of monetary policy and protecting discretionary spending from *ad hoc* cuts.

12. The current set of fiscal rules therefore provides a sensible anchor in the pursuit of the accountability of policy and has been effective in contributing to macroeconomic stability. The golden rule also promotes intergenerational equity, *i.e.* supports the notion that those generations who benefit from public spending should meet, as far as possible, the costs of the services they consume, but does not necessarily ensure it. The rule's contribution in this regard cannot be fully assessed satisfactorily without knowing the ultimate incidence of the costs and benefits of both expenditure (current and capital) and taxation. Generational accounts can be helpful in this respect and the Government commissioned an internationally acknowledged expert (Professor L. J. Kotlikoff) in conjunction with the National Institute

of Economic and Social Research, to set up a set of accounts on its behalf.[13] Such accounts could usefully complement the long-term fiscal projections that are included in the budget documentation. Meanwhile, the following potential drawbacks for resource allocation can be identified that are worth taking into consideration:

- The distinction between current and capital outlays embodied in the golden rule is not always relevant from an economic point of view. For example, education spending, while largely labelled as current expenditure, adds to the stock of human capital and thus should be considered as a form of investment. To the extent that the golden rule favours fixed over human capital formation there is a risk of misallocation of resources. This calls for careful cost-benefit analysis prior to expenditure decisions.
- Since the fiscal rules play out strongly in favour of public investment, there is, at least at the aggregate level, little trade-off between current and capital expenditure based on a comparison of their respective marginal cost and benefits. The implicit assumption seems to be that the marginal benefits from public investment are so large that the risks of overshooting its socially optimal level are negligible. However, the marginal benefits from public investment may fall quickly once the government's efforts to enhance public infrastructure — or to induce the private sector to do so in the framework of public-private partnerships — prove successful.
- The fiscal rules apply not just to general government but to the broader public sector and thus extend to public corporations. This is done on the presumption that their liabilities could ultimately burden the taxpayer and to prevent perverse incentives to move spending off budget. However, the fiscal rules do not extend to public-private partnerships, whose investment is classified as private sector spending, with only the services purchased by the Government from these partnerships recorded as current expenditure by the public sector. Since only the latter counts against the golden rule, the choice between public-private partnerships and "traditional" public investment may be distorted.[14] But in which direction depends on the cyclical position of the economy (in a boom the Government may be tempted to take more investment on budget and *vice versa*).

13. On current plans the fiscal position is projected to move towards a deficit of 1 per cent of GDP, consistent with the golden rule. While the Council of the European Union has noted that in the medium term the government's finances would not be in line with the prescription of "close to balance or surplus" contained in the Stability and Growth Pact, it has acknowledged that this emerges in the projections as a result of the use of a very cautious trend growth assumption of 2.25 per cent per annum and as a consequence of increased government investment as a share of GDP within the expenditure totals. The analysis summarised in Table 5 suggests that the current fiscal scenario is prudent enough. It calculates the rate of growth of GDP that would be required at a minimum for the fiscal deficit to stay above the 3 per cent limit, using standard assumptions with respect to the output sensitivity of budget outturns.[15] It appears that a growth rate averaging 1½ per cent per annum over the coming five years would be sufficient, which is well below the "prudent" growth projection of 2¼ per cent underlying the official fiscal base line (Table 4). Although five-year periods with similar growth averages have been observed in the past (Table 6), these were exceptional.[16]

Table 5. **Meeting the Maastricht deficit ceiling in the medium term**

	Definition	Outturn	Estimate	Simulation				
		1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06
Key assumptions								
Real GDP	% rate of change	2¾	3.0	1½	1½	1½	1½	1½
GDP deflator	% rate of change	2½	1¾	2½	2½	2½	2½	2½
Output gap	% of potential GDP	0.2	0.6	-0.4	-1.4	-2.3	-3.2	-4.0
Balances and debt								
Surplus on current budget	% of GDP	2.1	2.4	1.1	0.5	-0.4	-0.6	-1.1
Net investment	% of GDP	0.4	0.8	1.0	1.5	1.7	1.9	1.9
Net lending	% of GDP	1.7	1.6	0.1	-1.0	-2.1	-2.6	-3.0
Cyclically adjusted net lending	% of potential GDP	1.8	1.4	0.3	-0.3	-1.1	-1.1	-1.1
Net debt	% of GDP	36.8	31.8	31.0	31.3	32.8	34.7	36.9
Memorandum item:								
Maastricht Treaty definitions								
General government net lending	% of GDP	1.7	1.7	0.1	-0.9	-2.1	-2.5	-3.0
General government gross debt	% of GDP	43.7	40.6	38.3	37.8	38.8	40.4	42.5

Source: OECD.

Table 6. **Medium-run growth performance**

Per cent

	1965-70	1970-75	1975-80	1980-85	1985-90	1990-95	1995-2000
Average rate of real GDP growth	2½	2	1¾	2	3¼	1½	2¾
Output gap by end of period	0.0	-2.1	-3.3	-3.1	2.6	-1.5	0.1

Source: OECD Secretariat.

Allocation of funding across departments and programmes

14. A crucial element of the budgetary framework consists of the biennial *Spending Reviews*, comprising a set of three-year plans for discretionary expenditure, specified per department, called Departmental Expenditure Limits (DELs).[17] Remaining expenditure (mostly social security) is managed separately on an annual basis (called Annual Managed Expenditure or AME). Separate DELs are formulated for current and investment spending in order to achieve consistency with the golden rule — see the condensed representation of the 2000 Spending Review in Table 7.

Table 7. **Spending Review 2001: Resource and capital budgets**

Billion pounds

	Outturn	Estimate	Projection		
	1999-2000	2000-01	2001-02	2002-03	2003-04
Resource budget					
I. Departmental Expenditure Limits (DELs)	158.5	172.8	185.1	197.3	209.1
as a per cent of GDP	17.5	18.3	18.7	19.0	19.3
II. Departmental Annual Managed Expenditure (AME)[1]	128.7	132.5	137.6	141.6	147.2
III. Other current AME:					
Net payments to EC institutions	2.9	2.7	2.5	2.6	2.9
Locally financed current expenditure	16.4	17.3	18.2	19.0	19.8
Central government debt interest	25.6	27.0	26.1	25.3	24.7
AME margin	0.0	1.4	1.0	1.9	2.9
Various adjustments[2]	-8.6	-4.3	-3.7	-3.2	-2.3
IV. Public sector current expenditure (I+II+III)[3]	338.1	364.4	382.2	400.4	420.6
as a per cent of GDP	37.4	38.5	38.6	38.7	38.7
Capital budget					
V. Departmental Expenditure Limits (DELs)	18.2	22.4	27.0	31.9	36.6
as a per cent of GDP	2.0	2.4	2.7	3.1	3.4
VI. Departmental Annual Managed Expenditure (AME)[4]	3.3	3.3	2.8	2.7	2.7
VII. Other capital AME:					
Locally financed current expenditure	0.8	0.7	0.7	0.8	0.8
AME margin	0.0	0.1	0.0	0.1	0.1
Various adjustments[2]	-5.1	-4.2	-4.5	-4.6	-4.9
VIII. Public sector gross investment	17.2	22.3	26.0	30.9	35.3
IX. Depreciation	14.6	15.0	15.4	15.9	16.3
X. Public sector net investment (VIII+IX)	2.6	7.3	10.6	15.0	19.0
as a per cent of GDP	0.3	0.8	1.1	1.4	1.8
Total expenditure					
XI. Public sector total expenditure (IV+X)	340.7	371.7	392.8	415.4	439.6
as a per cent of GDP	37.7	39.3	39.7	40.1	40.5

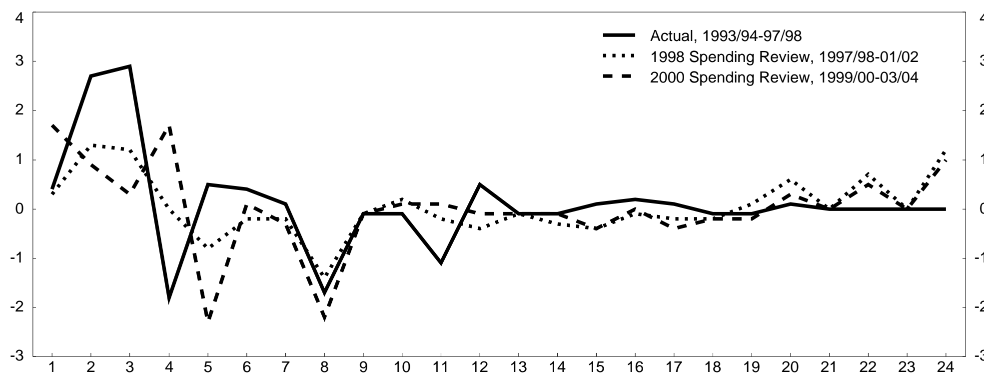
1. Includes non-cash items (depreciation and capital charges), social security benefits, housing revenue account subsidies, net public service pensions and common agricultural policy.
2. Accounting adjustments, classification changes to national accounts (to move from accrual to cash accounts) and other adjustments.
3. Including depreciation.
4. Including public corporation's self-financed capital expenditure.

Source: HM Treasury, Spending Review 2000.

15. The procedure for fixing DELs is iterative: they are the result of bids per spending department, which are negotiated with the Treasury. Once agreed, the Treasury is committed to funding the projected expenditure. In exchange, spending departments are being held accountable for achieving their policy targets, which are specified in so-called Public Service Agreements (see below). The two Spending Reviews implemented indeed suggest some reallocation of resources across departments, but so far not significantly more so than has been the case prior to the implementation of the new regime in 1997 (Figure 5).

Figure 5. Change in the departmental[1] shares in aggregate discretionary expenditures

Percentage points



1. The departments concerned are: 1. Education and employment; 2. Health; 3. *of which* NHS; 4. Employment, transport and regions; 5. Local government; 6. Home Office; 7. Legal Departments; 8. Defence; 9. Foreign and Commonwealth Office; 10. International Development; 11. Trade and Industry; 12. Agriculture, Fisheries and Food; 13. Culture, Media and Sport; 14. Department of Social Security; 15. Scotland; 16. Wales; 17. Northern Ireland; 18. Chancellor's Departments; 19. Cabinet Office; 20. Employment Opportunities Fund; 21. Invest to Save Budget; 22. Capital Modernisation Fund; 23. Policy Innovation Fund; 24. Reserve.

Source: HM Treasury, *Comprehensive Spending Review 1998* and *Spending Review 2000*.

16. The Spending Reviews aim to provide certainty to spending departments as to the amount of resources they will use over a three-year period. A department's spending is not allowed to breach the agreed current and capital expenditure limits in each year of the Review period. However, an important element of this set-up is that future funding is not reduced by the amount of under-spending in a previous year, thus avoiding incentives for end-of-year spending splurges and poor resource use. This has proved useful given that the targets for net investment contained in the 1998 Review have indeed been largely undershot to date (Table 8). To some extent this is a statistical artefact associated with upward revisions of public sector depreciation in the National Accounts (which reduces net investment for a given level of gross investment) totalling 3½ per cent of GDP. However, gross capital formation has also been less than was projected at the time, notably in fiscal year 1999/2000. The main reason seems to have been the slow implementation of new investment projects as spending departments adapted to the new regime. These teething problems seem to be waning, and the Treasury's current focus is on ensuring that investment projects that are coming on stream are selected on the basis of objective criteria.[18] Achieving the investment targets may nevertheless prove to be challenging.

Table 8. **The 1998 and 2000 Spending Reviews: projections and outturns to date**

Billion pounds

	A	B	A + B	*of which*		*memorandum*
	Departmental expenditure limits	Annual managed expenditure	Total expenditure	Current expenditure including depreciation	Public sector net investment	Public sector gross investment
1999/00						
Projection SR 1998	179.2	172.4	351.6	343.0	8.6	19.8
Outturn SR 2000	176.7	164.0	340.7	338.1	2.6	17.2
Revised outturn Budget 2001	179.3	164.2	343.5	340.0	3.5	18.1
2000/01						
Projection SR 1998	190.1	179.9	370.0	359.5	10.5	22.1
Estimate SR 2000	195.2	176.5	371.7	364.4	7.3	22.3
Revised estimate Budget 2001	194.2	174.1	368.3	360.9	7.4	22.3
2001/02						
Projection SR 1998	200.2	189.5	389.7	376.7	13.0	25.0
Projection SR 2000	212.1	180.7	392.8	382.2	10.6	26.0
Revised projection Budget 2001	212.3	181.4	393.7	382.5	11.2	26.7
2002/03						
Projection SR 1998	-	-	-	-	-	-
Projection SR 2000	229.2	186.2	415.4	400.4	15.0	30.9
Revised projection Budget 2001	228.5	189.3	417.8	402.5	15.3	31.3
2003/04						
Projection SR 1998	-	-	-	-	-	-
Projection SR 2000	245.7	193.9	439.6	420.6	19.0	35.3
Revised projection Budget 2001	245.1	197.5	442.6	423.9	18.7	35.3

Source: HM Treasury, *Spending Review 1998 and 2000*, Budget 2001.

Performance targets

17. The Public Service Agreements (PSAs) that underpin the targets set by spending departments represent the main innovation in public expenditure planning (see Box 1). The rationale for targets is straightforward: since the public sector is not subject to the same competitive pressure as the private sector, it requires other forms of pressure, and accountability, to perform. Indeed, the Spending Review requires that in return for funding, government departments commit themselves to deliver on targets. In the 2000 Spending Review there are PSAs for each of the 18 main departments and for five cross-departmental areas of policy where all the departmental targets relevant for the delivery of the government's objectives in that area are drawn together in a single agreement.[19]

Box 1. **The Public Service Agreements**

A Public Service Agreement (PSA) is essentially an agreement between the Government and the public and it is the responsibility of the senior minister of the department to deliver the targets set in the agreement. The final PSA is agreed by the responsible minister following a discussion with a committee of the Cabinet. The Treasury has also conducted a peer review to review the draft PSAs and has suggested improvements. The Treasury collects information on progress against targets every quarter and presents that to the Cabinet committee. Moreover, departments provide a public progress report annually in their departmental reports in the spring. The progress against targets provides a background to decisions on resources in the following budgeting round. For each PSA a Technical Note has been issued setting out in detail *inter alia* how each target will be measured including the source of data, the baseline and definitions of potentially ambiguous terms.

The structure of PSAs is similar across departments — see for an example Box 2 showing the PSA for the Department for Education and Employment. It formulates a single "aim" of the department's work, which is translated into a series of objectives setting out the aspirations of the department. For each objective, in turn, quantitative targets are formulated against which performance and progress can be measured. Each PSA also includes a "value for money" target that provides a measure relating inputs to outcomes. The PSA concludes with a statement of accountability of the minister responsible for delivery, including details on any targets that involve sharing of accountability with other departments.

PSAs are cascaded throughout the public sector and linked to the targets of agencies, non-departmental public bodies and local authorities who deliver services:

- In the 2000 Review 20 Local Government PSAs between the central government and 20 local authorities were concluded as a pilot exercise, containing a package of 12 key outcome targets reflecting national PSA targets and local priorities. If they perform well, local authorities will be rewarded through financial benefits and increased autonomy. The Government intends to extend local PSAs to 130 of the largest local jurisdictions in 2002.

- There are 136 executive agencies, most of which administratively belong to government departments, which play a key role in delivering government services and employ approximately three-quarters of civil servants. The achievement of the objectives and targets set out in the PSAs therefore requires that the priorities of agencies are aligned with those of the government departments and for the agency performance targets to be consistent with the delivery of the PSA targets. The shift at departmental level towards focussing on outcomes starts to be reflected in agency reporting.

- New in the 2000 Review were the Service Delivery Agreements (SDAs) for each government department that accompany the PSAs. The agreements set out how the departments intend to deliver their PSA targets.

The PSAs linked to the 2000 Spending Review contained 160 targets in total, 28 of which are shared by more than one department and so appear in more than one PSA. A report by the National Audit Office (2001) concluded that in the 2000 PSAs 68 per cent of targets were outcome targets, 14 per cent process targets, 13 per cent output targets and only 5 per cent input targets. This represents considerable progress against the previous set of PSAs, which contained a plethora of 600 targets, of which 7 per cent were input targets, 51 per cent process targets, 27 per cent output targets and only 11 per cent outcome targets. This shift in focus was achieved in part by moving the reporting of output and operational targets to the new Service Delivery Agreements, but also by an increase in the absolute number of outcome-focussed targets.

18. The use of targets to measure how public services are performing is a necessary step in the delivery of better public services. However, in order to become fully effective, learning and progress in the development and design of targets appear to be key. The Government recognised that the first set of targets in the 1998 Spending Review did not meet the "SMART" (specific, measurable, achievable, relevant and timed) requirements aimed for. They were also too numerous and too much focussed on inputs and processes as opposed to outputs and policy outcomes. The new set of targets has sought to address the earlier weaknesses, through both the enhanced focus on outcomes and a drastic cut in the number of targets. For example, a feature of the 2000 vintage of PSAs is that some include "floor targets" to ensure that improvements in national averages do not disguise continuing failure in individual areas (see for example the targets in Box 2 which set floors for the number of youngsters attaining a certain score of literacy, rather than an average literacy score for all pupils).

Box 2. **Aims, objectives and targets in Public Service Agreements — an example**

The Public Service Agreement for each department includes a single aim and a number of objectives, which set out the aspirations of the department, and for each objective outcome-focused targets against which progress can be measured. The example below shows the PSA for the Department for Education and Employment.

Aim

"To give everyone the chance, through education, training and work, to realise their full potential, and thus build an inclusive and fair society and a competitive economy."

Objectives

Objective I: "ensuring that all young people reach 16 with the skills, attitude and personal qualities that will give them a secure foundation for lifelong learning, work, citizenship in a rapidly changing world".

Objective II: "developing in everyone a commitment to lifelong learning, so as to enhance their lives, improve their employability in a changing labour market and create the skills that our economy and employers need."

Objective III: "helping people without a job into work." (objective and targets shared with the Welfare to Work PSA).

Performance Targets

1. Increase the percentage of 11-year-olds at or above the expected standard of literacy and numeracy for their age. By 2004:

– Increase the percentage of children who achieve level 4 in each of the Key Stage 2 English and mathematics tests beyond the targets for 2002 of 80 per cent in English and 75 per cent in mathematics. This target will be announced in due course.
– Reduce to zero the number of Local Education Authorities (LEA) where fewer than a set percentage of pupils achieve these standards, thus narrowing the attainment gap. This target will also be announced in due course.

2. Increase the percentage of 14-year-olds at or above the standard of literacy, numeracy, science and Information and Communications Technology (ICT) for their age. Subject to consultation:

– By 2007, 85 per cent to achieve level 5 or above in each of the Key Stage 3 tests in English, mathematics, and ICT, and 80 per cent in science.
– As milestones towards that target, 80 per cent to achieve level 5 in mathematics, 75 per cent in English and ICT, and 70 per cent in science by 2004.

– For 2004, a minimum performance target will be set which will result in higher standards for the bottom 20 per cent of pupils and narrow the attainment gap.

3. Increase the percentage of pupils obtaining 5 or more GCSEs at grades A* to C (or equivalent):

– Increase the proportion achieving the standard by 4 percentage points between 2002 and 2004.

– At least 38 per cent to achieve this standard in every LEA by 2004.

4. Increase the percentage of pupils obtaining 5 or more GCSEs at grades A* and G (or equivalent), including English and mathematics: by 2004, 92 per cent of 16 year olds should reach this standard.

5. On pupil inclusion:

– Reduce school truancies by a further 10 per cent from the level achieved by 2002.

– Ensure that all pupils who are permanently excluded obtain an appropriate full-time education.

6. By 2004, increase by 3 percentage points the numbers of 19-year-olds obtaining a qualification equivalent to National Vocational Qualification level 2 compared to 2002.

7. In Higher Education, while maintaining standards:

– Increase participation towards 50 per cent of those aged 18-30 by the end of the decade.

– Make significant, year on year progress towards fair access, as measured by the Funding Council benchmarks.

– Bear down on rates of non-completion.

8. Reduce the number of adults who have literacy or numeracy problems by 750 000 by 2004.

Targets contributing to the Welfare to Work PSA

9. Increase employment over the economic cycle.

10. A continued reduction in the number of unemployed people over the age of 18 over the 3 years to 2004, taking into account the economic cycle.

11. Reduce the number of children in households with no one in work over the 3 years to 2004.

12. Over the 3 years to 2004 increase in employment rates of disadvantaged areas and groups, taking account of the economic cycle — people with disabilities, lone parents, ethnic minorities and the over 50s, the 30 local authority districts with the poorest initial labour market position — and reduce the difference between their employment rates and the overall rate.

Value for money

13. Complete benchmarking work for schools by December 2002 so that schools will then be able meaningfully to compare costs with one another and thus improve value for money year on year.

19. Notwithstanding these improvements, questions still arise about the effectiveness of targeting. In particular, spending departments may focus excessively on achieving quantifiable targets at the detriment of less specific but perhaps equally important policy goals. The National Audit Office (NAO), which surveyed the new set of targets of 17 departments, found that there is concern among departments over the lack of incentives for meeting the targets, difficulty in identifying measures of intended outcomes and inability to influence final outcomes. It also found that an excessive use of targets may reduce local management's freedom to respond to local needs, that the focus on outcomes that can be quantified may come at the expense of others that cannot be easily measured and that poorly formulated targets may produce perverse incentives.[20] The NAO has made a number of recommendations that may provide useful guidance for further improvement in this regard:

- Departments need to adopt a consistent and comprehensive approach to performance measurement across the whole range of their responsibilities to prevent important but less urgent areas becoming neglected — only to be promoted priority status as performance deteriorates.
- Team bonuses should be paid to reward and encourage achievement of PSA objectives. If targets are exceeded, the Government should use part of the savings from productivity improvement to fund bonuses. Such financial incentives should be an essential part of a wider package, which could include flexible working hours and non-financial rewards and prizes to complement the performance related pay system.
- The Government should continue to pursue its policy to improve performance measurement and the quality of the underlying data systems. Validation of performance should be consistently defined, including the calculation and reporting of performance information and development opportunities.

However, overall the NAO's assessment was positive, concluding that the United Kingdom is among the leaders in performance measurement practice. It also acknowledged the progress that has been achieved in Spending Review 2000 in comparison with the previous Review, notably the increased focus on outcomes as opposed to processes (see Box 1), which reportedly has encouraged departments to reconsider their work practices in the pursuit of greater effectiveness.

Involving the private sector in public services

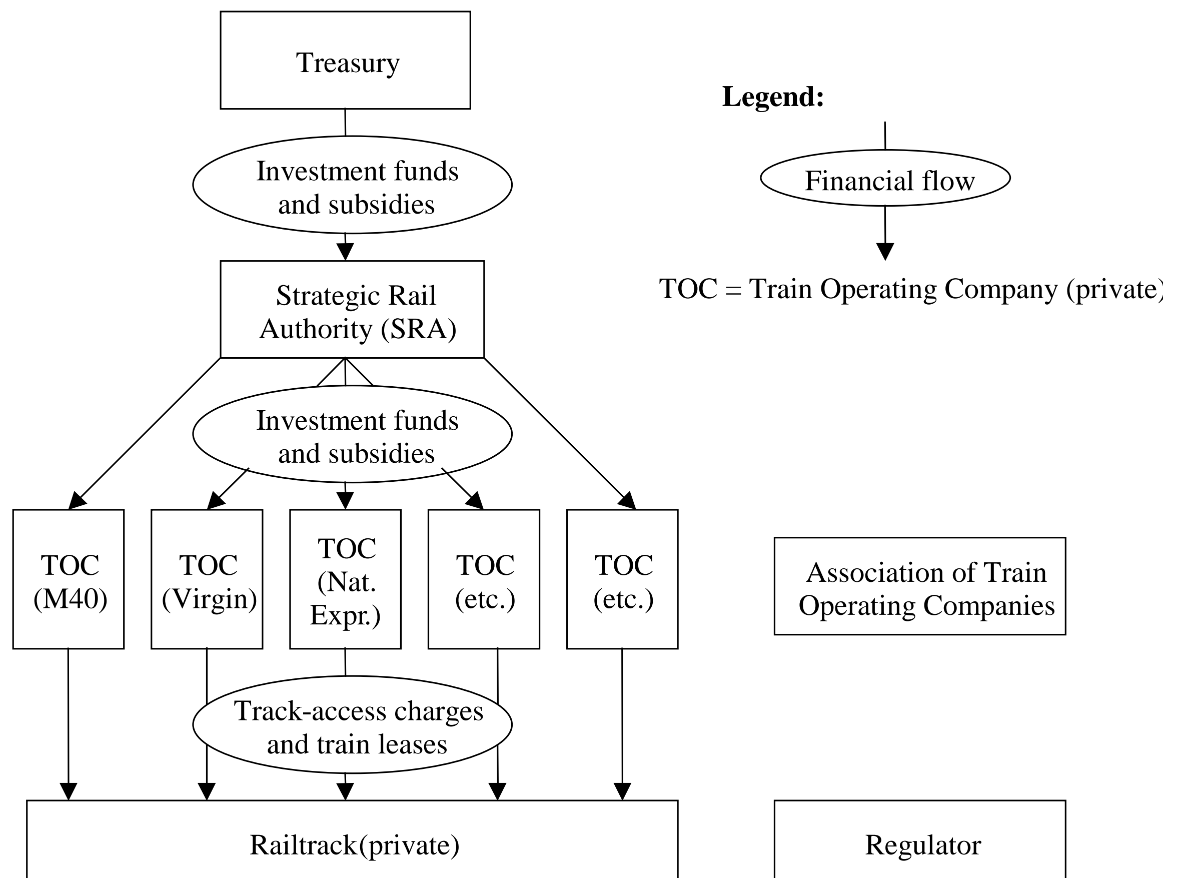
20. The United Kingdom has played a leading role in testing the boundaries of private provision of public infrastructure and utilities. A number of initiatives were launched to bring the private sector into these former public sector activities during the 1980s and 1990s through privatisation. In other public service areas, the United Kingdom has chosen to maintain the overall planning, funding and delivery to final users in public hands while involving the private sector through outsourcing of investment and production in the framework of the Private Finance Initiative. This section reviews the progress made so far.

Privatisation

21. Since the onset of the programme of privatisation in 1979, around 100 major businesses have been transferred to the private sector. As a result, employment in public corporations (nationalised industries plus other public corporations, excluding NHS trusts) has fallen from over 2 million in 1979 to around 400 000 since the beginning of the 1990s. Among the major "natural monopolies" only the BBC and the Post Office have been left in public hands. In fact, the Post Office stands out as the only major

example where the United Kingdom has been lagging developments in other European countries — in all other public utilities markets it has been leading. Continuing to manage the Post Office as a public service and therefore handicapping it in taking on joint ventures with other postal services abroad seems to be at odds with the ongoing opening up and integration of postal markets in the European Union. Therefore, the proposals in the 1999 White Paper to turn the Post Office into a public limited company with commercial freedom are encouraging. On the other hand, the almost complete privatisation of British Railways several years ago has been rather unsuccessful. It produced uneven incentives for efficiency and better performance, particularly on the part of the infrastructure provider, due to its very fragmented structure and the adversarial relationship between the main players in the industry after privatisation (Box 3). More generally, with privatisation having served to a large extent to move public expenditure off budget, many assets were sold before regulatory regimes to create a competitive environment were in place.

Figure 6. Structure of the railway industry in the United Kingdom



Source: OECD.

Box 3. **Privatisation of the railways industry**

The privatisation of the public monopoly British Rail was initiated by the Railways Act 1993. In 1993 the track was separated from train operations. A new entity, Railtrack, became responsible for operating all track and infrastructure, while passenger services were run by British Rail until they were franchised. Railtrack initially remained in state-ownership, but was privatised by the Conservative government just before it left office in 1997. British Rail restructured its passenger services into 25 train-operating units, which were franchised in 1996 based on the lowest subsidy for a given minimum service level for a certain period, in some cases as short as seven years.[*] Under the Railways Act 1993 the Office of the Rail Regulator was created to control the natural monopoly aspects with similar responsibilities and duties as the other sector regulators supervising water, gas, electricity and telecom industries. However, unlike the other sector regulators, its functions extend to approving contracts for the use of networks, including the access charges levied by Railtrack on the train operating companies. This meant that the Regulator was in a position to affect the level of government support paid to the industry.

In view of the numerous bottlenecks in the network and the very unsatisfactory performance of some of the operating companies, the Labour government’s July 1998 White Paper “A New Deal for Transport: Better for Everyone” called for the creation of a Strategic Rail Authority (SRA). It was formally established in January 2001 but de facto operated as a “Shadow” SRA from early-1999 onwards. It was based on the residual British Railways Board and the Office of Passenger Rail Franchising and also took in the consumer protection unit of the Rail Regulator. The SRA’s assignment is to secure the development of the railway network and, specifically, to refranchise the 25 operating units for up to 20 years and to allocate new public investment funds across these units. The new franchises are thus designed to be of a more long-term nature than their predecessors and the licensees take a broader responsibility, *i.e.* not only to operate train services with the existing infrastructure and rolling stock, but also to participate in enhancing it. The Government envisages in the recent 10-Year Plan for transport that £60 billion will be invested, of which £34 billion is expected to be privately financed. However, this Plan is not yet definitive and is likely to be adjusted in the light of further developments and assessment.

The privatisation and subsequent actions left a needlessly complex and fragmented structure (Figure 6). Moreover, this structure was designed to handle static demand in the long run, an assumption that has been thoroughly confounded by the actual growth in passenger transport (26 per cent between 1995 and 1998). The system clearly has been unable to cope with this situation, with the Hatfield crash on 17 October 2000, due to broken rails, being a sad piece of evidence. It led to a partial breakdown of the network from which it has still not recovered. This, together with a failure to control costs, contributed to Railtrack's financial collapse in October 2001, when the Government refused to make additional funding available over and above that provided through the Regulator. Since then Railtrack has been operating in a special form of Administration provided for under the Railways Act 1993, pending transfer of the assets to a new entity. The Government has proposed that this new entity be a private sector company limited by guarantee (CLG), with a commercial board reporting to members drawn from the industry and other stakeholder interests instead of shareholders. At the same time the Government proposes to streamline the regulatory regime through the combination of many of the functions of the Regulator and the SRA in a single entity, and to reform the performance regime that governs relationships between the infrastructure provider and the train operators. A key problem that so far stood in the way of the industry’s revival is the adversarial relationship between Railtrack and the operating companies who blame Railtrack for the deplorable state of the network. In a recent policy document, “A Strategic Agenda”, the SRA presented an inventory of the challenges, with current projections pointing to a 50 per cent increase in traffic until 2020, and a strategy to implement a (possibly revised) 10-Year Plan.

The announced merger of the SRA and the Regulator, is welcome as it would be conducive to a simpler regulatory framework for the industry. Experience in other areas of the UK public transport system has shown that similar structures produce better results. An example is the Docklands Light Rail (DLR) system in East London (owned by London Transport), where a single company not only develops and maintains the track but also gives out the franchises to operating companies. This model may not be immediately transferable to the national railway system given its much smaller scale, but a restructuring of the industry along these lines might nevertheless prove beneficial.

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* Rail freight operations were offered for sale (not franchised) in six lots, five of which were bought by one buyer.

Public-private partnerships

22. In the early 1990s the Private Finance Initiative (PFI) was launched. Like the privatisation programme, it was the offspring of severe public borrowing problems, coupled with cash accounting — which did not allow public-sector capital expenditure to score over the number of years the asset could be expected to last. As noted, this had long had the effect of distorting public policy decisions against investment, as evidenced by *e.g.* the situation in the railway sector. Privatisation, the first and simplest way of getting infrastructure investment off the Treasury's books, had by 1990 covered water, telecoms and energy, but left core public services untouched. Contracting-out had allowed private businesses to supply government with such peripheral services as cleaning and rubbish collection. But the PFI has been designed to prompt private providers not only to deliver services but also to make the necessary investment and to finance this off budget.

23. The PFI forms a specific class of public-private partnerships (PPPs) that can best be described as a comprehensive form of tendering and outsourcing.[21] It has three essential characteristics:

- *Considerable capital expenditure by the contractor*. The contractor is usually expected to invest heavily in productive assets such as buildings, roads or other physical infrastructure or IT-systems. These investments are financed by private sources involving the issuing of equity and debt securities.
- *Bundling of different operational tasks within a partnership.* Rather than outsourcing each activity separately (like cleaning, heating or maintenance), PFI combines several or most operations that together constitute a package of services within one long-term contract, thus enabling the contractor to seek innovative solutions for cost reductions within a longer planning horizon.
- *Performance-based payment schemes*. Both classical outsourcing and PFIs normally rely on competitive tendering. However, unlike classical outsourcing, PFI contracts make payments during the contract period dependent on a set of performance measures evaluated at regular time intervals. Moreover, PFI contracts typically set requirements regarding the quality of outcomes (rather than quantity of input or output) and leave the contractor freedom as to how to meet them.

24. The PFI concept of PPP is not new; it has been widely used in Europe and elsewhere, but almost exclusively for transportation infrastructure. Indeed, a unique feature of PPPs under the PFI is that they extend to the operation of structures for public services, such as hospitals, schools and prisons, although transport still accounts for two-thirds of the deals.[22] Moreover, as reported in Table 9, the overall volume of comparable PPP contracts concluded in the United Kingdom in 2000 by far exceeded those in other countries for which data are available (France, Netherlands and Finland). Private PFI investment in fiscal year 2000/01 amounted to 0.4 per cent of GDP, which corresponds to about one-third of net investment by the public sector and the PFI taken together (Table 10). It should be noted, however, that the PFI is not entirely comparable to the use of concessions given to private companies to develop, construct and operate infrastructure while charging the users, as is the case in some other OECD countries. Indeed, the novelty of PFI/PPP contracts is that the services of infrastructure utilities are purchased by the Government, rather than directly by the users. For example, instead of charging tolls from drivers, the contractor of a PPP-highway may receive “shadow-tolls” from the Government. The driver, in turn, receives the right to use the road as often as he wishes, without charge (*i.e.* an “implicit voucher”). The principal drawbacks of this approach are that it sets the relative prices across modes of transport at the wrong level and contributes to congestion.[23]

Table 9. **Private finance deals for public infrastructure and other services**

Deals concluded up to 2000

	Euro billion	As a per cent of: Total government outlays in sector	As a per cent of: GDP	Examples and comments
United Kingdom				The PPP model is used in a wide range of areas including roads, railways, IT-systems, prisons and buildings for schools and hospitals. By 2001 more than 400 deals have been completed – the bulk of which since 1996.
Transport	19.9	108		
Health	4.3	6		In health and education PPP's typically include the construction and maintenance of buildings along with services like catering.
Education	1.7	3		
Public order and safety	0.7	3		PPP's are considered to work well for prisons where the tasks for the private operator involves both design, construction and operation of the prisons including administration, catering etc. and guards. Construction periods have been reduced considerably.
Defense	4.1			
Total	30.7		2.3	
Netherlands				A number of projects are being prepared and contracted. Going beyond infrastructure, the use of PPP's is expanding to cover urban development, including the areas surrounding the Amsterdam World Trade Centre and the Hague Central Station, and research/knowledge centres.
Transport	1.4	40-70		Presently the first elements of the High Speed Line South railway from Amsterdam to the Belgian border to be completed in 2005 and the A59 road are being contracted. More large scale rail and road projects are likely to be organised as PPP's in the coming years.
Other infrastructure	0.5	10-20		Water purification in Delfland.
Total	1.9		0.5	
France				
Transport	1.0	5-10	0.1	A28 highway and Millau bridge which are both based on competitive tendering. See box in the main text.
Finland				
Transport	0.2	20-30		The Järvenpää-Lahti highway including re-construction and maintenance of 69 km highway for 15 years. Payment to the private consortium is based on the traffic volume (shadow tolls), but with a fixed upper limit to the total payments. The road was constructed in 1997-99 and put into operation almost a year before planned.
Total	0.2		0.1	

Source: OECD

Table 10. **Capital spending by the private sector for signed PFI deals**

Million pounds

	Estimate	Projections		
	2000-01	2001-02	2002-03	2003-04
Defence	121	147	200	100
Foreign and Commonwealth Office and International Development	7	7	6	7
Agriculture, Fisheries and Food[1]	0	0	0	0
Trade and Industry	36	61	24	26
Environment, Transport and Regions[2, 3]	619	639	855	1 015
Education and Employment[4]	15	28	9	0
Home Office (Prisons and IT)	160	136	297	0
Legal Departments	37	36	13	6
Culture, Media and Sport	0	0	0	0
Health (Hospital equipment)	491	501	235	67
Social Security (IT)	42	17	67	14
Scotland (roads, schools, housing, etc.)	540	289	78	20
Wales (roads, schools, housing, etc.)	160	11	0	0
Northern Ireland	39	26	4	0
Chancellor's Departments (customs property)	104	87	19	19
Cabinet Office (IT property)	155	159	42	6
Local authorities (roads, schools, housing, etc.)[5, 6]	1 352	1 404	1 215	1 150
Total	3 878	3 548	3 064	2 430
As a per cent of GDP	0.4	0.4	0.3	0.2
As a per cent of total public investment + PFI	34.5	23.8	11.8	11.4

1. Includes Forestry Commission.
2. Includes the private sector capital investment in Channel Tunnel Rail Link.
3. In addition, substantial private investment is levered in through housing, urban regeneration and other programmes.
4. Excludes private finance activity in education institutions classified to the private sector. Estimated total values for these are £80 million in 2000-01 and £226 million in 2001-02. Includes projects in Voluntary Aided schools only; Schools projects funded through Revenue Support Grant are included in the Local Authority figures.
5. Figures represent spending on projects supported by central government through Revenue Support Grant.
6. PFI activity in Local Authority schools is included in the Local Authorities.

Source: HM Treasury, Budget 2001.

25. The PFI is expected to yield gains in operational efficiency because it creates opportunities to make a profit for the private partner who would thus be induced to perform well, especially in combination with a bundling of tasks and the freedom to innovate. To some extent capital market institutions may also play a role in the screening of projects and disciplining of operators. On the other hand, transferring the risk to the private partner implies a higher cost of capital as compared to funding by the public sector.

26. Although the prospect of efficiency gains is an important rationale for PPPs, the opportunity they offer to shift public investment and borrowing off-balance sheet has been considered an attractive property by the Government. However, this argument neglects that possible macroeconomic "crowding out" of market activities in principle is the same for public investment and private investment via PPPs (Heald, 1997), the more so since in both cases taxes need to be levied in order to meet future capital and operating costs.[24] Only if efficiency in delivery is enhanced or if payment is shifted to users through charges as part of the private finance arrangement will there be a net benefit. Unfortunately there is a lack of systematic evaluations of the results from PPP projects, although the use of PPPs in road procurement has led to more rapid completion of the construction of projects.[25] The often-cited study by Arthur Andersen (2000) concludes that PPP projects can reduce costs by 17 per cent, but this study has raised controversy.

27. In fact, it is still too early to judge whether savings can be maintained in the long run as many contracts are still in their early stages. The potential for future savings could be undermined by the long horizon of contracts, which could have adverse effects on the effectiveness of competition. It is conventional wisdom that contract periods should not be too long so that the firms that are *not* winning the contracts will survive and be around to bid in the next round of competitive tendering of the same task.[26] Moreover, the specificity of assets (such as a hospital building or an IT-system) implies that the private and public partners become mutually dependent in a way that may stifle competition. When the contract expires, other potential contractors may be reluctant to undertake the effort necessary to make a bid in a renewed tender process, knowing that the incumbent will have a considerable cost advantage — other things being equal. This phenomenon may also weaken market scrutiny during the contract period since the threat that the Government could contract another private partner in case of under performance may not always be credible.

28. The United Kingdom has been experimenting with other forms of PPPs as well, notably the formation of joint ventures with joint public and private ownership in a company established to carry out the activities of the partnership. Normally the Government secures a minority stake in the equity capital of such a partnership in order to ensure it remains off budget (a majority stake would convert the partnership into a public enterprise) while still allowing to share the benefits from efficiency gains with the taxpayers. There are several arguments put forward in favour of this model. Joint ventures can be tailor-made for the core activities of public agencies. For instance this could be IT based on information resources held by a public agency. Also, it is argued, joint public-private ownership can introduce private sector management skills while sustaining a public service ethos within an organisation that would not exist if the activities were carried out under pure private ownership. As indicated above, retaining a public ownership share in partnerships also allows the Government to share the benefits from better performance with the taxpayers if the return is high.

Box 4. **The Millennium Dome**

The Millennium Dome, built to house a huge exhibition in east London, was proposed in 1994 as the centrepiece of the national millennium celebration. The state-owned New Millennium Experience Company (NMEC) was established to manage/construct the Dome, funded in part by lottery proceeds distributed by the government-appointed Millennium Commission. However, while the Dome had been expected to welcome 12 million visitors, in reality only 4.5 million paying visitors showed up. Each downgrade in expected visitor numbers resulted in the need for more funding to stave off bankruptcy, but the NMEC was found insolvent in August 2000 despite £179 million in emergency funding during the year. Moreover, in September a potential buyer of the Dome, who intended to run it as a theme park, pulled out. In all, some £900 million (0.1 per cent of GDP) has been invested in the Dome, more than half from lottery proceeds.

The National Audit Office reported to Parliament that the targets for visitor numbers and income required by the Millennium Dome were "highly ambitious and inherently risky" and involved a significant degree of financial risk. It found in addition that "the task of managing the project has been complicated by the organisational arrangements put in place from the outset, and by the failure to establish sufficiently robust financial management." Eventually the government's main financial adviser recommended tearing down the Dome to maximise returns on the sale of the site. He believed the site was not commercially suited for use as a leisure destination and would be more valuable as a mixed-use scheme, possible centred on an office park.

29. While establishment of new partnerships based on joint ownership may produce innovation, there is reason to be cautious about the long-term effects of this ownership structure. Government ownership reduces the likelihood of closing down activities by "firm exit". Consequently, while a system of public-private joint ventures may spur innovation, its ability to sort out the failing firms may be poor. This is problematic, as productivity studies of firm level data suggest that the contribution from firm exit may

be as important as the contribution from firm entry for aggregate productivity growth. Using public-private joint ventures for developing new business opportunities is therefore likely to create not only successful innovation but also long-lived failures. It is also not immediately obvious that the objective of sharing windfall gains with the taxpayer is best served by (partial) public ownership if this would lead to less efficiency for which ultimately the taxpayer will have to foot the bill. Moreover, the flip-side of the medal is that taxpayers also carry more of the financial risk if a company fails. The Millennium Dome is a sobering experience in this regard (Box 4).

Scope for improving and expanding private involvement

30. The experience gained in the United Kingdom with public-private partnerships under the PFI is valuable also for other countries, but past mistakes in privatisation need to be corrected. In particular, a redesign of the regulatory framework for the railway sector is urgently needed, and similar mistakes in new infrastructure projects should be avoided. The choice of public-private partnerships should be the outcome of a careful comparison between a wide range of options, and should not be imposed by the Government as the favoured way of management of public services. Where public-private partnerships are being pursued, their performance could benefit from considering the following issues:

- Simpler transactions could reduce the relatively high costs of writing contracts and bidding for tenders. Public-private partnerships could be made more financially beneficial for the Government by containing the amount of financial and legal advice they currently generate.
- The empirical evidence suggests that most efficiency gains stem not from the tender as such but rather from the permanent exposure of potential contractors to competition. It is therefore essential that the process of tendering and contracting be organised in such a way that they reduce the government's dependence on the incumbent franchise or concession holder.
- Often the Government is a co-owner of the public-private partnerships in order to ensure that any financial gains arising from the partnership will be shared with the taxpayer. However, this set-up may confuse the roles of the Government as a shareholder and regulator, and could establish a *de facto* monopoly position of the incumbent private partner. It also entails a greater exposure of the budget if a private partner fails. The Government should weigh the pros and cons (*i.e.* greater public financial gains but less efficiency) of entering into partnerships as a shareholder.

31. As noted, to date public-private partnerships have been mainly confined to the transport sector or support tasks, while the core of public services remains firmly in the hands of the public sector. For example the National Health Service (NHS) is still based on universal provision. The private health sector is gaining importance, partly in response to long waiting times and partly because of the increasing popularity of employer-funded private health insurance, but it remains small compared to other European OECD countries. The same holds true for education. In several European countries a significant share of education is run by private non-profit institutions, either fully or partly publicly funded. While such private institutions are committed to the core of national policy objectives, they otherwise maintain their own staffing, maintenance and investment policy. Plans to allow some private initiative in setting up schools or hospitals have been aired recently, but are still very modest by international standards. Significantly widening the scope for private provision of merit goods may be instrumental in getting better value for money than can be achieved by relying solely on public provision.

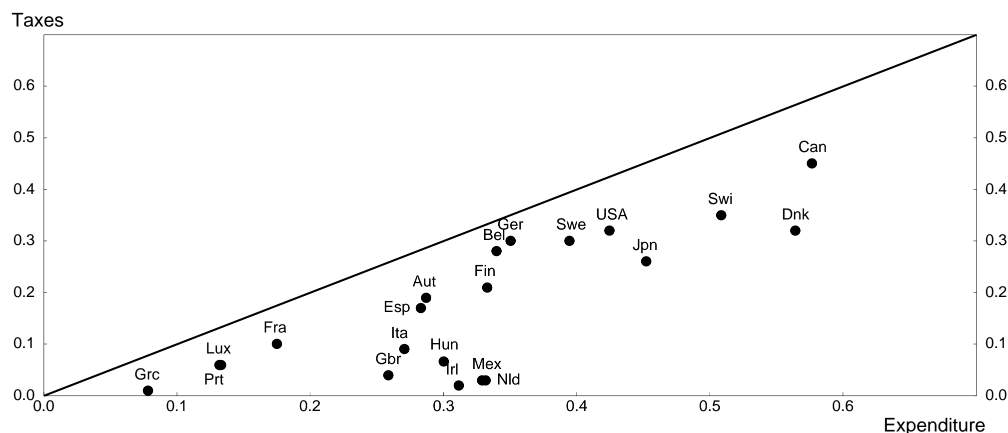
Mobilising sub-central governments

32. Local governments in the United Kingdom have responsibility for key priority areas of public policy, notably education, social housing and local infrastructure development. A particular challenge local governments will be facing is to deliver on performance targets they will agree with the central government in the framework of future Spending Reviews. In a recent Green Paper the Government has set out its view on a range of local government issues and suggests some reforms, which are reviewed below.[27]

33. A key feature of the UK's sub-central governments (county and town councils and devolved countries) is their relatively small share in overall public outlays and their limited command over funding. As shown in Figure 7, sub-central government's share in total spending is among the lowest in the OECD — albeit comparable with the other major unitary countries in Europe, France and Italy.[28] Local governments' own resources (council tax on household property and sales, fees and charges) is also low by international comparison[29] and account for about a third of their current budget and "external" finance for the remaining two-thirds (capital budgets are dealt with separately; see below). The latter comprise the local share in the yield from the business rate, which is a tax on commercial property collected by the local authorities, paid into a central fund and redistributed on a simple per capita basis, and government grants. Of the government grant around 90 per cent is general and the remainder is ring-fenced, *i.e.* tied to specific expenditure programmes, mostly education.

Figure 7. Tax receipts and expenditure by regional and local governments[1]

Share in non-transfer receipts and expenditure, 1999[2]



1. Receipts include direct and indirect taxes received by regional and local governments and are expressed as a share of taxes received by the general government. Fees and charges are not included. Expenditure corresponds to total expenditure by regional and local governments expressed as a share of general government expenditure (excluding capitalist transfers). The country ranking in this figure does not necessarily correspond to the comparative fiscal autonomy of lower governments.
2. For Finland, Luxembourg and United Kingdom: 2000. For Portugal and Mexico: 1998. For Canada, France and the United States: 1997. For Ireland and Switzerland: 1996. For Greece: 1995.

Source: OECD, *National Accounts*; OECD, *Revenue Statistics*, 1965-2000 and Hungarian Ministry of Finance.

34. Problems have been identified with regard to both types of grants:

- The *general grant* to local authorities is based on a formula to determine their "standard spending assessment" (SSA) and the amount of revenues they could raise by charging a standard rate of council tax together with their share in the yield from business rates.[30] The SSA formula has been widely criticised because the grant level varied sharply from one year to another, thus hampering sensible forward planning.[31] Therefore, from 1999, the Government introduced a moratorium on

formula changes, and local authorities henceforth received a minimum grant increase of 1½ per cent per annum for education and social services — which comprises the bulk of current expenditure. However, this is a temporary measure, awaiting further decisions. In particular, the grant formula may be revised every two or four years, on a timetable aligned with the Spending Review, while volatile data changes entering the grant formula would be smoothed.

– The use of *ring-fenced* grants has increased over time because the Government has considered that the general grant system does not provide any direct means by which local governments can be induced to meet its commitments to increase education spending and to raise standards. However, the system of earmarked grants has been criticised for its negative impact on accountability at the local level and has also produced excessive red tape, affecting schools in particular. The green paper suggests that incentives and rewards for achieving targets in the Spending Reviews could be built into the general grant system. This is being developed through a programme of Local Public Service Agreements to link funding to service delivery. As noted in Box 4, the 2000 Spending Review contained 20 Local PSAs as a pilot exercise, which are currently being rolled out to 130 local authorities as part of the upcoming Spending Review.

35. The funding of capital expenditure of local governments is separate from that of current expenditure and has also been prone to problems. Roughly one-third of capital expenditure is debt-funded, with the amount of borrowing constrained by a system of strict top-down credit approvals. While protecting local authorities from running unsustainable debt levels, it blurs accountability and has become an obstacle to capital investment. The green paper suggests removing the credit approvals while local governments would need to report a core set of prudential indicators. This would represent a major improvement since it provides local government with more flexibility as to the timing of investment projects. Central government would, however, continue to decide in Spending Reviews how much investment in individual programmes it would support via grants. It also intends to continue to provide ring-fenced support to private finance deals under the PFI.[32]

36. The green paper rightly identifies scope for improving the efficiency of the existing system of local taxes and charges. For example, it notes that while properties are re-valued for the business rate every five years, the council tax on household property is still based on its value in 1991. This undermines the fairness of the tax since relative property prices have changed considerably. Therefore the Government is moving to a fixed cycle for council tax revaluation which was long overdue. Moreover, local governments are encouraged to develop efficient charging policies, for example road user charges to tackle congestion. However, while the green paper considers giving local authorities limited freedom to vary the business rate in their jurisdiction, either by granting rebates or setting a supplementary rate, strings are attached. In particular, the supplementary revenues would need to be earmarked for additional expenditure agreed with local business.

37. The Government should revisit the system of local government funding along these lines once a window to do so opens up. An occasion to do this could be once devolution of executive and legislative power to a regional administrative layer in England — akin to the establishment of elected administrations of Scotland, Wales and Northern Ireland — figures firmly on the policy agenda. However, the government should guard against uncontrolled growth in local government spending once greater autonomy has been granted. Local governments provide individual welfare services that are strongly redistributive, and therefore distributional conflicts may result in an upward spending bias. These services are also typically monopolistic and prone to agency problems: producer interests are strongly and consumer interests weakly represented, although privatisation, contracting-out and opening up procurement for competition eases this problem to some extent. So far the UK Government has been rather successful in containing spending pressures by keeping a tight lid on local government's financing, but with devolution this may become more difficult. A strict no bailout rule for local governments would be one way to enhance fiscal prudence.

Summing up

38. History importantly affects any country's choice for a particular way of managing its public sector. Therefore, reforms aimed at greater efficiency of public expenditure typically rely on gradual change and learning by doing within a given set of cultural and socio-economic constraints. The approach to reform in the United Kingdom should be assessed against this backdrop. The sections above suggest that the reforms implemented since 1997 contain important innovations, but on the basis of the experience so far a number of weaknesses have been identified. These have led to recommendations for further progress that are discussed below; Box 5 provides a synopsis.

39. Fiscal management in the United Kingdom has come to be organised around the golden rule to address the serious concerns about the low level of capital expenditure in the past. Together with the sustainable investment rule, it is also instrumental in pursuing several key objectives of budgetary policy, including macroeconomic stability and fiscal sustainability. However, a main drawback is the risk of reduced allocational efficiency introduced by the somewhat arbitrary distinction between current and capital expenditure as well as between public and private investment. Sound cost-benefit comparisons of investment projects, and between public investment and investment through public-private partnerships, remain a necessity. Meanwhile, while the rules promote intergenerational equity, they do not ensure it. The rules' contribution in this regard cannot be fully assessed satisfactorily without knowing the ultimate incidence of the costs and benefits of both public expenditure and taxation, although long term projections and generational accounting, both of which the Government also undertakes, can be helpful in this regard.

40. The current set of fiscal rules provides a sensible anchor in the pursuit of better conditions for macroeconomic stability and accountability of policy. While the Council of the European Union has noted that in the medium term the government's finance would not be in line with the prescription of "close to balance or in surplus" contained in the Stability and Growth Pact, the authorities have argued *vis-à-vis* the European Commission that since Treasury projections for government revenues and the departmental expenditure limits are based on conservative projections for economic growth, the likelihood of breaching the Maastricht deficit ceiling in a recession would be smaller than the projections suggest. An alternative would be to base the projections on central rather than conservative assumptions and aim for a larger surplus on the current budget instead. Moving in that direction would also eliminate a built-in tendency for "pleasant surprises". Such surprises have already led to (so far small) top-ups of departmental expenditure limits in the 2000/01 Budget, thus raising the spending limits that were agreed less than a year earlier in the 2000 Spending Review. If future Budgets consistently make larger additions over the Spending Review allocations, the credibility of the Reviews may suffer.

41. The experience to date with public-private partnerships has been mixed. Through public-private partnerships, the Government purchases the services of public infrastructure, rather than the infrastructure itself, from a private provider, which may result in cost savings, provided that the higher interest cost associated with private funding and the cost of writing contracts and bidding for tenders is not excessive. The Government should continue its work on simplifying transactions to reduce these costs. In some cases the Government participates in the capital of the provider through a joint venture. The advantages of this set-up are that partnerships can be tailor-made, while private sector skills are introduced in the public sector and benefits from higher efficiency may be shared with taxpayers. However, the taxpayer will also bear the financial risk of failure, and some potential efficiency gains may be foregone, because the incumbent provider likely faces less market scrutiny as compared with a situation where he would have to rely fully on private funding. The Government should therefore seek to reduce any tendency to become dependent on the incumbent franchise or concession holders. It should be noted, moreover, that the current plans to provide services privately in sectors such as health and education are modest. Such services are provided on a much larger scale privately in many OECD countries and greater ambition in this respect would raise competition and performance in these sectors as well.

Box 5. **Synopsis of recommendations**

1. The current set of fiscal rules favours public investment. While appropriate in view of the substantial backlog in public infrastructure, the Government should guard against distorting decisions on capital and current expenditure. In particular:

- The trade-off between current and capital expenditure should be guided also by a comparison of their respective marginal cost and benefits to the extent these can be approximated.
- The choice of public-private partnerships should be the outcome of a careful comparison between a range of options and should not be imposed as the favoured way of management of public services under all circumstances.

2. While the medium-term fiscal projections appear prudent enough, the authorities may wish to consider basing the fiscal projections on central rather than conservative assumptions and aim for a larger surplus on current balance to further promote transparency.

3. The scope for private provision of public services should be better exploited. In areas where public-private partnerships are being pursued (transport and support tasks), efforts should focus on the following issues:

- Continued simplification of transactions in order to cut down further the costs of writing contracts and bidding for tenders.
- A reduction in any tendency of the Government becoming dependent on the incumbent franchise or concession holders.
- Weigh more carefully the pros and cons of the Government entering into partnerships as a shareholder.

4. There may be benefits to further devolution of spending and taxing power. In particular, local governments should be given:

- More freedom to raise household and commercial property tax. Property valuation should be kept up to date.
- More clarity about the public expenditure programmes for which they are accountable *vis-à-vis* the local electorate and which ones are in the domain of the central government.
- More freedom to design structures of fees and charges that reflect the marginal cost of provision.

Meanwhile the Government should guard against uncontrolled growth in local government expenditure once greater autonomy has been granted. The strict enforcement of a no bailout rule would be instrumental in this regard.

5. The Government should further improve the design of targets. Although there is a strong public commitment to deliver on the targets by the Government, appointing an external auditor that reports directly to Parliament and the public, such as the National Audit Office, might strengthen the framework further. In addition:

- Spending departments should not focus excessively on quantifiable targets to the detriment of harder to specify objectives.
- The Government could take further steps to encourage good performance against targets by granting financial bonuses or other rewards to departments or teams that perform well.
- The Government should continue to improve performance measurement.

42. Despite recent initiatives to devolve legislative and executive power to elected governments in Scotland, Wales and Northern Ireland, the United Kingdom still has one of the most centralised governments in the OECD area. While it is difficult, if not impossible, to determine the optimal split of local and central government expenditure on the basis of pure economic arguments (this is largely a matter of political preference heavily influenced by historical considerations), there may be benefits to a greater devolution of spending and taxing power. As it stands local governments are operating more like agents for the central government than as executives of their local electorate, as evidenced by the growing importance of earmarked grants, notably for education. This reduces the transparency and accountability of local policy. It would be advisable for local governments to be given more freedom to organise the expenditure programmes, for which they have been given responsibility, as they deem appropriate and to design better fees and charging structures. A related challenge is the need to reform the grant distribution system, which is complex and controversial, not least because of growing earmarked grants to promote national policy goals. Greater autonomy in borrowing policy should help to encourage investment in local infrastructure development. However, the Government should guard against uncontrolled growth in local government spending once greater fiscal autonomy has been granted. Moreover, borrowing should remain prudent, which requires the strict enforcement of a no bailout rule.

43. The core of the budgetary framework consists of the biennial Spending Reviews to grant three-year spending limits to departments and agencies, which in turn are being held accountable for achieving the policy targets specified in the Public Service Agreements. The current set of Agreements has benefited from the experience that was gained in the previous Spending Review held in 1998, which rested upon more numerous, but also more poorly designed targets. However, to strengthen the framework further, the auditing of the achievement of targets could be entrusted with a body that operates independently from the administration and directly reports to the parliament and the public, such as the National Audit Office. Moreover, the Government should pursue further improvements in the design of targets for policy outcomes in future Spending Reviews. In particular, it is important that targets cover a broader range of policies to avoid that spending departments focus excessively on quantifiable targets to the detriment of less specific but perhaps equally important policy objectives. The Government should also take further steps to encourage good performance against targets by more systematically granting financial bonuses or other forms of rewards to departments or teams that perform well. As set out by the Government in a recent report on performance information, this requires further efforts to improve the measurement of performance (HMT, 2001).

NOTES

1. In UK policy documents reference is made usually to finances of the public sector, which is broader than general government. Capital grants from the Government to state-owned companies are included in general government outlays, and so is expenditure by public bodies outside government departments, unless they are part of state-owned companies (this is the case if for example, a regulatory activity is carried out by a state-owned company). Local authorities and social security institutions are also in general government. However, if public service providers are organised in trusts or partnerships selling their services to a government department, such providers are outside general government. This is the case in the United Kingdom, where National Health Service Trusts are part of the public sector but not comprised in general government. Hence out-of-pocket payments by users are not in general government revenue either and only the grants or fees paid by the relevant department on behalf of the users are included in general government expenditure — similar to subsidies to state-owned companies. Due to privatisation of public companies, the differences between general government and public sector spending levels have come to be insignificant.

2. For a number of reasons, international and inter-temporal comparisons of public expenditure may be misleading due to differences in institutions and accounting conventions with regard to social transfers, see Adema (2000). Specifically, the extent to which social benefits are taxed varies across countries and over time and mandatory or voluntary private arrangements providing close substitutes to public social expenditure are usually not taken into account.

3. Based on National Accounts numbers for general government.

4. This table reports expenditure as a percentage of trend rather than actual GDP in order to remove the impact of GDP volatility on the denominator.

5. Meanwhile, with the National Health Service being funded largely by general tax revenues and providing universal health care free of charge, the United Kingdom has the most redistributive health care system of a sample of countries including Denmark, Finland, France, Germany, Ireland, Italy, Netherlands, Portugal, Spain, Sweden, Switzerland and the United States. This reflects the large share of expenditure funded by general taxes, and its relative progressivity. See Wagstaff *et al.* (1999) and Van Dorslaer *et al.* (2000).

6. The privatisation of the National Bus Company has been less problematic as the coach operators recovered part of the clientele of the railways.

7. Each budget cycle a ritual dance between spending departments and the Treasury would typically continue until time ran out and core Ministers (the Star Chamber) or the Prime Minister had to step in.

8. Accrual accounting and budgeting recognises the financial implications of transactions when they occur, irrespective when cash is paid or received.

9. The Government thus *de facto* pre-empted key elements of the IMF's *Code on Good Practices* and the OECD *Best Practices* on fiscal transparency, akin to the reforms introduced by New Zealand and Australia (the Fiscal Responsibility Act and the Charter of Budget Honesty, respectively).

10. The United Kingdom is not unique in this regard: in Germany the golden rule is enshrined in the constitution, and is used by most individual states in the United States, while Australia adopted it recently.

11. The basic assumptions underlying this projection are the following. Trend GDP growth is assumed to be 2¼ per cent per year rather than the central estimate of 2½ per cent. As a result, the output gap, which is estimated to be 0.6 per cent in 2000/01, would steadily fall to zero by the end of the projection period. Net investment is projected to gradually approach the target of 1.8 per cent of GDP.

12. The *Code* stipulates that discretionary fiscal policy could be used in support of monetary policy through changes in the fiscal stance, "where prudent and sensible". Its thrust is clearly to avoid a pro-cyclical fiscal

stance, *i.e.* to stimulate in an upswing or to tighten in a downturn, but does not exclude anti-cyclical fiscal policy. The prominence given to automatic stabilisers has prompted the Government to provide estimates of the structural fiscal balances since 1997. The methodology adopted for these calculations is broadly similar to that used by the IMF, OECD and the European Commission.

13. Generational accounts for the United Kingdom suggest that intergenerational equity is practically achieved on the basis of current fiscal policy, given that a simultaneous increase in health and education spending, as intended by the Government, is directed to different age groups. See Agulnik *et al.* (2000), Banks *et al.* (2000) and Carderelli *et al.* (2000). On the other hand, it could be argued that the "unchanged policy" assumptions, on which such accounts are based, are not realistic.

14. In a system of pure accrual accounting public-private partnerships and publicly funded investment are broadly equivalent from a budgeting point of view, because capital charges would be the same in both cases. However, in national accounts terms, off-budget investment gives rise to a decline in the surplus on current account equivalent to the total capital charges whereas on-budget investment would have this effect only for the amount of the depreciation charge.

15. Van den Noord (2000).

16. Earlier work by the OECD suggests that the budget would need to be in structural surplus of around ½ per cent of GDP to reduce the probability of breaching the ceiling within five years to 10 per cent (Dalsgaard and de Serres, 2000). However, this is based on the previous policy framework which may have been conducive to larger economic volatility than the present framework.

17. The Government has started to produce detailed medium-term projections for public expenditure every two years for a planning horizon of three years, in the so-called Spending Reviews. The first Review was published in July 1998 and spanned the period from fiscal year 1999/2000 to 2001/02. The second Review was published in July 2000, and covered 2001/02 to 2003/04. The third Review for the period 2003/04 to 2005/06 has been scheduled for July 2002.

18. While spending departments will be held accountable for success or failure of investment projects, the Treasury retains a role in monitoring and advising project teams at all stages of the investment process, including planning, procurement and implementation.

19. The five policy areas with a cross-departmental PSA are Sure Start (a programme for disadvantaged children aged 0-3), Welfare to Work (a programme providing employment opportunities for the young and the long-term unemployed), the Criminal Justice System, Action against Illegal Drugs and Local Government issues.

20. A striking example of this was the former PSA concerning the National Health Service, which set a target for the reduction of the number of patients waiting more than a year. This gave an incentive to treat new patients with priority and keep patients who had been on a waiting list for over a year waiting even longer. This was corrected in the new PSA, which targets a reduction in the maximum wait for treatment.

21. Unlike competitive tendering and outsourcing, the concept of “public-private partnerships” may have different meanings across countries. For instance, in the United States it often refers to programmes for technological innovation linking publicly funded research with industry application.

22. In the United States the use of private prisons has grown rapidly from a capacity of 1 200 prisoners in 1985 to almost 50 000 ten years later. Still, only 3 per cent of all prisoners are held in privately operated prisons. Savings from outsourcing this activity to private companies through competitive tendering generally amount to 10 per cent of the cost, largely due to publicly employed prison guards on average earning 15 per cent higher wages than private guards.

23. For example, the French toll road system allows rationing based on variation in toll levels during the day and managing traffic flows by expanding or reducing the number of tollgates.

24. The implications for long-term fiscal sustainability are similar in both cases. Consequently, the increased use of private finance of public services might call for reconsidering the present practice of not including public obligations under such schemes in the measures of public debt when evaluating the government’s debt position.

25. For example the Lewisham concession of the Dockland Light Railway extension in east London was put into operation almost a year before planned.

26. Although, in a sufficiently large market this may not be a problem, since there would be a continuous flow of contracts despite their long duration.

27. DETR (2000). The Local Government Association (2000) largely shares these recommendations.

28. The recent devolution of legislative and executive power to Scotland, Wales and Northern Ireland have raised this share somewhat (the numbers in Figure 30 refer to 1997, the latest year for which internationally comparable data are available). However, the overall picture has not changed much to date (see Table 3).

29. The share of local government in the total tax take in the United Kingdom has been found to be the second-lowest of a sample of 19 OECD countries after the Netherlands, see OECD (1999). However, this stylised fact conveys little information on the UK's relative position against other OECD countries concerning sub-central tax autonomy, which depends also on the power of local governments to set tax rates and/or bases.

30. The SSA formula attempts to capture variations in the cost of providing services due to factors that are beyond the control of any individual authority. Local authorities do not necessarily have to spend exactly the amounts indicated by the formula, as this depends on the level of efficiency achieved (higher efficiency means they could spend less) or the actual rate of council tax (a higher rate means they could spend more than the formula indicates).

31. This is due mostly to changes in the population data that enter the formula and *ad hoc* changes to the formula. Moreover, the grant system relies too much on the mechanical use of statistics and seldom draws on wider evidence.

32. The arrangements for investment in council housing would also remain separate.

ANNEX

THE MEDIUM-RUN FRAMEWORK FOR FISCAL POLICY: SOME THEORETICAL CONSIDERATIONS

This Annex presents a formal though somewhat simplified exposition of the UK's fiscal framework.

The framework rests on two fiscal rules. The first one is the so-called *golden rule*, stipulating that the Government will borrow only to fund net fixed investment and not to fund current spending. The second one is the *sustainable investment rule*, requiring that the ratio of public sector net debt to GDP be held stable at a prudent level. These rules are presumed to hold on average over the economic cycle, *i.e.* do not need to be met necessarily on a year to year basis, and serve two main purposes. First, they aim to avoid investment outlays being crowded out by increases in current expenditure or declines in tax revenues, might these occur, while ensuring sound public finances over the longer haul. Second, they aim to promote intergenerational equity, by ensuring that government borrowing is at least matched by net investment in the public capital stock. It will be demonstrated that the two rules together provide a unique solution for the level of net investment (gross investment less depreciation) by the public sector *only* if they are both binding.

The following budget identity for the public sector is assumed to hold:

$$(1)\quad dB = iB + G^{C} + G^{I} - \theta K^{G} - T$$

where d is the first-differential operand, B = net public debt, i = the rate of interest on government debt, K^{G} = the public capital stock, T = tax revenue, θ = the rate of return on the public capital stock and G^{C} and G^{I} denote public consumption and public investment, respectively. If lower-case characters denote ratios to GDP, the above identity may also be written as:

$$(2)\quad db = (i - n)b + g^{C} + g^{I} - \theta k^{G} - t$$

in which n = rate of growth of nominal GDP. Net investment as a share of GDP g^{In} is defined as

$$(3)\quad g^{In} = g^{I} - \delta k^{G}$$

with δ denoting the depreciation rate of public sector capital. The golden rule implies that current revenues, consisting solely of tax revenue and the return on the public capital stock, cover at least current expenditure. Hence:

$$(4)\quad ib + g^{C} + \delta k^{G} \leq \theta k^{G} + t$$

Combining the identities (2) and (3) with the golden rule (4) implies that the ratio of net investment over GDP will be constrained according to the following relationship:

$$(5)\quad g^{In} \geq nb + db$$

in which the right-hand side is in fact the overall budget deficit, as can be checked via equation (2). Furthermore, it follows from the sustainable investment rule that the ratio of net debt over GDP should stay at or below a prudent level b^*:

(6) $b \leq b^*$

From inequalities (5) and (6) four cases can be derived: [a] neither rule is binding; [b] the sustainable investment rule is binding but the golden rule is not binding; [c] the reverse case; and [d] both rules are binding. These four cases are summarised in the table below:

Sustainable investment rule	Golden rule	
	Not binding	Binding
Not binding	[a] $g^{In} > nb + db$	[b] $g^{In} = nb + db$
Binding	[c] $g^{In} > nb^*; db = 0$	[d] $g^{In} = nb^*; db = 0$

It is now immediately clear that if both rules are binding (case [d]), the ratio of net investment to GDP is exactly equal to the product of the growth rate of the economy and the ratio of net debt over GDP. With the official estimate of the prudent net debt ratio at around 40 per cent and the medium-run (nominal) growth rate of the economy assumed to be in the range of 4¼ to 5¼ per cent,[1] this would imply that both net investment and the overall deficit can fall in the range of 1.7 to 2.1 per cent of GDP. This roughly corresponds to the official medium-term target for investment.[2] However, if one or both rules are not binding, as is currently the case, investment is undetermined by the fiscal rules *ex ante*. Specifically, investment may exceed the overall deficit (cases [a] and [c]), or be just equal to it but without the deficit being constrained by the debt ratio (case [b]).

Therefore, the fiscal rules will determine the investment level *ex ante* only in the exceptional circumstance where both rules are binding, *i.e.* in a fiscal crisis where debt threatens to exceed its "prudent level" and a current deficit is about to open up. The fiscal rules then offer a floor for net investment in the range of 1.7 to 2.1 per cent of GDP, as noted. Under current circumstances, in theory, the investment level can be chosen, and hence raised. However, in practice public investment is subject to a number of additional constraints: *i)* it needs to be consistent with the predicaments of cost-effectiveness; *ii)* the pace of increase in investment is limited by the available capacity for planning, design and production; and *iii)* the associated demand stimulus must be consistent with the aim for macroeconomic stability and not excessively burden monetary policy.

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1. This assumes that nominal GDP growth will be in the range of 4.25 to 5.25 per cent on average per annum over the cycle (with inflation and real GDP growth assumed to be in the ranges of 2 to 2.5 per cent and 2.25 to 2.75 per cent respectively).

2. The official deficit target for the medium term is 1 per cent of GDP, suggesting that the government in fact will not allow the golden rule to become binding.

GLOSSARY OF ACRONYMS

AME	Annually Managed Expenditure
DEL	Departmental Expenditure Limit
GDP	Gross Domestic Product
ICT	Information and Communication Technology
IMF	International Monetary Fund
IT	Information Technology
LEA	Local Education Authority
NAO	National Audit Office
NHS	National Health Service
PFI	Private Finance Initiative
PPP	Public-Private Partnership
PSA	Public Service Agreements
PSBR	Public-Sector Borrowing Requirement
SR	Spending Review
SRA	Strategic Rail Authority
SSA	Standard Spending Assessment

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