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Foreword

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The Editors

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Budgeting in Turkey

by

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The Turkish budget process has three features which set it apart from other OECD countries: a centralised yet fragmented decision-making process; the IMF standby agreement as a de facto *fiscal rule; and a very detailed line-item classification. This article analyses these features and makes suggestions for policy adjustment to improve effectiveness and efficiency. The article examines all stages of the budget process (preparation, parliamentary approval, execution, and accounting and auditing) and assesses Turkey's recent rapid progress with reform. The article offers suggestions for next steps and new priorities for Turkey in the light of other OECD country experience.*

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1. Introduction

1.1. General characteristics

Turkey is a member of the OECD which joined the organisation at its creation in 1960. Since then there has been remarkable economic progress in the country, but this development has been accompanied by many shocks and upheavals. These convulsions originated sometimes in external economic circumstances, such as the oil crises of the 1970s and the Russian default of 1998, but more often in internal economic and political circumstances. Since the 1960s, Turkey has gone through many political and economic crises with severe repercussions on the management of public finance. The latest crisis occurred in 2001 and resulted in a very difficult economic situation. Since then a positive development has begun which has led to rapid economic growth and enormous improvements in public finance management. This article takes stock of these improvements and makes some suggestions about next steps in the light of experiences with budgetary reform in other OECD countries.

Turkey is a large country with a population of 72.1 million, situated partly on European and partly on Asian soil. The population is relatively young compared to western Europe. The average annual rate of change of the population has in recent decades been comparatively high (1.6% in the period 1995-2005; OECD, 2006a), but has declined rapidly since 2000 (from 1.41% in 2000 to 1.26% in 2005). By 2010, the number of inhabitants is expected to be around 76 million, somewhat smaller than the population of the most populous EU country, Germany (84 million in 2010).

Most of the Turkish people are Muslim. Since the foundation of the Republic in 1923 by Mustafa Kemal Ataturk, Turkey has been a secular republic. At the time of its foundation, the system of governance of the Turkish Republic was inspired by that of the French Republic. Some features of this system are still present and are considered as important or even essential parts of the constitutional or legal structure of the Turkish state. Apart from a strong emphasis on the secularity of the state, these features include: the strong centralisation of service provision with uniform countrywide quality standards; the limited role of private initiative in health care, education and social services; the absence of sub-national tax autonomy; and the special position of the civil service. In the area of public finance management, typical French republican features include the judicial role of the Court of Accounts, the centralisation of the accounting function for the entire central government in the Ministry of Finance and, until very recently, the "Napoleonic" system of preventive spending control by the Ministry of Finance.

According to the Constitution, Turkey has a unicameral parliament, the Grand National Assembly, with 550 seats. It is directly elected by universal suffrage on the basis of proportional representation with an electoral threshold of 10% of the total poll. The Assembly is elected for a period of five years. As a consequence of the relatively high threshold, it is difficult for small parties to enter parliament. Since the elections of 2002, there are two main parties in parliament, namely the Justice and Development Party led by Mr. Erdogan, the present Prime Minister, with 352 seats on the basis of 34% of the electoral vote, and the Republican Peoples Party led by Mr. Baykal, with 151 seats on the basis of 19% of the vote. In addition to the two main parties, five smaller parties (28 seats) and independent deputies (11 seats) are represented in parliament, mainly as a consequence of resignations and realignments.[1]

Of the working population of 22.3 million (civilian employment), about 27.3% (6.1 million) is employed in agriculture (as opposed to 6% on average in the OECD area). The sectors of industry and construction employ 25.4% (5.7 million), and the services sector 47.3% (10.2 million). The population that makes its living from agriculture is mostly scattered over villages in the countryside. There are 34 500 villages in Turkey with their own elementary form of local administration. Industry and service employment is mainly concentrated in the big cities (Istanbul 10 million, Ankara 4 million and Izmir 3.4 million inhabitants) and in a number of fast growing medium-sized cities ("Anatolian tigers" such as Bursa, Denizli, Diyarbakir, Eskisehir, Gaziantep, Kayseri and Konya). In view of the low productivity of labour in agriculture (less than a third of that in industry), this leads to a large dispersion in income and prosperity between the cities and the countryside, which in turn induces a continuous exit from agricultural employment to urban employment (around 10% of agricultural employment between 2002 and 2005).

Although Turkey has made considerable progress since the financial crisis of 2001, there is still a long way to go before the Turkish economy can achieve the level of prosperity which characterises the member states of the European Union. GDP per person measured at purchasing value of the currency is a third of the EU average. In view of the large population growth, Turkey would have to achieve a real growth of 4% per year just to make sure that the gap with the EU does not widen. Real growth in the 1990s amounted to 3.1% a year. Only since the beginning of the century has the growth performance improved, albeit at a quite volatile rate (between 5 and 10%). Real growth is now somewhat higher than the average in the new central European and Baltic EU member states, but its take-off level has been much lower. Convergence with the European level of prosperity will not occur unless Turkey grows at a rate of at least 8% a year for the next 25-50 years.

The macroeconomic performance of Turkey is impaired by a number of structural shortcomings that the government has put at the top of the political agenda only since the financial crisis of 2001. Two of these shortcomings which have a major impact on the budget process are: 1) the large size of the informal and half-formal parts of the Turkish economy; and 2) a lack of institutional barriers against off-budget and back-door public spending.

It is estimated that of the 18.9 million persons working in the private business sector, 50.1% are informally employed (88.2% in the agricultural, forestry, hunting and fishing sector; 32% in the manufacturing sector; 64.3% in the construction sector; 43.8% in the wholesale, retail, trade, restaurant and hotel sector; 39% in the transportation, communication and storage sector; and 21.6% in the finance, insurance, real estate and business service sector). Informal firms are mostly micro-enterprises (family enterprises and self employment). Half-formal firms are mostly medium-sized enterprises (between 10 and 249 employees). Informal firms avoid labour regulations and labour taxes, environmental and safety regulations, corporate and other income taxes, and value-added taxes. Half-formal firms, typically run by families and employing both formal and informal personnel, while being registered, comply only partly with regulations and tax obligations. Generally, they use special arrangements to avoid the burdens of formality. A popular avenue is to employ workers under sub-contracting agreements, outside company payrolls (OECD, 2006a).

A lax attitude on public spending control has been characteristic for consecutive cabinets in the last decades of the 20th century. The state has played a leading part in the development of the Turkish economy since the foundation of the Republic. The first factories built in the 1930s were owned and operated by the state. The same was true for mines, utilities and railways. Most banks were also state owned. In the second half of the century, consecutive governments promised to reduce the stake of the public sector in the economy but it has not happened. Privatisation never took off, and the public sector remained overmanned. Its efficiency was impaired by political interference. Transfers were made for political reasons to business sectors (agriculture, construction, transport) through credits from state banks, covered by state guarantees (quasi-fiscal activities), off-budget spending (loans, guarantees, off-budget revolving funds) and back-door spending (tax exemptions, entitlements in substantive legislation). Similarly, there was a deeply ingrained culture of electoral spending for regional development through bank credit and for social purposes through extension of entitlements without funding. The resulting losses were often covered by Treasury borrowing from the Central Bank which until 2001 was not independent but under tight political control. In the last three decades of the 20th century, annual inflation oscillated between 60% and 100% or more. In 2001, a number of state banks had to be rescued by the central government in the worst financial crisis that the Turkish Republic had ever experienced. The crisis led to an IMF standby agreement, in which the Turkish government committed itself to a programme of far-reaching structural and institutional reform.

Since the beginning of the 21st century, macroeconomic and fiscal developments are promising. The Turkish authorities seem firmly committed to the reform programme. Reform of the budget process is only a small part of this programme and is dependent on structural reform in related areas such as deregulation, tax relief, public enterprise reform, social security reform and privatisation. Deregulation, tax relief and social security reform are needed to rein in the informal economy. Public enterprise reform and privatisation are needed to cut off quasi-fiscal activities and off-budget spending on the part of publicly owned entities. However, in combination with these structural reforms across a broad front, institutional reform of the budget process has to play its own important role. Without other structural reforms, the budget process cannot successfully be improved. Without improvement of the budget process, structural reforms in other sectors may remain ineffective or become undermined.

Since the beginning of the 21st century, Turkey's growth record has been good. Until 2005, the country's economic performance was 1.5% to 3.5% better than the average of the 10 new EU countries. After 2001, due to strong currency devaluation after the fiscal crisis, initially net exports started to grow. Simultaneously, capital inflows increased, both in portfolio investment and foreign direct investment, mainly as a consequence of the start of the EU accession process, political stability and increasing confidence in macroeconomic policy. However, capital inflows also led to gradual currency appreciation in subsequent years. Together with strong domestic demand, this provoked a widening of the current account deficit, which reached a record level of more than 6% of GDP in 2005. A tightening of the international capital market conditions in the spring of 2006 (due to decreased risk appetites in developed countries) triggered once more a sharp and sudden currency depreciation in May-June 2006. Following this depreciation, inflation surged well beyond the end-of-year target set in the IMF agreement. The Central Bank reacted with sharp successive increases of its policy interest rates which reached a level of 17.5% in July 2006. As a consequence, real incomes, household consumption and business investment were weakened in the second part of 2006. On the other hand, exporting sectors picked up again due to the depreciation.

While both exports and domestic demand have been increasing in all major sectors of the economy, some sectors have been more exposed to competition from low-wage Asian countries and have seen their profit margins squeezed and their growth impaired. Highly competitive sectors which experienced no profit squeeze as a consequence of Asian competition and in which a strong increase in employment took place since the beginning of the 21st century included the car and electronic industries. Declining sectors that lost market share and employment included textiles and clothing. The intermediate sectors that combined good and bad performance in competitive markets and had a modest increase of employment included food and plastics. Table 1 shows the total growth record of the Turkish economy since 2002 in comparison to both the older EU15 countries and the 10 central European and Baltic accession countries. Forecasts from the EU and from the Turkish government are also shown.

Table 1. **Growth in real GDP**

Per cent change on previous year

	2002	2003	2004	2005	2006	*2007*	*2008*	*2009*
EU15	1.1	1.1	2.3	1.5	2.7	*2.2*	*2.3*	*n.a.*
EU10 (new)	4.1	4.3	5.3	5.8	6.2	*5.5*	*5.1*	*n.a.*
Turkey (EU)	7.9	5.8	8.9	7.4	6.0	*6.4*	*6.3*	*n.a.*
Turkey (PEP 2006)	7.9	5.8	8.9	7.4	6.0	*5.0*	*5.7*	*6.0*

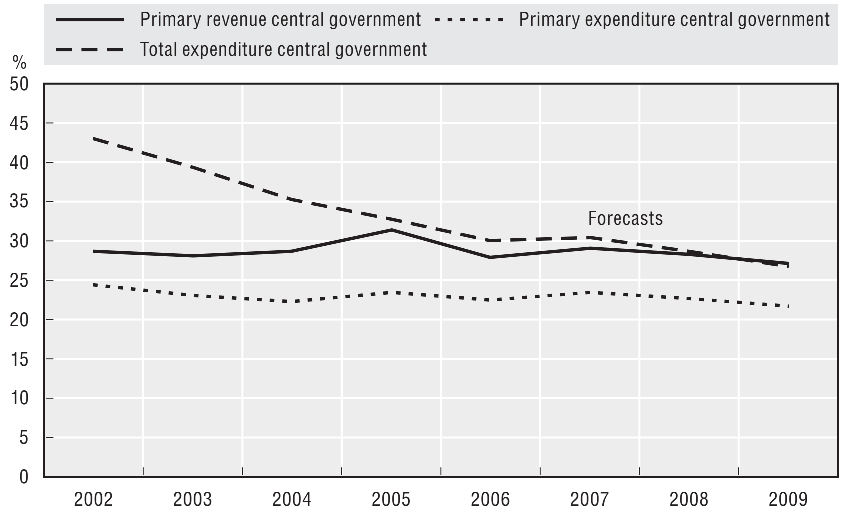
Sources: Realisations: Eurostat; forecast EU15, EU10 and Turkey (EU): Eurostat; forecast Turkey (PEP): Pre-accession Economic Programme 2006, SPO, Turkey.

Fiscal policy is a cornerstone of Turkey's macroeconomic strategy. Since the crisis of 2001, Turkey has achieved very impressive fiscal outcomes, especially for central government. A significant problem for the assessment of Turkish fiscal policy is that, apart from Mexico, Turkey is the only OECD country that does not publish government fiscal accounts according to national accounting standards (SNA93 or ESA95). However, in 2006, the accounting framework for the government sector was revised in accordance with international standards (although not yet entirely, see Box 1). Figure 1 shows the development of primary and total expenditures and revenues of central government. The latter numbers are the targets of the Medium-Term Fiscal Plan as submitted to parliament with the 2007 budget.

The IMF monitors Turkish fiscal policy as part of consecutive standby agreements. The latest agreement was concluded in May 2005 and will expire in May 2008. The IMF has developed its own performance measure, named the Public Sector Primary Balance (Box 1). Table 2 shows the development of the

Figure 1. **General government expenditure and revenues**

Per cent of GDP



Note: The numbers for 2002-05 have been retrospectively revised in accordance with international accounting standards (see Box 1).

Sources: Years 2002-06: Financial Accounts Central Government, Ministry of Finance, Turkey. Years 2007-09: Medium-Term Fiscal Plan, Ministry of Finance, Turkey.

Table 2. **General government deficit**

Per cent of GDP

	2002	2003	2004	2005	2006	*2007*	*2008*	*2009*
Primary balance central government	3.5	4.9	5.3	5.5	5.8	*5.2*	*5.0*	*5.0*
Primary balance public sector[1]	5.1	6.2	7.2	6.8	6.6	*n.a.*	*n.a.*	*n.a.*
Total balance central government	– 14.5	– 11.2	– 6.8	– 1.4	– 0.7	*– 2.7*	*– 0.8*	*0.9*
Total balance public sector[1]	– 12.5	– 9.1	– 4.6	– 0.3	– 0.4	*n.a.*	*n.a.*	*n.a.*

1. IMF definition.

Sources: Estimates IMF and Ministry of Finance, Turkey, April 2007.

central government balance as well as the public sector primary balance since 2002. The IMF programme target was set at 6.5% of GDP in 2002. Since then, the target has been exceeded twice: in 2004 (by 0.7%) and 2005 (by 0.3%).

The public debt ratio has declined in recent years far more rapidly than programmed. This was mainly due to higher-than-expected privatisation receipts, higher primary surplus, stronger-than-projected economic growth, an appreciating lira, and a further decline in the domestic interest rate (apart from the recent jump). The financing structure of public debt has also improved in recent years. The share of foreign currency debt has been

Box 1. **The scope of the government sector in Turkish financial accounts**

The general government sector in Turkey is divided into three parts: the central government, social security institutions and local governments. This is in accordance with national accounting standards (SNA93 and ESA95). Social security institutions and local governments all prepare their own budgets. Information on expenditures, revenues and balance of social security institutions and local governments is comprised in the budget documentation of the central government and submitted to parliament, but not for the purpose of authorisation. The central government budget does however comprise the current and capital transfers to social security institutions and local government (including tax shares) which are subject to authorisation in the central government budget process.

The **central government budget** consists of three parts, totaling 159 agencies: 1) the general budget agencies: ministries and agencies directly affiliated to ministries (50 agencies);[1] 2) special budget agencies: agencies belonging to the central government but with some degree of autonomy (101 agencies, of which 70 are universities and bodies of higher education);[2] and 3) regulatory and supervisory agencies: agencies belonging to the central government but with a larger degree of autonomy (8 agencies).[3]

Until 2006, the special budget agencies and regulatory and supervisory agencies were included in the central government budget on a net basis (the so-called **consolidated budget**). This implied that their revenues and expenditures were not subject to authorisation but only net transfers to their budgets from the central government budget. As from 2006, the scope of the central government budget has broadened so that now 25 special budget agencies and all regulatory and supervisory agencies are included in the central government budget.[4]

Although general government accounts in accordance with international accounting standards are not yet entirely completed,[5] the Turkish government publishes a primary and total balance of the **consolidated government sector** (CGS). This comprises the primary balances (primary revenue minus non-interest expenditures) of: 1) the consolidated budget/central government budget;[6] 2) three extra-budgetary funds;[7] 3) all four social security institutions;[8] 4) the unemployment fund; and 5) 23 state-owned enterprises. This CGS primary balance summed with the balance of local government provides a measure of the general government primary balance but, since it is not prepared in accordance with international standards, it is unclear what might be missing (OECD, 2006a). For one thing, the CGS does not include the Iller Bank which is a state-owned bank operating under the supervision of the Ministry of Public Works and which has some extrabudgetary fund characteristics, providing financing of infrastructure and financial services for municipalities (IMF, 2006a).

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Box 1. **The scope of the government sector in Turkish financial accounts** *(cont.)*

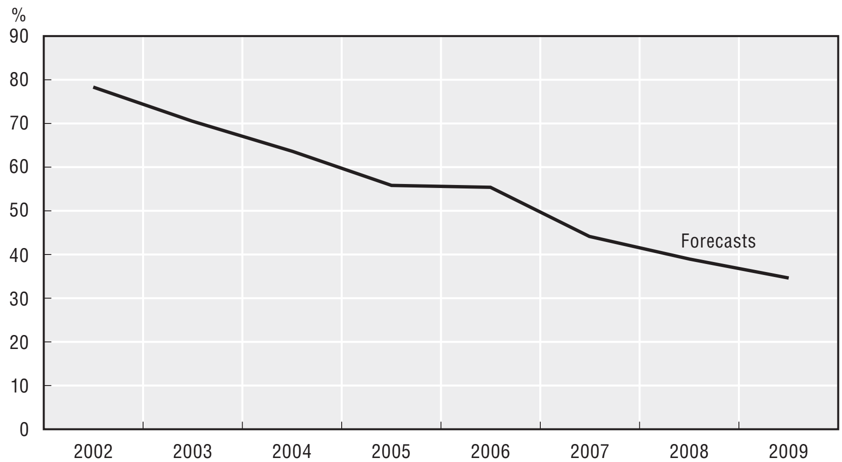
For the purpose of fiscal monitoring, the IMF has defined its own measure of fiscal performance, named the Public Sector Primary Balance. This measure does not aim at exhaustive general government accounting but focuses on the key and fiscally most risky components of public finance. The difference between the CGS balance and the IMF's measure are considerable (for instance, 3% of GDP in 2004 and 4% of GDP in 2005; OECD, 2006a).

1. Listed in Chart 1 of the Public Financial Management and Control Law (PFMC).
2. Listed in Chart 2 of the PFMC.
3. Listed in Chart 3 of the PFMC.
4. Listed in Annex F of the Letter of Intent of 7 July 2006 from the Minister of State for Economic Affairs and the Governor of the Central Bank of Turkey to the Managing Director of the International Monetary Fund (IMF, 2006, pp. 80-86).
5. Public sector statistics have been compiled in Turkey for decades. These statistics are disseminated in the Economic and Social Indicators report which covers the entire public sector and is published by the State Planning Organisation every year. The publication of national accounts statistics in accordance with ESA95 standards has been a huge project (for example, the consolidation of the accounts of 3 225 municipalities required for the general government and the local government statistics) and has largely been completed successfully.
6. See above for the move from the consolidated budget to the central government budget in 2006.
7. Namely the Defence Industry Support Fund, the Privatisation Fund, and the Social Aid and Solidarity Incentive Fund.
8. Namely the Pension Fund (for civil servants), the Social Insurance Institution (for workers and contracted personnel), BAG-KUR (for craftsmen, artisans and other self-employed persons) and the Turkish Labour Agency.

reduced, maturities have been lengthened and the share of fixed-rate debt (as opposed to floating lira notes) has been increased. However, the recent lira depreciation and the increased risk perception of Turkey's government bonds may slow down the debt reduction trend of the past years. The lira depreciation is estimated by the IMF to have added some six percentage points to the net debt ratio of 2006, while the impact of higher interest rates will be felt in the coming years. These effects have so far been offset by strong economic growth, a primary public sector surplus in 2006 of 6.7% of GDP, and privatisation receipts of over 2.5% of GDP. The public sector debt burden is projected to continue declining in the coming years. According to the Medium-Term Fiscal Plan, net debt should be reduced to 34.4% of GDP in 2009. However, the achievement of this target is predicated on continued economic growth of 7% of GDP and the maintenance of a public sector primary surplus of 6.5% of GDP (IMF, 2006b).

Since 2001, various international organisations have written reports in which the Turkish budget process has been assessed and recommendations for institutional reforms have been formulated. These assessments and recommendations will be reviewed in the next paragraph. The present article builds on these reports and adds some new findings and suggestions. Because the OECD does not lend or provide other benefits, the findings are not influenced by conditionalities frequently found in the reports of other institutions.

Figure 2. **Net debt of the public sector**
Per cent of GDP



Sources: Years 2002-06: IMF (2006b); years 2007-09: Medium-Term Fiscal Plan, Ministry of Finance, Turkey.

1.2. Institutional policy in the recent past

In the recent past, and on several occasions, international organisations have assessed the progress of institutional reform of the budget process in Turkey. In the light of these assessments, they have also made recommendations for priorities in the reform efforts. Here particular attention shall be paid to the findings and suggestions concerning budget institutions in the economic surveys of the OECD (OECD, 2002, 2004 and 2006a), the "Report on the Observance of Standards and Codes – Fiscal Transparency Module" (Fiscal ROSC) of the IMF (IMF, 2006a), and the assessment of the public expenditure management system of Turkey by OECD/SIGMA at the request of the European Union (OECD, 2006b).

The OECD economic survey of 2002 provided a general overview of the shortcomings of the public finance management system soon after the economic crisis of 2001. Many of these shortcomings have been addressed in the "Strategic Framework for Public Management Reform" that the Turkish government established in response to the crisis. This reform programme focused on three objectives: 1) widening the coverage of the budget preparation and execution process and increasing its capacity to assess performance; 2) enhancing accounting standards, procurement procedures and audit functions; and 3) introducing modern and transparent public liabilities management practices. The OECD report noted that in each of these areas important progress had already been made. The number of extrabudgetary funds was drastically reduced. Subsidies to state-owned banks were being put on budget. A start was made on the improvement of the financial accounts in accordance with national accounting standards. Budget arrears were inventoried. Investment plans were streamlined. The debt management system was improved. The Public Procurement Law, which established a modern procurement system, was adopted. The report noted, however, that these improvements were only the very first steps of a far-reaching reform effort that would be required in order to modernise the Turkish budget process. The report recommended in particular to move towards multi-annual fiscal planning, to reform the audit system and to speed up the implementation of the new procurement system (OECD, 2002).

The OECD economic survey of 2004 treated the quality and cost efficiency of public expenditure as a special theme. The report noted that the improvement of budget institutions was of crucial importance for Turkey in order to avoid future financial crises similar to the one that occurred in 2001. The report noted that on top of the reform of the budget institutions, the Turkish government had launched a far-reaching governance reform that entailed an ambitious legislative programme. Regarding public expenditures, the report noted that up to the mid 1990s Turkey had one of the lowest shares of general government expenditures in the OECD area, and that this share had soared in the previous decade to end up among the highest shares (total expenditure) or around the average share (primary expenditure) in 2002. The report identified the factors behind this development, mainly in the spheres of social security, infrastructure investment, quasi-fiscal activities of banks, earthquakes and high interest on foreign borrowing. It also identified future pressures in the areas of public pay, pensions, education and funding of earthquake damage. The report noted major shortcomings in the budget institutions, in particular: the non-accordance of financial accounts with international accounting standards; massive off-budget funding of investment; rigidity of public sector pay; pre-commitment of investment expenditures; and the large share of entitlement spending. The report discussed the Public Financial Management and Control Law that had been passed by parliament in 2003, and made recommendations for implementation policies. It emphasised among other things the improvement of the accounting system, a better registration of liabilities from grants, and better control of the expenditures of sub-national government and social security. As to the efficiency of service delivery, the report recommended far-reaching decentralisation, more autonomy for executive agencies, more room for private supply and competition in public services (hospitals, social services), the application of user fees, and social security reform (OECD, 2004).

In March 2006, the IMF published a "Report on the Observance of Standards and Codes – Fiscal Transparency Module" (Fiscal ROSC) in Turkey. The report concluded that considerable progress had been made since the previous fiscal ROSC (of 2002), especially in the area of transparency and improvement of financial reporting. The Law on Public Financial Management and Control (PFMC Law) was seen as a major step forward in the direction of modernising the Turkish financial management system. The report noted that confusion could arise because of inconsistency of various laws pertaining to the budget process. The report also drew attention to the fragmentation of the budget process arising from the division of competences between the Ministry of Finance, the State Planning Organisation and the Treasury. The report recognised that full implementation of the PFMC Law would eliminate most but not all remaining omissions in the coverage of central government. The report noted that the absence of a system of commitment controls weakened the accuracy of cash planning. It also characterised the compensation system for civil servants as extremely complex and not transparently managed. The report stated that the development of internal control was still at an early stage and that auditing remained fragmented, with overlapping responsibilities between different units. The report recommended clarifying the relations between laws pertaining to the budget process and ensuring that the PFMC Law has primacy in this matter. The report stated that good co-ordination had to be imposed in view of fragmented responsibilities. It recommended the speedy integration in the budget of the remaining forms of off-budget spending so that full coverage of the financial accounts in accordance with international standards would be achieved. The report also recommended the notification of commitments to the Treasury, as well as the overhaul of the compensation system for civil servants. The early implementation of the PFMC Law in the areas of internal control and internal auditing were seen as priorities (IMF, 2006b).

In June 2006, OECD/SIGMA published an assessment of the public expenditure management system of Turkey at the request of the European Union (OECD, 2006b). This was the second standard assessment against the baselines set by OECD/SIGMA for EU candidate countries. The report noted that Turkey had made considerable progress in budget reform since the previous assessment of 2005. Reform measures included the decentralisation of the internal control procedures to line ministries and agencies, the implementation of a Medium-Term Fiscal Plan, and the inclusion of revolving funds and extrabudgetary funds in the budget. The report mentioned that various secondary laws and decrees on the basis of the PFMC Law were enacted, but that not all of these were yet implemented. The law on the Turkish Court of

Accounts was not yet enacted. The report noted the need for checking the consistency between the laws. It also drew attention to the fact that the Ministry of Finance, the State Planning Organisation and the Treasury share the responsibility for the budget process and that this required costly co-ordination. According to the report, the budget documentation had very much improved but shortcomings remained, for instance the fact that budget documents did not distinguish between existing commitments and new policies. The scope of the budget had been further broadened but not all revolving funds had been brought on budget, and the position of some agencies, such as the Iller Bank, remained unclear. Domestic borrowing by local governments still posed potential risk. Financial reports and national accounts still showed discrepancies with ESA95 norms. The report noted that the new budget formulation calendar was respected but that there were inefficiencies in resource allocation attributable to the fragmented responsibilities for the budget process. The report saw the rapid implementation of the decentralised system of internal control and internal audit and the modernisation of the cash management system as high priorities. The report stressed the need for organisational arrangements for the management of the reform process and recommended that the new strategic development units (decentralised financial services units) in the line ministries and agencies should take the lead in this respect.

The OECD economic survey of 2006 again paid attention to institutional reform of the budget process. Against the backdrop of the most recent disturbances in the international capital markets that have affected the Turkish economy quite severely, the report noted that fiscal policy is crucial to protect the domestic economy against such shocks. Budget institutions must ensure that fiscal policy contributes to risk containment. The report noted that, to ensure a longer-term commitment to strong fiscal control and public spending efficiency, budget institutions and processes will need to be made more robust to both economic and political cycles, and greater attention will need to be devoted to controlling current expenditures. The report emphasised the remaining shortcomings in the coverage of the budget and the financial accounts, and showed the quantitative difference between the various measures for the deficit. The report enumerated the remaining challenges for managing public finances, which include: the improvement of the legislative environment by improving the consistency of key laws; better co-ordination between the key players in the budget process; further broadening of the coverage of the budget and the financial accounts; more transparency of the tax system; improved training of civil servants; the establishment of a unit to ensure that PPPs will not lead to excessive risk for public finances; and more decentralisation of service delivery to local governments.

2. Budget formulation

2.1. The Public Financial Management and Control Law

After the financial crisis of 2001, Turkey modernised the legislation concerning the budget process. The main change was the introduction of the Public Financial Management and Control Law (PFMC), adopted by the Turkish parliament in December 2003 (Law No. 5018, amended in 2005, Law No. 5436). This law replaced the General Accounting Law of 1927, which was outdated in many respects. The purpose of the PFMC Law is stated in its first article:

> The purpose of this Law is to regulate the structure and functioning of the public financial management, the preparation and implementation of the public budgets, the accounting and reporting of all financial transactions, and financial control in line with the policies and objectives covered in the development plans and programmes, in order to ensure accountability, transparency and the effective, economic and efficient collection and utilization of public resources.

The PFMC Law is being implemented step by step, covering public financial management and control at all levels of government. Although not an organic law in the sense of legal prevalence,[2] it has the structure of a frame law and requires in many instances secondary legislation for its implementation. At present, all secondary legislation has entered into force except one. The aim of the Turkish authorities is to complete the required secondary legislation by the end of 2007. Other laws that are important for financial management (although not secondary legislation of the PFMC Law) are the 2005 Municipality Law and the 2005 Law on the Organisation and Duties of the Revenue Administration. Many laws imply far-reaching changes and require extensive training of the personnel charged with their execution.

2.2. Key characteristics

Key characteristics of the Turkish budget formulation process are:

- The combination of centralisation and fragmentation of decision making;
- The IMF standby agreement as a *de facto* fiscal rule;
- The detailed line-item budget classification.

2.2.1. Centralisation and fragmentation

The Turkish budget formulation process can be described as simultaneously centralised and fragmented. It is centralised in the sense that there is strong top-down steering from the centre, in particular by the committee known as the High Planning Council. This council is chaired by the Prime Minister and has members determined by the Prime Minister. Other ministers can attend by invitation of the Prime Minister (see Box 2). The High

Box 2. The High Planning Council

The High Planning Council is chaired by the Prime Minister and has members determined by the Prime Minister. At present the members of the Council are: the Prime Minister, the Deputy Prime Minister, the Undersecretary of the State Planning Organisation, the Undersecretary of the Treasury, the Minister of Finance, the Minister of Industry and Commerce, the Minister of Transport, the Minister of Energy and Natural Resources, and the Minister of Public Works and Settlement. Secretarial services for the Council are provided by the State Planning Organisation.

The High Planning Council is responsible for the macroeconomic forecast, prepared by the SPO, and adopts the Medium-Term Fiscal Plan prepared by the Ministry of Finance.

Planning Council is responsible for the annual updating of the Medium-Term Fiscal Plan, which contains the expenditure targets for the central government excluding regulatory and supervisory agencies. At the end of the budget formulation process, the High Planning Council decides on remaining points of difference that have not been solved in bilateral contacts between the Ministry of Finance and the line ministries.

Top-down steering is essential for budgetary control, but in the Turkish process there is little room for line ministries and agencies to propose new initiatives or to plead for reallocation between ministries or agencies. In the long run, this may undermine the legitimacy of the process, especially after the expiration of the IMF standby agreements. The Turkish authorities may make more room for new initiatives at the very beginning of the budget formulation process by soliciting budget requests before the decision is taken on targets for ministries and agencies. These requests may assume reallocation within the ministries and agencies, but also between ministries and agencies.[3] The decision on the targets could then be strengthened by announcing them as ceilings and strictly enforcing them (apart from updating for macroeconomic factors, including inflation, at the very end of the process). Such a reform would simultaneously improve the legitimacy of the process for line ministries and agencies and strengthen top-down steering.

The Turkish budget formulation process is also fragmented, in the sense that there is no single budget authority responsible for all expenditures in the budget. Instead, there are three budget authorities: the Ministry of Finance, the State Planning Organisation (SPO) and the Treasury, each with different responsibilities.

- **The Ministry of Finance** has the overall responsibility for fiscal policy, including budget preparation, medium-term fiscal programming, budget execution, revenue collection, reporting and accounting. It also bears the responsibility for the co-ordination and harmonisation of public internal financial control.

- **The Undersecretariat of the State Planning Organisation** is an agency reporting to a State Minister within the Prime Minister's Office. It is responsible for long-term development plans, macroeconomic monitoring and forecasting, medium-term strategic programming, and the preparation and execution of investment plans (see Box 3).

Box 3. **The State Planning Organisation (SPO)**

The State Planning Organisation was founded in 1960 to introduce planning and co-ordination in the Turkish economy. The duties and responsibilities of the SPO are described in the Decree Law on the Establishment and Duties of the State Planning Organisation.

The SPO is responsible for the Development Plan (long term), the Medium-Term Programme, the Annual Programme and the Annual Public Investment Programme. For the latter purpose, the SPO analyses and assesses the investment proposals of ministries and agencies and performs cost-benefit analysis. The SPO is also responsible for the "Pre-accession Economic Programme" that is submitted to the European Commission.

The tasks of the SPO also include macroeconomic modelling and forecasting, scenario analysis, and costing of entitlement programmes. The SPO serves as the secretariat of the High Planning Council.

The SPO also has extensive expertise in the area of regional development and regional policy, and it monitors and analyses the results and effectiveness of regional policies.

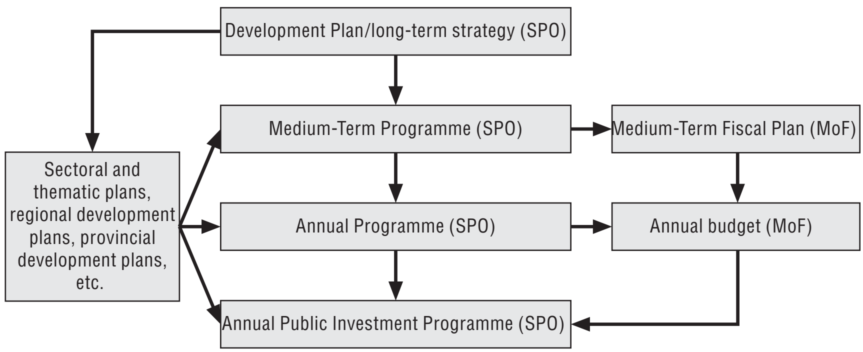
- **The Undersecretariat of the Treasury** is an agency reporting to a State Minister within the Prime Minister's Office. It is responsible for: cash management; short and long-term debt management in local and foreign currency; relations with international financial institutions; and monitoring the activities of state-owned enterprises and extrabudgetary funds.

The SPO is responsible for evaluating investment projects. This means that line ministries and agencies negotiate their current budget and capital investment projects separately with two different authorities. Apart from the split of responsibilities in the annual budget process, this split also applies to medium-term planning.

Like many transition countries and like many western European countries during the 1950s and 1960s, there is a plethora of planning procedures in

Turkey. For the economy as a whole, there is a Development Plan (for seven years), a Medium-Term Programme (for three years, annually updated), an Annual Programme and an Annual Public Investment Programme. Apart from these global plans, there are the sectoral plans of the line ministries and the regional and provincial plans of the sub-national governments. These plans are in turn supposed to inform the medium-term, annual and annual public investment programmes (see Figure 3).

Figure 3. **From long-term plans to the annual budget**



The Medium-Term Programme is a document stating overall policy priorities. It also contains a macroeconomic forecast for the next three years (the budget year and two out-years), including a forecast of general government expenditures and revenues, general government interest expenditures, the general government borrowing requirement, the public sector borrowing requirement, the public net debt stock and the tax burden. The Medium-Term Fiscal Plan contains budgetary targets for central government for three years (the budget year plus two out-years) and divides the central government target among line ministries and agencies. The Annual Public Investment Programme covers all public investment projects, including those funded by means outside the central government budget, such as those funded by the state-owned enterprises, the Iller Bank, the social security institutions and the local governments. Each investment project is characterised by parameters such as total costs, previous cumulative expenditures, and current year allocation. The investment programme, for which the SPO is responsible, should be distinguished from the investment budget, which is the total of budget appropriations for investments. The responsibility for the investment budget is shared by the SPO, the Ministry of Finance and the Treasury. The investment programme is set up on the basis of the proposals of the ministries and agencies after the investment budget is decided. In recent years, more flexibility has been given to the agencies during the implementation stage of investment projects, for example through aggregating many similar sub-projects under a single project, and through allowing reallocation and other changes in sub-projects.

OECD countries generally have a single budgetary authority, namely the budget bureau which is part of the Ministry of Finance.[4] Moreover, most have never had, or have gradually abolished in the latter part of the 20th century, global planning procedures that were supposed to inform the budget process. In OECD countries, discussions about desired outputs and outcomes of government policies generally take place on the basis of sectoral plans of ministries. These plans are subject to debate and amendment in parliament and society at large. In this debate, the responsible line minister represents the government. Subsequently, trade-offs are made in the light of limited resources in the multi-annual budgetary framework and then in the annual budget process. This might in turn rebound on the sectoral plans in the sense of temporisation or restraint.

Turkey may consider a simplification of its budgeting and planning procedures. Strengthening co-ordination and gradually moving towards a single budget bureau would improve allocative efficiency by facilitating the trade-off between current expenditure and capital investment, and would reduce bureaucratic costs. Simplification of global planning procedures (Development Plan, Medium-Term Programme, Annual Programme, Annual Public Investment Programme) and integration with other planning documents would make the budget process more transparent and efficient, and would reduce the administrative burden. At the same time, care should be taken that the large expertise in the State Planning Organisation concerning long-term priority setting, regional policy, agriculture and capital budgeting is not lost but rather put to its best use. Reforms in this direction need not impair the various roles of the SPO, but could instead make them stronger. In particular, the role of central macroeconomic forecasting and policy analysis could be strengthened. Such an agency would then become comparable to similar indicative planning bureaus that exist in Austria, the Netherlands, Slovenia, Sweden and other countries. The experiences with such bureaus are generally very good; they provide an objective basis for the policy debate, and tend to depoliticise economic discussions. In general they have a strong impact on strategic decision making, since it is assumed that they possess a reputation of professionalism and impartiality. This requires among other things a certain protection of independence (of working methods and results, not of task assignment) by special statute and close contacts with the academic research community.

2.2.2. The IMF standby agreement as de facto *fiscal rule*

Turkey has had standby agreements with the IMF since 1998. The subsequent agreements of February 2002 and November 2005 committed Turkey to aim for a primary surplus of the public sector of 6.5% of the gross national product. This primary surplus target is divided into separate targets of 5.0% of GNP for the central government and 1.5% of GNP for the rest of the public sector (social security, local government, state-owned enterprises and extrabudgetary funds). The current standby agreement will end in May 2008 and, apart from this agreement with the IMF, no national fiscal rule exists.

The Turkish agreement with the IMF also includes provisions on how to use windfalls from higher-than-expected tax revenues and lower-than-expected spending. A better outcome than forecast can be used to repay debt or to decrease taxes in the banking and financial sector. There are also provisions for increased investment expenditure in the case of windfalls in tax revenue. Expenditure windfalls can be used for new spending, as long as the ceilings imposed by the agreement are kept.

The IMF agreements have probably helped to acquire and maintain political and public support for major reforms and fiscal consolidation efforts and have also contributed to investor confidence by the implied monitoring of the Turkish fiscal accounts. After 2008, when the latest IMF agreement will expire, the Turkish government has to take a clear decision on the fiscal rule it will adopt and on the next steps of the reform programme. The EU notification process that started in 2000 (five years before the opening of accession negotiations) may play a useful role to support the new fiscal rule and the next steps of the reform process. For this purpose it would help if the adjustment of the financial accounts in accordance with the ESA95 system would be entirely completed before the expiration of the IMF agreement.[5] In addition, it would be useful for the Turkish government to again commit itself for the coming years to a fiscal rule of total expenditure ceilings aiming in the medium term at a primary surplus of general government. Consultation with the IMF and the EU about the size of the surplus would contribute to the confidence of the international capital markets. In the longer term, when the vulnerability of interest expenditures to current account volatility and risk appetites in capital markets has substantially declined, the expenditure ceilings could be retargeted at the total balance of general government in the medium term and aim at a level compatible with fiscal sustainability in the long term. Such a target could be a balance of between 0% and 3% deficit of GDP to which the euro zone countries have committed themselves in the European Stability and Growth Pact.

2.2.3. Detailed line-item budget classification

As part of the reform of the budget process, the budget classification system was changed, starting with a pilot phase for six ministries and agencies in 2002 and full implementation for the central government at the end of 2004. As from the 2006 budget, the new classification has been prescribed for all parts of the general government, including social security institutions and sub-national governments (see Box 4).

Box 4. **Budget classification**

The budget classification consists of four levels: institutional, functional, financing, and economical.

Institutional classification

The institutional classification consists of four hierarchical levels, each with a two-digit code. The first level identifies ministries and regulatory and supervisory agencies. The second level identifies divisions that directly report to the first level. The third level covers units operating under the second-level divisions. The fourth level refers to support and logistics units as well as certain executive units. Depending on the organisation, not all appropriations have all codes: all appropriations have code levels 1 and 2, but some might have only one of the level 3 and level 4 codes.

Functional classification

The functional classification follows the international "Classification of Functions of Government" (COFOG). This classification divides government expenditure into 10 functions, each of which is divided into sub-functions up to four levels of detail (with one-digit and two-digit codes).

Financing classification

The financing classification consists of a one-digit code and shows the source of funding, for example the general budget, social security institutions, revolving funds or extrabudgetary funds.

Economical classification

The economical classification consists of four levels (with one-digit and two-digit codes). The first level includes codes for personnel expenditure, intermediate consumption, social benefits in kind, interest payments, current transfers, gross capital formation and capital transfers. Levels 2 to 4 provide further details.

All in all, the Turkish budget contains around 34 500 legally binding line-item estimates (appropriations). This has significant implications for managerial flexibility and reallocation during budget execution (to be discussed in Section 4). Parliament votes only at a more aggregate level (the first level of the institutional classification and the first level of functional classification) so that each vote authorises a large number of appropriations.

Since the 1990s, budget classifications have been adjusted in a number of OECD countries in connection with reforms aimed at more results-oriented financial management. In general this has led to a stark reduction of the number of line items, to 10 to 20 per ministerial portfolio, based on programmatic-institutional criteria. Such a limitation of the number of line items does not preclude that, for purposes of fiscal accounting in accordance with international standards (for instance ESA95, including COFOG), line items can be subdivided into smaller units. However, these smaller units only serve for accounting purposes and have no legal status. Such a reduction of the number of line items provides more flexibility to programme managers and makes it easier for parliamentarians to focus their discussion with ministers on results (value for money). Given the very systematic classification that Turkey has now achieved, a next step in this direction would be relatively easy to implement. For that purpose, it would suffice to redefine the concept of line-item estimate (appropriation) at a fairly aggregate level (for instance the level at which voting presently takes place) and remove all further detail from the budget (for relegation to the fiscal accounts).

The annual budget also contains general principles and ceilings for new recruitment. The Ministry of Finance and the State Personnel Directorate are responsible for recruitment and staff control. The entire system of separate staff control is presently under discussion and may have to be rationalised or integrated into the system of internal expenditure control (to be discussed in Section 5).

2.3. Budget formulation process

The budget formulation process as described in this section applies to the ministries and the special budget agencies (see Box 1 above). Regulatory and supervisory agencies follow a somewhat different procedure and submit their budget proposals directly to parliament (with a copy to the Ministry of Finance to be included in the central government budget law). Within the Ministry of Finance, the General Directorate of Budget and Fiscal Control bears the main responsibility for the co-ordination of budget formulation (see Box 5).

A recent feature of the budget process is that all ministries and agencies under the central government since 2006 have their own “local” financial services units. These units are called Strategic Development Presidencies in ministries and Strategic Development Departments in other agencies. Before 2006, there were budget offices in line ministries and agencies which were staffed by and under the responsibility of the Ministry of Finance. This major reform implies that the line ministries and agencies are now

Box 5. **The General Directorate of Budget and Fiscal Control**

The General Directorate of Budget and Fiscal Control of the Ministry of Finance is the most important actor in budget preparation. It consists of *circa* 20 divisions with responsibilities grouped into five areas, each headed by a deputy director general, namely: 1) budget policy and international relations; 2) budget preparation and implementation; 3) state personnel issues; 4) health economy, social security system, public vehicles and labour law; and 5) implementation of the PFMC Law.

The main responsibilities of the General Directorate are:

- Co-ordination of the budget preparation process and determination of the principles that ministries and agencies shall take into account during budget preparation.
- Review of appropriation requests and control of consistency with the Development Plan, the Medium-Term Programme, the Annual Programme, and the Medium-Term Fiscal Plan.
- Compilation of the consolidated budget of the central government and drafting of the annual budget law.
- Overall responsibility for performance-based budgeting, including the development of procedures for linking expenditures to performance targets and central co-ordination and harmonisation of public internal financial control.

themselves responsible for budget formulation and execution in their own organisations.

The annual process of budget preparation takes place between May and October according to a fixed timetable (see Box 6).

The budget formulation process starts in May when the SPO prepares and presents the three-year Medium-Term Programme (the upcoming budget year and two out-years) to the Council of Ministers. The Medium-Term Programme includes a macroeconomic forecast containing general government revenue estimates and main priorities and objectives presented in short bullets. The objectives include an inflation target for the medium term. The programme also presents estimates for general government expenditures, revenues and borrowing for the next three years. The document is a Cabinet Decree and is published in the *Official Gazette*.

After the Council of Ministers has adopted the Medium-Term Programme, the Ministry of Finance prepares the Medium-Term Fiscal Plan, covering the same years as the Medium-Term Programme (the budget year plus two out-years). The Medium-Term Fiscal Plan is a more operational

Box 6. **Budget formulation timetable**
Budget year = calendar year

End May	The Council of Ministers takes a decision on the Medium-Term Programme prepared by the SPO. The programme includes policy objectives, priorities and macroeconomic forecasts.
Mid June	The High Planning Council adopts the Medium-Term Fiscal Plan prepared by the Ministry of Finance.
End June	The Ministry of Finance prepares and publishes the Budget Call and the Budget Preparation Guide. These include general principles and standards on the budget preparation process.
End June	The SPO prepares and publishes the Investment Preparation Guide.
July	Line ministries and special budget agencies prepare their budget proposals.
End July	Line ministries and special budget agencies submit budget proposals to the General Directorate of Budget and Fiscal Control of the Ministry of Finance, and investment project proposals to the SPO.
August	Evaluation of budget proposals by the General Directorate of Budget and Fiscal Control (non-investment expenditure) and the SPO (investment proposals).
September	Negotiations between the General Directorate of Budget and Fiscal Control, the SPO and line ministries and special budget agencies on budget proposals.
End September	The SPO finalises the macroeconomic forecast.
End September	The Ministry of Finance compiles and finalises the draft budget.
First week of October	The High Planning Council debates and finalises the macroeconomic forecast and the draft consolidated budget.
Mid October	The budget bill is approved by the Council of Ministers (no less than 75 days before the end of the year).
Mid October	Submission of the budget bill to the Turkish Grand National Assembly. The Court of Accounts, the parliament and regulatory and supervisory agencies submit their budget proposals to the Grand National Assembly by end September.

document. It includes overall expenditure targets for central government but, more importantly, it divides these overall figures over separate ministries and special budget agencies for all three years of the plan. The expenditure targets are based on the medium-term inflation target of the Medium-Term Programme. The targets can be adjusted from year to year in the light of recent macroeconomic developments and political priorities. This provides a certain flexibility to accommodate unexpected macroeconomic developments that Turkey will still need in the near future.[6] The targets are not formally binding but rather serve as the first bid of the Ministry of Finance in the budget process. They can still be changed in the subsequent negotiations between the Ministry of Finance and the ministries or agencies.

In early June, the Medium-Term Fiscal Plan is presented to the High Planning Council (see Box 2 above) for adoption in mid-June and it is subsequently published in the *Official Gazette*.

At the end of June, the Ministry of Finance prepares and sends out the Budget Call and the Budget Preparation Guide, and the SPO prepares and sends out the Investment Circular and the Investment Preparation Guide. Within the framework of these guidelines, line ministries and agencies prepare their budget proposals (see Box 7). The proposals are submitted to the Ministry of Finance (except investments) and the SPO (investments) before the end of July. Line ministries find the time available for responding to the Budget Call generally too short and indicate that this time limitation impairs the quality of their submissions. The Ministry of Finance may consider sending out the Budget Call at the beginning of June, instead of at the end of that month. This adjustment of the timetable would give the line ministries four more weeks to prepare their submissions. It would require a similar shift forward of the adoption of the Medium-Term Fiscal Plan by the High Planning Council to the third week of May.[7] Revenue estimates for ministries (including tax estimates) are made by the Ministry of Finance. Special budget agencies prepare and submit their own revenue estimates to the Ministry of Finance.

After the General Directorate of Budget and Fiscal Control of the Ministry of Finance and the SPO have received the budget requests, the

Box 7. **Budget preparation in line ministries**

Budget preparation in line ministries is co-ordinated by the Strategic Development Presidencies and Departments (SDPs and SDDs) which are the financial services units in the line ministries and special budget agencies respectively. Until 2006, there were similar offices in line ministries and special budget agencies which had important duties in the budget formulation and implementation process but which were part of the Ministry of Finance.

Local units of the ministries submit appropriation requests to the relevant general directorate of the ministry by the end of May. When the Budget Preparation Guide is published at the end of June, SDPs and SDDs send instructions to all spending units. These instructions include macroeconomic assumptions, targets derived from the Medium-Term Fiscal Plan and requests for information that should be reported together with request estimates.

Spending units then prepare their request estimates by the end of July and enter their estimates into the budget system.

SDPs and SDDs review the requests and compile the budget request of the ministry or special budget agency for submission to the General Directorate of Budget and Fiscal Control of the Ministry of Finance or to the SPO.

evaluation and negotiation phase starts. This process takes place in August (evaluation) and September (negotiations). In this phase, meetings are held between line ministries or special budget agencies and the Ministry of Finance/SPO with the purpose of harmonising proposals within the constraints of the overall targets for the central government. According to the Ministry of Finance, differences between request estimates and targets are usually not large, but there is still an upward drift which requires correction in order to maintain the overall targets. Negotiations take place at various hierarchical levels but rarely reach the level of ministers.

At the end of September, the Ministry of Finance and the SPO finalise their respective budget proposals. The Ministry of Finance then compiles the documents and prepares the draft annual budget law. This document, together with the final macroeconomic forecast of the SPO, is then presented to the High Planning Council in the first week of October. The High Planning Council discusses the bill, resolves final problems and submits it to the Council of Ministers. This may also lead to adjustment of the multi-annual estimates/targets in the Medium-Term Programme and the Medium-Term Fiscal Plan.

The Council of Ministers submits the budget bill with accompanying documentation to the Turkish Grand National Assembly no later than 75 days before the start of the new budget year, *i.e.* in mid October, as stated in Article 162 of the Constitution.

2.4. Conclusion

Many changes have been introduced in the budget process in recent years. The establishment and implementation of the PFMC Law have been the main processes through which these reforms have been achieved. Important elements of these reforms have been:

- Broadening the scope of financial management and fiscal control; extending the budget and financial accounts to the entire sectors of central government and general government in accordance with international standards of national accounting (SNA93, ESA95).
- Introducing a Medium-Term Fiscal Plan covering three years (the budget year and two out-years).
- A new classification system for the budget.
- Moving the responsibility for financial services units in line ministries and special budget agencies from the Ministry of Finance to the ministries and special budget agencies.

The introduction of the PFMC Law is a major achievement, but increasing its efficiency is a high priority. As the PFMC Law, although being a frame law, has no automatic prevalence over other laws, it is important that secondary legislation is thoroughly checked for conformity with the PFMC to avoid confusion and contradictory legislation. This has been highlighted also by the OECD (2006a) and the IMF (2006a).

The Turkish budget formulation process is simultaneously centralised and fragmented. It is centralised because it is based on a strong top-down steering process. Top-down steering is essential for budgetary control, but in the Turkish process there is little room for line ministries and agencies to propose new initiatives or to plead for reallocation between ministries or agencies. In the long run, this may undermine the legitimacy of the process. The Turkish authorities may consider making more room for new initiatives at the very beginning of the budget formulation process by soliciting budget requests before the decision is taken on targets for ministries and agencies. The decision on the targets could then be strengthened by announcing them as ceilings and strictly enforcing them (apart from updating of macroeconomic factors, including inflation, at the very end of the process). Such a reform would simultaneously improve the legitimacy of the process for line ministries and agencies and strengthen top-down steering.

The Turkish budget formulation process is also fragmented. Turkey may consider a simplification of its budgeting and planning procedures. Strengthening co-ordination and gradually moving towards a single budget bureau would improve allocative efficiency by facilitating the trade-off between current expenditure and capital investment, and would reduce bureaucratic costs. Simplification of global planning procedures (Development Plan, Medium-Term Programme, Annual Programme, Annual Public Investment Programme) and integration with other planning documents would make the budget process more transparent and efficient, and would reduce the administrative burden. At the same time, care should be taken that the large expertise in the State Planning Organisation concerning long-term priority setting, regional policy, agriculture and capital budgeting is not lost but rather put to its best use. Reforms in this direction need not impair the various roles of the SPO, but could rather make them stronger. In particular the role of central macroeconomic forecasting and policy analysis could be strengthened. Such an agency would then become comparable to similar indicative planning bureaus that exist in Austria, the Netherlands, Slovenia, Sweden and other countries.

After the expiration of the IMF standby agreement in May 2008, it would be useful if the Turkish government would commit itself on a more permanent basis to a fiscal rule of total expenditure ceilings aiming in the medium term at a primary surplus of general government. Consultation with the IMF and the EU about the size of the surplus would contribute to the confidence of the international capital markets. In the longer term, when the vulnerability of interest expenditures to current account volatility and risk appetites in capital markets has substantially declined, the expenditure ceilings could be retargeted at the total balance of general government in the medium term and aim at a level within the band of between 0% and 3 % deficit of GDP to which the euro zone countries have committed themselves in the European Stability and Growth Pact.

The Turkish budget classification is very detailed. Reducing the level of detail would improve the accountability of managers and make it easier for parliamentarians to focus the budget debate on results and value for money. The good and very systematic classification that has been achieved in Turkey could be used for the financial accounts, rather than for the budget.

Line ministries find the time available for responding to the Budget Call generally too short and indicate that this time limitation impairs the quality of their submissions. The Ministry of Finance may consider sending out the Budget Call at the beginning of June, instead of at the end of that month. This adjustment of the timetable would give the line ministries four more weeks to prepare their submissions. It would require a similar shift forward of the adoption of the Medium-Term Fiscal Plan by the High Planning Council to the third week of May.

Turkey has made large progress on the improvement of its financial accounts in accordance with international standards of national accounts (SNA93 and ESA95). This has been a very difficult exercise that has mainly achieved its aims and that is now in its last phase. However, this effort has not yet entirely be completed. Its completion should retain the highest priority, and the pace of progress should not be allowed to slip. Reliable accounts are essential for effective fiscal monitoring and fruitful international co-operation.

3. Parliamentary approval

3.1. The Turkish parliament

The Turkish central government budget is a law which is subject to the approval of the Grand National Assembly like all laws (see Box 8). Furthermore, no special restrictions apply to the parliamentary right of amendment as far as the content of amendments is concerned. However, according to the Constitution, amendments to the budget bill that increase expenditures or decrease revenues must originate in the Plan and Budget Committee of the Assembly and cannot be introduced directly in the plenary session of the Assembly. The Assembly can only accept or reject the bill as it emerges from the committee stage.

Box 8. The Grand National Assembly

The Grand National Assembly – Turkiye Buyuk Millet Meclisi – is a unicameral parliament consisting of 550 deputies who are elected for a term of no more than five years. The right to vote in elections is granted to all citizens over 18. A member of parliament has to be at least 25 years old and must hold Turkish citizenship. By-elections to fill empty seats are held once between general elections unless more than 5% (28 MPs) of the total seats are empty. General elections can be called earlier than planned if the Assembly so decides by simple majority.

Since the elections of 2002, the Justice and Development Party holds a majority of 352 seats. The main opposition party is the Republican Peoples Party with 151 seats. These two parties were the only ones that passed the electoral threshold of 10% of the vote necessary to get into parliament in the 2002 elections. Since the elections of 2002, a small number of MPs have changed party affiliation.

Members of parliament are elected from 85 electoral districts through proportional representation. The 10% threshold is an effective barrier against parliamentary fragmentation.

3.2. Parliamentary budget process

According to the Turkish Constitution and the PFMC Law, the Council of Ministers shall present the draft annual budget law to parliament no later than 75 days prior to the start of the fiscal year, *i.e.* in mid October. A special rule applies to the regulatory and supervisory agencies; these entities have a special budget process and submit their budget bills directly to parliament before the end of September. The budget bill must be voted on before the start of the budget year (ultimately on 31 December). Table 3 shows the parliamentary timetable.

The PFMC Law has expanded the requirements for information to be submitted in the budget documentation or attached to the final accounts draft law of the previous year.[8] This documentation should include:

- Budget memorandum, including the Medium-Term Fiscal Plan.
- Annual economic report (a comprehensive report on economic developments in the previous year).
- List and figures for tax exemptions, discounts, etc.
- Report on public debt management.
- (Provisional) outcomes of the two previous years and estimates for the following two years for both expenditures and revenues for the general government sector.

Table 3. **Parliamentary budget timetable**

Date	Activity	Legislation
30 September	Regulatory and supervisory agencies, the parliament and the Court of Accounts submit their budget proposals directly to the Grand National Assembly.	PFMC Law: Article 18
Mid October (no later than 75 days prior to the beginning of the new fiscal year)	The government submits the draft budget law to parliament.	Constitution: Article 162; PFMC Law: Article 18
End of October	The Minister of Finance presents the draft budget law to the Plan and Budget Committee.	Parliamentary custom
Early November – early December (within 55 of the 75 days; in practice approximately 20-25 days)	Draft budget law discussed in the Plan and Budget Committee.	Constitution: Article 162
Mid December (within 20 of the 75 days; in practice approximately 12 days)	Draft budget law and amendments deliberated and voted upon in parliamentary plenary session.	Constitution: Article 162
31 December (at the latest)	Draft budget law that has been approved by parliament has to be signed by the President.	Constitution: Article 162
1 January	Start of fiscal year.	
Early January	Publication of Annual Public Investment Programme.	

- Budget estimates of local governments and social security institutions.
- A list of public agencies which are not included in the Turkish definition of central government but which receive funding from the central government budget.

The budget bill itself is an extensive document (1 920 pages including articles, annexed tables and appropriations and revenues sheets). It enumerates all estimates at the line-item level. The information provided in the budget bill does not show the difference between the present estimates for the upcoming budget year and the multi-annual estimates of the previous year for that same (upcoming) year. It does not explain either to what extent the present estimate is determined by current law or current policy and possible estimation updates (which may explain deviations from the multi-annual estimates of previous years), nor to what extent it is determined by new policy initiatives that have been taken since then. The absence of this information makes it very hard for parliamentarians to assess the proposals. The interpretation of the estimates is also impaired by the fact that outcomes of previous years and multi-annual estimates for future years are provided at a different level of aggregation and in different parts of the budget documentation.

In Turkey, like in all other OECD countries, a large part of expenditures is determined by entitlements provided in substantive law outside the budget process. However, the documentation accompanying substantive bills is not always clear about the consistency of the budgetary consequences with the current budget and the multi-annual ceilings.

The parliamentary budget process, covering the 75 days between the government submission of the draft budget bill to parliament and the beginning of the fiscal year, can be divided into two phases. In the first phase, according to the Constitution, the Plan and Budget Committee (see Box 9) must review, make amendments and adopt the revised budget bill within 55 days. In the second phase, after debates, amendments and adoption of the budget bill in the Plan and Budget Committee, the bill must be discussed and approved in the plenary session of the Assembly before the beginning of the fiscal year (*i.e.* during the 20 remaining days). This stage is more political and ceremonial, as the power to make amendments for expenditure increases and revenue decreases is exclusively vested in the Plan and Budget Committee.

Box 9. **The Plan and Budget Committee**

The Plan and Budget Committee is the main locus for discussion of financial matters in the Turkish parliament. It is one of 17 parliamentary committees and it is the only one dealing with the budget. The budget bill is not presented or deliberated in other sectoral committees of the parliament. However, members of other committees can participate in the discussion of their respective areas when they are discussed in the Plan and Budget Committee. This committee has 40 members, currently 25 from the governing party and 15 from the opposition. Members of the Plan and Budget Committee are often former civil servants with experience in the budgeting area.

The Plan and Budget Committee plays a leading role in the parliamentary budget process and considers not only the draft budget law, but also all other legislation that might have a budgetary impact. If legislation affects expenditure or revenues, the Plan and Budget Committee has the right to analyse and scrutinise the bill to assess whether the proposed legislation is in line with the overall budgetary strategy and budgetary situation. Besides these tasks, the Plan and Budget Committee also reviews the long-term Development Plan.

The discussion in the Plan and Budget Committee proceeds in two sittings. The first is devoted to an overall discussion on macroeconomic and budgetary issues; the second is devoted to a detailed discussion on budget chapters and articles, followed by voting in the committee.

The parliament, including the Plan and Budget Committee, has limited access to analytical resources to analyse the budget bill and to prepare amendments. In general, staff employed by the parliament are involved in the administrative process of the budget, not in the analysis of the content (see Box 10).

Box 10. **Analytical capacity of parliament**

The analytical capacity available to parliament for budget issues is limited. There is a General Secretariat Organisation attached to the president of parliament; it employs approximately 60 experts divided among six departments. One of these departments supports the Plan and Budget Committee and is responsible for the day-to-day organisational matters of the committee. In practice this means preparing documents and organisational matters of the committee, not supporting members of parliament in analysing the budget. The staff of the department supporting the Plan and Budget Committee is approximately 15.

Apart from this, financial support is available to individual MPs for the purpose of employing one expert and one secretary for each member. But as MPs are involved in a wide range of topics, these resources are not often used to employ experts in the budget area.

There is currently a discussion on a proposal to set up a special unit to support MPs in the budget process, but nothing has been decided yet.

3.2.1. First sitting of the Plan and Budget Committee

The first sitting of the Plan and Budget Committee in mid October starts with the Minister of Finance presenting the overall budget, including the macroeconomic development in Turkey and internationally, targets for the budget, expenditure reforms, and changes to the tax system. There is also a presentation and discussion of the final accounts of the previous year.

After this presentation, the committee decides on the procedures for the budget discussion in the second sitting (allocation of time to speakers, order of treating the chapters, etc.). Then there is a general discussion on the budget where the Minister of Finance represents the government. This discussion is on overall macroeconomic and fiscal policy and does not address separate line items. Members of the committee usually receive the draft budget law on the evening before the meeting. This first sitting usually lasts one day. The meeting can be attended by journalists.

After the first sitting, the Plan and Budget Committee retires for one week, thus allowing committee members to study the budget bill and its annexes and prepare the discussion.

3.2.2. Second sitting of the Plan and Budget Committee

The second sitting of the Plan and Budget Committee last for about 20-25 days. The appropriations and final accounts (for the previous year) for each budget chapter are discussed separately in the order decided during the first sitting. Usually, each chapter is allocated one day, with the responsible minister representing the government.

During the discussion of chapters, individual members of the Plan and Budget Committee have the **exclusive** right in the parliamentary process to introduce amendments. Any kind of amendment can be introduced according to the Constitution (Article 162). Revenues and expenditures can be increased or decreased and reallocations can be proposed but, given the high party discipline, amendments usually have to be supported by the majority party to be successful. During the voting on amendments, the view of the Minister of Finance is requested, but his views are not binding.

The number of amendments amounts to approximately 300-400 per year. For most ministries and special budget agencies, 2-4 amendments are proposed. The total upward effect on the budget in the years 2001-07 was 0.2% of total expenditures (central government) on average.

After discussion of all chapters and amendments, votes are taken on the amendments, the draft budget law and the final accounts of the previous year. Members of other committees can participate in the discussion but not in the votes. The vote on the entire budget finalises the committee stage of the parliamentary process.

3.2.3. Parliamentary plenary session

Around mid December, the draft budget law, including approved amendments, is submitted to the plenary Assembly. In the plenary session, members of parliament can make amendments to the articles of the draft budget law but they cannot propose amendments that increase expenditures or decrease revenues. The right of amendment concerning expenditure increases or revenue decreases lies exclusively with the Plan and Budget Committee.

Thus the plenary Assembly has a more formal role. Still, the plenary Assembly votes on the draft budget law. Rejection of the budget would normally result in the resignation of the cabinet (by parliamentary custom, not by constitutional provision). However, the rejection of the draft budget law by the plenary Assembly is a rare event. It has happened, though, showing that the plenary vote is not merely a rubber-stamp procedure.

As in the Plan and Budget Committee, the plenary session starts with a presentation of the budget by the Minister of Finance, followed by a discussion on fiscal policy. Then follows a chapter-by-chapter discussion and voting (by first-level institutional and functional classification; see Section 2). The discussion in the plenary session is not as detailed as in the Plan and Budget Committee.

After the budget has been approved by parliament, it has to be signed by the President. This is only a formal procedure. The President has no power to veto the budget but, according to the Constitution, must countersign the budget law before the beginning of the fiscal year. If the budget bill is not adopted before the start of the fiscal year, the Constitution sets the conditions for a provisional budget (see Box 11).

Box 11. **Provisional budgets**

In the event that the budget is not enacted in time, Article 19 of the PFMC Law takes effect. This article calls for the adoption of a provisional budget law, which cannot last longer than six months. Rules for the provisional budget basically imply that 1/12th of the budget of the previous fiscal year can be spent in each of the six months.

In practice, a provisional budget has been enacted 17 times between 1923 and 2007. The latest provisional budget covered the first three months of 2003. The second-latest provisional budget was the one for the first six months of 1999.

3.3. Conclusion

The concentration of budgetary authority in the Plan and Budget Committee reduces the involvement, accountability and ownership of the sectoral committees for the separate ministries. In many OECD countries, the budget committee is responsible for overall fiscal policy but the detailed consideration of line items is the responsibility of the sectoral committees. A move in this direction would ease the burden of the Plan and Budget Committee.

The information provided in the budget bill does not show the difference between the present estimates for the upcoming budget year and the multi-annual estimates of the previous year for that same (upcoming) year. It does not explain either to what extent the present estimate is determined by current law or current policy and possible estimation updates (which may explain deviations from the multi-annual estimates of previous years), nor to what extent it is determined by new policy initiatives that have been taken since then. The absence of this information makes it very hard for parliamentarians to assess the proposals. The interpretation of the estimates is also impaired by the fact that outcomes of previous years and multi-annual estimates for future years are provided at a different level of aggregation and in different parts of the budget documentation.

A motion is currently under consideration in the Turkish parliament to improve the functioning of the parliamentary process. This includes: 1) the creation of two permanent sub-committees of the Plan and Budget Committee with separate responsibilities for the budget process and the evaluation of the final accounts; 2) a larger participation of sectoral committees; and 3) the improvement of the research capacity of parliament and a larger participation of civil society in the budget process. Reforms in these directions are very useful and would strengthen the parliamentary budget process.

4. Budget execution

4.1. The organisation of budget execution

The PFMC Law reforms provide for the transfer of internal control from the Ministry of Finance to the line ministries and agencies. Internal control is now integrated in the new financial services units of these agencies (the Strategic Development Presidencies and Departments mentioned in Section 2.3).[9] The previous Ministry of Finance control staff has largely been transferred to these units. The units report to the head of the agency.[10]

General budget agencies prepare their detailed expenditure programmes at the beginning of the budget year and submit them to the Ministry of Finance (General Directorate of Budget and Fiscal Control) for approval. On the basis of principles determined by the Ministry of Finance, budget appropriations are released on a quarterly basis with a view to cash planning. Special budget agencies and social security institutions prepare their own detailed expenditure programmes, while quarterly release rates are determined by the Ministry of Finance.

The standards and procedures for the financial management and internal control processes are developed and set by the Ministry of Finance as a central co-ordination and harmonisation unit, and those for internal auditing by the Internal Audit Co-ordination Board (affiliated to the Ministry of Finance). Within the line ministries and agencies, the financial services units perform the control function in co-operation with the agency's authorising officers. The authorising officers have to issue spending instructions stating policy conditions for the commitment and payment decisions. The authorising officers are responsible for the effective, economic and efficient utilisation of appropriations. Accounting services are provided by the Ministry of Finance's accounting offices within general budget agencies, while accounting services of special budget agencies and regulatory and supervisory agencies are provided by their own accounting offices located within their financial services units.

The realisation officer initiates a spending request that is approved by the authorising officer. The payment request is submitted by the general budget agencies to the local accounting officer of the Ministry of Finance. In other agencies, accounting officers belong to the financial services units. The accounting officer checks the documents for the signature of the authorising

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Table 4. **Execution steps**

Step	Person	Institution	Activity
1	Realisation officer	Line ministry/agency	Initiates spending request according to law.
2	Authorising officer	Line ministry/agency	Checks compliance of request with law and policy.
3	Accounting officer	Ministry of Finance	Checks technical aspects of request.
4	Treasury Accounting Office	Treasury	Transfers funds to relevant institution.
5	Realisation officer	Line ministry/agency	Checks timely delivery and quality of goods and services.
6	Accounting officer	Ministry of Finance/agency	Records the transaction and makes it available for MoF in Say2000i system.

officer, completeness of the documents and other errors – in essence whether the details of the payment order are correct. This is a purely technical control. The responsibility for the policy execution lies with the line ministry. The accounting officer records the transaction in the central IT system (called Say2000i), which allows the Ministry of Finance instant access to monitor transactions and aggregate cash spending. In the past, there were sometimes disagreements between the line ministry and the Ministry of Finance accounting officers about whether the payment was in compliance with legislation. This is now the sole responsibility of the line ministry; the Ministry of Finance's role is limited to a technical check.[11]

The payment requests made by the line ministry are transmitted to the Treasury via the accounting officers. The Treasury does not receive any prior notification about payment commitments made in the line ministries, and commitment information is not used in the cash planning process.

In Turkey, the Treasury has a number of accounts both in the Central Bank and in the state-owned Ziraat Bank (see Table 5). All government spending units have their own accounts in the Central Bank of Turkey. This is the so-called "central system". All government income is deposited in the Treasury's accounts and all payments are made from these accounts. Upon request of the accounting officers, the Treasury transfers funds to the line ministry's or agency's account at the Central Bank and the line ministry or agency effects payments from these accounts. There is no sweeping, and balances are kept in the line ministry's or agency's accounts. Regional offices of the central government are supplied with cash via the Ziraat Bank. As the Central Bank of Turkey does not have branches throughout the country, it uses the Ziraat Bank as correspondent bank in the provinces. Revenues collected in a specific area are used for the payment of expenditures made in that area. If revenues in a region are insufficient so that there is not enough cash in the accounts of an agency in the region, the agency can still perform its payments via Ziraat Bank resources. The Central Bank of Turkey makes a weekly

Table 5. **Treasury cash accounts**

Institution	Name	Type	Users
Central Bank of Turkey	410	Revenues and payments of line ministries and agencies	Treasury
	411	Receipts from domestic borrowing and domestic debt service	
	412	Revenues and payments of regional offices of central government	
	416	External debt service	
	85	Foreign exchange account and receipts from foreign borrowing	
	NN	Risk account for guarantees	
Ziraat Bank	Deposit account	Same as the 410 account (revenues and payments), but no overdraft facility	Regional offices of central government if no Central Bank of Turkey facilities are available

settlement with the Ziraat Bank and transfers funds from the 412 account to the Ziraat Bank deposit account.

Recently a project has been started to modernise the payment system in the provinces. It is planned that the regional offices will send their cash requirements to the Treasury via the Say2000i system and that the Treasury will transfer the cash to the accounts of the regional offices in accordance with their cash plans and priorities determined by the Ministry of Finance and the Treasury. Regional offices will no longer be allowed to make payments before the Treasury has deposited their accounts. Moreover, revenues collected in the provinces will be transferred to the 410 account on a daily basis.

With the full implementation of the PFMC Law, the Turkish budget execution system will have many aspects in common with most OECD countries: a relatively simple pre-control system centred on an agency's own financial services unit, a Treasury responsible for cash delivery and management (discussed in further detail below), and a unified accounting system.[12] However, the system has been reformed very recently and it will take some time before it is fully operational.

4.2. Budget flexibility and reallocation

The general rule in the PFMC Law about appropriations transfers is that line ministries and agencies of central government are entitled to transfer up to 5% of the appropriation in the line item from which the appropriation is transferred, unless a different ratio is specified in the annual budget law. This rather low limit of 5% was raised to 20% in the annual budget law of 2007. The Ministry of Finance has to be notified of the transfer within seven days. Parliament does not need to be notified. Transfers are not allowed from personnel expenditure items, from items to which transfers have already been made, nor from items to which transfers have been made from contingency appropriations.

The PFMC Law allows the government to set up a contingency appropriation of maximum 2% of total appropriations of the general budget. The Ministry of Finance is responsible for the transfers from the contingency appropriation. According to Article 23 of the PFMC Law, the contingency appropriation can be used to realise the services and objectives stated in the annual budget law, to remedy any appropriation shortage or to perform services not foreseen in the budget. The contingency fund is used, among other things, for the compensation of inflation in excess of the target inflation that is already put into the line-item estimates. However, there is no automatic compensation. The difference between target inflation (embodied in the line-item estimates) and real inflation is assessed on a case-by-case basis. Only if the deviation creates problems for service levels are funds transferred from the contingency appropriation. Excess inflation in personnel appropriations (caused by salary increases) is compensated automatically, although not from the contingency appropriation but rather from *ad hoc* adjustments of the personnel appropriations (compensated by reallocation). Within 15 days following the end of the fiscal year, the Ministry of Finance reports the distribution of the transfers from the contingency appropriation.

Public administrations are not allowed to spend or to commit in excess of appropriations (Article 20 of the PFMC Law). In principle, no commitment can be made for expenditures for which adequate appropriations are not provided in the budget. Similarly, appropriations that could not be used during the budget year are cancelled at the end of the year. In case of insufficient appropriations, a supplementary budget bill is possible which provides for increased appropriations and simultaneously identifies new sources of funding. In practice the need for a supplementary budget bill arises only if the contingency appropriation is insufficient. This occurs only rarely in Turkey.

Subject to approval of the head of an agency, commitments can be made beyond the budget year for certain specific tasks that cannot be limited to a fiscal year and are continuous by their nature, provided that, for each task, the funds to be committed beyond the budget year do not exceed 50% of the appropriation and provided that the task is completed by June of the subsequent year and the term of the contract does not exceed twelve months. Agencies of central government can carry over committed funds to the subsequent years for the investment projects that cannot be completed in one fiscal year.

The increase of the threshold for reallocation from 5% to 20% has increased the flexibility of budget execution considerably. Moreover, this change is in line with a more results-oriented way of budgeting in which ministers and agency heads are held responsible for outputs. The same is true for the relatively lenient regime for the carryover of commitments. On the other hand, the reallocation rules call into question the need for the extremely detailed line-item classification of the budget (see Section 2). However, even if the line-item classification were less detailed, flexibility would remain important. Some OECD countries have put in place a regime of "rules of budgetary discipline" which in fact allow all reallocations without thresholds, provided that adequate compensation is provided for under the supervision of the Ministry of Finance and that parliament is informed in a timely manner. Such a regime avoids the need to interpret complicated rules and saves bureaucratic costs.

4.3. Cash and debt management

Article 6 of the PFMC Law stipulates that cash planning and debt management are the responsibilities of the Treasury. All revenues of all government agencies shall be deposited in the Treasury's bank accounts, from which all expenditures shall be paid.

On the basis of the monthly budget revenue estimations and the current expenditure appropriations and in the light of the cash flow patterns of previous years, the Treasury prepares an annual cash flow programme of the central government. This programme is broken down into monthly, weekly and daily programmes. The cash flow programme is revised monthly by the Treasury on the basis of the conclusions of the monthly cash management co-ordination meeting. The Ministry of Finance, the Treasury and the relevant agencies, if necessary, participate in these meetings. The Treasury also takes into account the cash requirements of other government agencies (not central government).

If a deficit is projected in the cash flows, the Treasury finances through domestic and external borrowing.[13] A modern system of borrowing and debt management was put in place by the Law on Public Financing and Debt Management of 2002. Apart from unexpected cash needs, borrowing is based on a schedule for debt services and redemption and estimates of revenues and expenditures. Short-term excess liquidity stays in the government accounts. In the event of a build-up of cash in the government accounts, borrowing is reduced in the course of the year.

The Treasury publishes a monthly debt management report that contains detailed information and analyses on borrowing and guarantees. This report clearly distinguishes central government and other general government debt, external debt and domestic debt, and debt in domestic and foreign currency. It also includes sensitivity analysis for debt servicing. Quarterly information on debt is provided to parliament, and monthly statistics are published on the Treasury website (*www.hazine.gov.tr/indexe.htm*).

The potential liability that public guarantees represent for the Treasury is not added to direct public debt. However, a "risk account" appropriation is included in the budget to cover possible losses from guaranteed debt stock on the basis of a risk assessment. The guarantees related to PPPs are monitored in the same way as other guarantees. Law No. 5216 of July 2004 limits the debt stock of metropolitan municipalities[14] to no more than 1.5 times their annual revenue, while the debt stock of other sub-national governments is limited to their annual revenue.[15] New domestic borrowing of sub-national governments in excess of 10% of annual revenues requires the authorisation of the Ministry of the Interior. About 900 (of some 3 200) municipalities have already reached their maximum debt stock limits (OECD, 2006b).

The Turkish cash management system needs to be modernised (see Box 12). At present, idle cash is not consolidated, but is either kept in the

Box 12. **Systems of cash management**

There are basically three models of cash management in central governments.

In the decentralised model, all budgetary institutions have their own account with the commercial banks. These accounts are funded by periodical cash advances supplied by the Treasury on the basis of cash flow estimates and cash allotment decisions. Budgetary institutions make payment orders by drawing on their own accounts.

In the centralised model (now in place in Turkey), budgetary institutions are not allowed to have their own accounts with commercial banks. There is only a single account (with sub-accounts), usually kept at the Central Bank, which belongs to the Treasury. Since the Treasury is not allowed to borrow from the Central Bank, the Treasury handles short-term borrowing by auctioning securities among the commercial banks. All budgetary institutions have to send payment orders to the Treasury in order to draw upon their sub-accounts.

In the hybrid model, budgetary institutions are allowed to have their own bank accounts with a single commercial bank, but any positive balances in these accounts are transferred daily to the Treasury account with the Central Bank and bank accounts are supplied daily with cash advances. The contract with the commercial bank is usually auctioned. Similarly, short-term borrowing is centralised at the Treasury. Budgetary institutions make payments by drawing on their own account with the commercial bank.

Both the centralised and the hybrid model realise efficiency gains through consolidation of balances and centralisation of short-term debt management at the Treasury.

agencies own accounts or only settled on a weekly basis. In fact, reforms are already under way but need to be enhanced. Cash planning needs to be based on a more analytical framework rather than on previous years' experiences. Furthermore, a commitment notification system should be put in place as soon as possible. In view of modern IT technology, there does not seem to be any reason for maintaining the Ziraat Bank system. Considerable savings could be generated by moving towards a centralised single treasury account with daily sweeping of cash balances and accommodation of short-term debt management to avoid idle cash balances.

4.4. *Service delivery*

The general government sector consists of three sub-sectors: the central government, the social security institutions and the local governments. This subdivision mainly coincides with the subdivision of general government in the national accounts (ESA95 and SNA93). Turkey is a strongly centralised country with a local government share of total primary spending of only 9.5% of GDP (see Table 6).

Table 6. **Size of central and local government**

	Per cent of primary general government expenditure	Per cent of GDP
Central government and social security	90.5	33.3
Local government	9.5	3.5

Source: OECD (2004).

In Turkey the central government budget consists of:[16]

- **General budget agencies** (50 ministries and directly affiliated agencies). Each of these may consist of: 1) central units, which set goals and policies and supervise and monitor delivery of services; 2) decentralised units, which are responsible for delivering services and implementing ministerial policies in a particular regional area and which reside under a provincial governor (see Box 13); and 3) units abroad, such as embassies, etc.
- **Special budget agencies** (70 universities, 31 others). These agencies are established for the performance of a certain public service as defined in a special law. They have their own budget line in the budget law and have a certain autonomy *vis-à-vis* the ministry that provides for their funding.
- **Regulatory and supervisory agencies** (8 agencies). These agencies are also established by special laws. They have financial and administrative autonomy. They prepare their own appropriation requests and submit them directly to the parliament, without negotiations with line ministries or the Ministry of Finance.

The social security institutions are established by law to provide social security services. They consist of the Pension Fund (for civil servants), the Social Insurance Institution (for workers and contracted personnel), BAG-KUR (for craftsmen, artisans, and other self-employed persons) and the Turkish Labour Agency. The government has proposed to merge the first three of these funds into a single social security institution covering all citizens.

The local governments consist of special provincial administrations, municipalities and villages (see Box 13).

In many OECD countries, the reform trend in service delivery has been to loosen input controls and to strengthen accountability for outputs. This is a road that Turkey wants to follow, and indeed has followed by granting more financial responsibility to line ministries. However, an important element is still largely missing: the split between the "purchaser/principal" and the "provider/agent" within line ministries. Separating policy making from service delivery enables each agency to focus on one thing. In addition, moving the responsibility for service provision as close as possible to users can improve efficiency and make it easier for the provider to respond to local needs and

Box 13. **The organisation of sub-national government in Turkey**

The Turkish sub-national government sector consists of special provincial administrations (SPA), metropolitan municipalities, municipalities and villages. In addition, the central government is represented at the regional level by the provincial administrations.

The 81 provincial administrations (PA), sub-divided into 849 sub-provinces, are decentralised units of the central government and not part of the sub-national level of government. Each PA is headed by a governor and each sub-province by a sub-governor. The governor and sub-governor are appointed by the Council of Ministers with approval of the President. The PA and sub-provinces are responsible for the management and co-ordination of field directorates of ministries within the geographical area of the province (and sub-province).

As part of the sub-national level of government, there are 81 **special provincial administrations** (SPA), each covering the same geographical area as the provincial administrations. The functions of the SPA are twofold: 1) general provincial functions belonging to the sub-national level of government, such as the provision of land for the construction of school buildings (primary and secondary education), social services and AIDS prevention, and the protection of soil; and 2) municipal functions for rural areas that are not incorporated in municipalities. These rural areas consist of roughly 35 000 **villages**. Villages have councils in which all citizens can participate (direct democracy), but their competences are very limited. The head of the SPA is the governor of the PA, but the SPA is still a separate administrative entity, with a directly

Box 13. **The organisation of sub-national government in Turkey** *(cont.)*

elected assembly as superior decision-making body. For tasks assigned to the SPA, the governor is accountable to the provincial assembly.

The local level consists of 3 225 **municipalities.** Municipalities are the most important level of sub-national government, established to meet the local need of citizens. Their combined territory covers about 75% of Turkey and their combined expenditures amount to approximately 90% of sub-national expenditure. Municipalities are divided into different groups depending on their size, but they are all subject to the same rules of governance (organisation, competences of decision-making bodies, etc.) The legal minimum size of municipalities is 5 000 inhabitants but this size limit is not enforced: of the 3 225 municipalities, almost 2 000 have between 1 000 and 5 000 inhabitants. The mayor and general assembly of municipalities are elected directly by the inhabitants. Services provided by municipalities are limited to local infrastructure, water, sewerage, waste treatment and fire protection. Public services such as education and health, which in many countries have been decentralised, are tasks of the central government in Turkey.

Of the 3 225 municipalities, 16 **metropolitan municipalities** enjoy a special status, introduced in 1984 and with a legislative basis in the Constitution (Article 127) which says that "for the big settlements special administrative systems may be established". A metropolitan municipality is basically an umbrella organisation for one or more municipalities within a larger city.[1] A metropolitan municipality must have at least 750 000 inhabitants. A metropolitan municipality is headed by a mayor and a council. The council consists of representatives of the municipalities on its territory. Metropolitan municipalities have larger responsibilities than other municipalities. Apart from rendering ordinary municipal services transferred to them, they ensure the co-ordination between the municipalities on their territory and they implement large-scale projects (road construction, etc.).

The activities of the sub-national governments are mainly financed through a tax-sharing arrangement, grants from the central government and own non-tax revenue. The sub-national governments have only limited own tax revenues. For municipalities, revenue from tax sharing amounts to approximately 44% of total revenue, the rest coming from own tax revenues (13%) and non-tax revenues (43%). Municipalities receive 6% of total taxes collected by the central government, allocated on the basis of population size. SPAs receive 1.12% of total central government tax revenue, allocated on the basis of population size, and metropolitan municipalities receive an additional 5% of total central government tax revenue collected on the metropolitan territory. Grants are usually non-earmarked grants.

1. Ankara consists, for example, of 34 municipalities (IMF, 2006a).

preferences. This entails more autonomy for executive agencies *vis-à-vis* the parent ministry in the determination of the input mix, in personnel management and in procurement. Moreover, it requires a separate financial administration for executive agencies so that cost prices of services become available. Turkey has started to move in this direction, but it would be important to put more emphasis on these reforms.

4.5. *Revolving funds*

Revolving funds are a mechanism for agencies that collect considerable fees or other non-tax revenues, such as hospitals, to conduct their activity on a net basis and to have flexible carryover mechanisms. The number of revolving funds would have been reduced to 1 434[17] but the total expenditures from revolving funds as a share of GNP increased from 1.8% in 1999 to 2.2% in 2004. The PFMC Law stipulates that revolving funds shall be reconstructed by the end of 2007. Spending from revolving funds is not subject to the same parliamentary scrutiny as spending from the central government budget. Including them on a gross basis will increase transparency and efficiency, but at the same time will require additional flexibility. Reforms to ensure managerial flexibility must go hand in hand with the abolition of the funds (OECD, 2004).

4.6. *Human resource management*

Public sector employment in Turkey amounted to about 2.6 million in 2005, or 12% of total employment. Central government employed 2 000 000 people, state-owned enterprises 345 000 and local government 240 000. Main functional sub-sectors of central government employment are general administration (296 000), security (police) services (175 000), health (250 000), education (including academic staff of public universities) (650 000), and administrative support services (145 000). Of the 2.6 million in public employment, 2 million (76%) are civil servants with life-time contracts, 528 000 (20%) are public sector workers with sheltered positions, and the remaining 120 000 (4%) are on fixed-time contracts.[18]

Cadre charts annexed to the Decree Law on General Cadres No. 190 determine the maximum number of civil service positions for each agency and the Council of Ministers determines the number of positions to be filled. The annual budget law determines the principles governing appointments and ceilings for recruitment. Hiring of civil servants is subject to approval of the State Personnel Directorate in the Office of the Prime Minister in conjunction with the Ministry of Finance (for central government agencies), the Ministry of the Interior (for local government) and the Treasury (for state-owned enterprises). The Constitution virtually guarantees a job for life once hired on the basis of a state examination. Despite the double lock (the cadre charts[19] and the budget law), central government civil service employment increased by 30% from 1990 to 2005, from 1 240 000 to 1 700 000, an annual growth rate of 2.3%.

The civil service employment procedures are clear and understood. However, there are a number of complexities that limit transparency, especially concerning pay. For civil servants there are 9 service groups, 15 grades and 3 steps in each grade. The wage system for civil servants is relatively rigid, based on educational starting levels and automatic steps according to seniority. The envelope for total civil service pay is subject to budget constraints and, since the grade structure is fixed, wage coefficients

Box 14. **The public procurement system in Turkey**

In 2002, the Turkish public procurement system was thoroughly reformed in order to address shortcomings such as:

- Most public agencies were not covered by the main procurement law and had the right to issue their own regulations on procurement.
- Publication of notifications was not always required and even when it was required, announcement periods were too short for interested economic agents to react.
- Selection and evaluation criteria were not objectively determined and announced.
- Unsuccessful bidders were not properly informed about the decisions of the contracting agency.

The purpose of the Public Procurement Law (PPL) No. 4734 of 2002 is to ensure transparency, competition, equal treatment, accountability, efficiency and effectiveness in public spending. With the PPL of 2002, the Public Procurement Authority was established as an administratively and financially autonomous entity at the central government level to regulate and monitor the public procurement process. The Authority consists of the Public Procurement Board, the Presidency and service units.

Information on tendering requirements is available via the website of the Public Procurement Authority (*www.kik.gov.tr*). In 2006, 4 602 complaints were filed out of a total number of 47 743 calls for tender.

The system is broadly in line with international standards: tender is required for large contracts, decisions are open to audit and a clear system for complaint procedures is in place. For contracting entities in the utility sectors, procurements below TRY 4 428 537 (approximately EUR 2.3 million) are not yet fully covered by the PPL. These procurements are covered by a simplified procedure until the necessary legislative arrangement is in place.

serve as a residual. Civil service pay is not transparent because of a complex allowance system and in-kind benefits (housing, food, transport, etc.). While the total basic salaries and the annual inflation adjustments are published and accounted for in the budget, information about total compensation costs is lacking. Many of the benefits are accounted for under other budget items than wages and are not part of the personnel budget.

The pay package for public employees seems to be competitive compared to the private sector, especially for public workers and civil servants with less than 10 years of experience. In contrast to civil servants, public sector workers are represented by strong unions that have achieved high pay levels and rapid wage growth. Since public sector workers are primarily employed by subsidised state-owned enterprises, the favourable compensation of public sector workers may partly be due to a lack of countervailing power on the part of employers. The ratio of the net pay of a public sector worker to that of a private sector worker with comparable duties was 1.5 in 2003. The result is a compressed wage structure between university-educated civil servants and low-skilled public sector workers.[20]

Furthering the goals of the PFMC Law – more focus on performance and accountability – will require reform of the pay system in the direction of more flexibility. In addition, the costs of allowances and in-kind benefits should be brought on budget.

4.7. The sector of state-owned enterprises (SOE)

The Turkish state owns a substantial number of enterprises and banks. The Privatisation Authority also monitors state economic enterprises assigned to it. According to the State Planning Organisation, the 39 state-owned enterprises are expected to make earnings of about 2% of GDP before tax, interest, depreciations and amortisation. The government owns three large state banks, accounting for 36% of the banking system assets and 41% of deposits. Furthermore, the government is heavily involved in the running of the businesses. As far as the non-financial enterprises are concerned (not the banks), the Treasury can give directives about prices, employment, administrative expenses and borrowing. The State Planning Organisation has to scrutinise the investment programme of non-financial enterprises. This programme is approved annually by the Council of Ministers and published in January. Dividends are decided on an *ad hoc* basis in the light of the company's future needs.

Quasi-fiscal activities, which consist of policy-driven spending implemented by government-owned banks and enterprises, were a major concern in the 1990s. These quasi-fiscal activities came under better scrutiny after the IMF standby agreement of May 2001. Since then, quasi-fiscal losses (duty losses) began to be explicitly budgeted and reported. At present, the quasi-fiscal activities include purchase of agricultural produce at non-market prices, the provision of goods and services on non-commercial terms, and subsidised lending to students, small enterprises and the agriculture sector (Table 7).

Table 7. **The duty loss mechanism**

Step	Activity
1	The Council of Ministers assigns a state-owned enterprise (SOE) to carry out a duty.
2	In the Council Decree, the amount of loss due to the duty is also specified.
3	Once the duty is realised, the SOE calculates the loss and informs the Treasury.
4	The Treasury and the line ministry jointly determine the loss on the basis of the accounts.
5	The Treasury makes the duty loss payment to the SOE. The timing of this payment depends on the availability of appropriated funds. For financial SOEs, the appropriation is known before the fiscal year and the activity has to be stopped when the appropriation is spent.

Duty losses in non-financial enterprises have decreased from 0.4% of GDP in 2001 to 0.1% of GDP in 2006, and subsidised bank lending has declined from 0.2% of GDP in 2001 to less than 0.1% of GDP in 2005. Law No. 4603 of November 2000 stipulates that the state may not assign any duties to public banks without paying the due amount. Duty losses henceforth have to be funded from the central government budget. According to this law, banks must determine their credit policies in accordance with the appropriated subsidy; in 2005, this subsidy amounted to TRY 112.8 million (EUR 57.1 million), and in 2006, the budget allocation for this purpose was TRY 210 million (EUR 106.3 million). The state-owned enterprises are audited by the High Auditing Board, which reports the findings to the Prime Minister, Treasury and parliament.

Since 2001, the quasi-fiscal activities of state-owned enterprises have become more transparent. Nevertheless they have not yet been entirely abolished. Further effort is needed to implement and enforce Law No. 4603 of November 2000.

4.8. Conclusion

With the full implementation of the PFMC Law, the Turkish budget execution process will have many aspects in common with most OECD countries:

- Decentralisation of budget execution by financial services units of line ministries and agencies;
- A relatively simple pre-control system centred on the financial services units of ministries and agencies;

- A Treasury responsible for payments and cash management;
- A unified accounting system;
- Some end-year flexibility.

Aspects of the budget execution process that still need to be improved or require further reform include:

- The complicated rules for reallocation and carryover could be simplified.
- The methods for the projection of cash needs could be improved. Notification to the Treasury of commitments of a substantial size should be made mandatory.
- Cash management could be made more efficient. Idle cash is not consolidated, but is either kept in the agencies' own accounts (central system) or only settled on a weekly basis. Savings could be generated by moving towards a centralised single treasury account with regular sweeping of idle cash and improved co-ordination with short-term debt management.
- More emphasis on the separation between policy making and service delivery through more autonomy for executive agencies would be beneficial. In addition, moving the responsibility for service delivery as close as possible to users can improve efficiency and make it easier for the provider to respond to local needs and preferences.
- The current remuneration system for public employees is too fragmented and overly rigid. A first step in reforming the system could be to introduce a new uniform civil service pay system which gives managers more freedom to decide on grades and steps within grades.
- Quasi-fiscal activities of state-owned enterprises have not yet been entirely abolished. Further effort is needed to implement and enforce Law No. 4603 of November 2000.

5. Accounting and auditing

5.1. *Accounting*

Establishing a uniform accounting system for general government and supervising the system are the responsibilities of the Ministry of Finance's General Directorate of Public Accounts. In contrast to budget preparation and financial control, the accounting function in general budget agencies (ministries and directly affiliated agencies, see Box 1 above) has not been transferred to the line ministries and agencies. The Ministry of Finance continues to have 1 619 accounting offices in ministries and agencies. The offices are responsible for collecting revenue, ordering payments and recording the financial transactions of the line ministries and agencies

(Article 61 of the PFMC Law). The Ministry of Finance is responsible for compiling, consolidating and disseminating accounting data and financial statements for the central government on a monthly basis as defined in the PFMC Law. For other agencies (special budget agencies, regulatory and supervisory agencies, social security institutions and local governments), accounting services are provided by their own accounting units, but they report to the Ministry of Finance.

The accounting officers record the appropriations given to the relevant agency at the beginning of the year, conduct technical pre-control of payments, and record reallocations and cancellations of remaining appropriations during and at the end of each year. Accounting data are compiled instantly in the Ministry of Finance via the automated accounting system Say2000i. Special budget agencies and regulatory and supervisory agencies send their accounting data monthly, and social security institutions and local governments are obliged to submit their data quarterly to the Ministry of Finance. The Ministry of Finance (General Directorate of Public Accounts) has established a module for local governments in Say2000i, and in 2006 local governments transferred their data to the Ministry for the first time via Say2000i.[21] The accounts of the state-owned enterprises – apart from appropriated transfers – are not included in general government accounts (IMF, 2006a).

The accounting and reporting standards for general government are set by the State Accounting Standards Board, which is established within the Ministry of Finance. The board consists of representatives from the Turkish Court of Accounts, the Ministry of Finance, the State Planning Organisation, the Treasury, the Higher Education Council, the Ministry of the Interior, and the social security institutions. The Ministry of Finance sets rules for the preparation of the final accounts and supervises the compilation. Final accounts are currently on a modified cash basis. The PFMC Law allows the Ministry of Finance to determine accounting principles for the preparation of final accounts. After completion, the final accounts law is submitted to the Turkish Court of Accounts and the Grand National Assembly. The Turkish Constitution mandates that the final accounts law should be submitted to parliament within seven months of the end of the fiscal year and that the Court of Accounts shall submit its certification no later than 75 days thereafter.

Currently the main fiscal policy indicators are the overall balance and primary balance of the central government budget, and the total and primary balance of the "consolidated government sector" (see Box 1 above). In order to submit fiscal notifications to the European Commission, huge efforts have been made to prepare accounts in accordance with ESA95 standards (see Section 2.2.2). The ambition is to produce accounts in accordance with ESA95 for the year 2009.

5.2. Internal audit

The line ministries will be responsible for the new internal audit units (*ex post* audit). For that purpose, internal auditors within the line ministries and agencies will be made responsible for system, performance, financial, compliance and IT audits. The internal auditors will report to the head of the agency. The new system entails a quite far-reaching reform. The target is to hire 1 200 new internal auditors with appropriate qualifications by the end of 2007. Only 50 were hired in 2006. In order to further the transmission process, a twinning project has been set up with the French Ministry of Finance. The overall framework is in line with international practice, but final evaluation of the new internal audits must await implementation.

5.3. External audit

External audit is regulated by the law on the Turkish Court of Accounts (TCA). Article 68 of the PFMC Law specifies that the TCA may audit all general government organisations (central government agencies, local governments and social security institutions). At present, the capacity of the TCA is not sufficient to fully cover the auditing of local government. However, the possibility of outsourcing contained in the new draft law might help solve this problem.

The independence of the TCA is secured. It prepares its own budget and presents it to parliament directly. It decides on its own audit programme. The president and the members of the court are elected by the parliament. The tenure of the president is seven years, eligible for re-election. The tenure of members and auditors continues until the age of 65. The president, members and auditors cannot be appointed to another position without their consent. Removal can only happen due to criminal conviction or medical reasons.

At present, the TCA predominantly carries out compliance audits, the results of which are dealt with through a judicial procedure. In addition, two to three performance reports a year are completed and presented to parliament. The TCA also submits a report to parliament on the general conformity of the central government. Both types of reports are published and publicly available. There is no legal arrangement concerning the process for dealing with audit findings and there is no legal requirement for the government to respond to the reports submitted to parliament. The Plan and Budget Committee of the parliament considers the TCA reports. Parliament does not have a special audit committee dedicated to scrutinising the reports.

To bring external audit in line with generally accepted international audit principles, a new law on external audit was submitted to parliament. The draft law is in line with international best practice.[22] In the new law, it is envisioned that the following reports will be prepared every year:

- A statement of general conformity. This is submitted to parliament and sums up the status of the compliance audit (compliance with rules and regulations) as in the present system.
- An external audit general evaluation report, divided into a financial audit report and a performance audit report. The performance audit is to be based on the new performance indicators that will be set up in 2007.
- A general evaluation report on activity, assessing the activity-based studies of the Turkish Court of Accounts.
- An evaluation report on financial statistics.
- Reports on public economic enterprises.

In the draft law, the term of office of the president of the TCA is reduced from seven years to four years, with the possibility of re-appointment.

In order to build up the capacity for the new external audit areas, the TCA has established a twinning project with the British National Audit Office and conducted a number of training exercises for staff. The TCA finds that it has sufficient resources to carry out its mandate despite the capacity problem mentioned above. The TCA currently has about 540 auditors, approximately half of whom are being trained in the twinning project. The long-term objective is to increase the number of professional auditors to 900 over ten years.

5.4. *Conclusion*

The current Turkish unified accounting system seems to be working appropriately. It is essential, however, that accounting is brought in line with international standards (ESA95 in particular) as soon as possible. It is too early to assess the new internal audit system. The framework looks promising, but training of the auditors and general implementation will be challenges. A further challenge will be for the TCA to move from more financial compliance control towards value-for-money audit, but the reform is well organised and firmly on the rails.

Notes

1. Namely: the Motherland Party, 20 seats, led by Mr. Mumcu; the True Path Party, 5 seats, led by Mr. Agar; the People's Ascent Party, 1 seat, led by Mr. Öztürk; the Social Democratic People's Party, 1 seat, led by Mr. Karayalçin; and the Young Party, l seat, led by Mr. Uzan. At present 8 parliamentary seats are empty.
2. Organic laws do not exist in the Turkish legal system. All non-constitutional legislation is on the same "level".

3. As long as the Turkish budget process works with ceilings that can be adjusted from year to year, the requests may even assume an increase in total expenditure. See Section 2.3.
4. In the United States, the budget bureau (the Office of Management and Budget) is located in the Executive Office of the President.
5. Turkey does compile general government statistics, which are submitted to the European Commission as part of the notification procedure. Until now, there are still small shortcomings in these statistics (see Box 1).
6. A number of OECD countries are using fixed expenditure ceilings that remain in place from year to year (or can only be adjusted for inflation). This is the case, for instance, in the Netherlands, Sweden and the United Kingdom. However, such a system requires a certain degree of macroeconomic stability in the sense that the balance fluctuations induced by the economic cycle remain moderate (within an acceptable band). Such stability has not yet been achieved in Turkey.
7. Perhaps it is not necessary to shift forward the adoption of the Medium-Term Programme, as this document may be treated simultaneously with the Medium-Term Fiscal Plan (see also Section 2.2.1).
8. Article 18 of the PFMC Law. Article 42 of the PFMC Law specifies information that should be attached to the draft budget law and final accounts draft law.
9. The term "financial services units" will be used for the new Strategic Development Presidencies/Departments in the ministries or special budget agencies where the functions of budgeting, accounting and internal control are now located.
10. Typically an undersecretary in ministries, the highest administrator in other agencies, the governor in special provincial administrations, and the mayor in municipalities.
11. PFMC Law (Amendment: 22.12.2005 – 5436/Article 10-a): "An accounting officer shall not request any evidencing document other than those set out in the applicable legislation. The responsibilities of accounting officers in relation to the controls they carry out as herein provided are limited to the documents they examine as required by their duties."
12. In a number of OECD countries, the accounting function, although based on a uniform system, is decentralised to the line ministries and agencies as well. This is not the case in Turkey, where the Ministry of Finance remains responsible for financial reporting.
13. The funds raised via borrowing are recorded to either the 411 account or the 85 account (see Table 5). Debt servicing is realised by the accounts 411 or 416. If there is not enough cash in the 410 account, then funds are transferred from the 411 or 416 accounts.
14. See Box 13 for a description of local government.
15. Law No. 5393 of July 2005 for other municipalities, and Law No. 5302 of February 2005 for special provincial administrations.
16. See also Box 1.
17. SPO quoted by the "Report on the Observance of Standards and Codes – Fiscal Transparency Module" (IMF, 2006a).
18. Source: communication by the Ministry of Finance of Turkey.

19. The cadre chart does not serve as a ceiling in practice because 25% of the available positions are not filled.
20. The ratio of the highest to the lowest public sector wages has been estimated at 7 in 2004, considerably below internationally observed averages of around 12-13 (OECD, 2004).
21. Henceforth the Ministry of Finance will disseminate the local government statistics quarterly. (Until 2007, the data pertaining to local governments were being compiled by the State Planning Organisation through surveys.)
22. This includes: the Lima Declaration, INTOSAI auditing standards, European implementation guides, recommendations of the EU to candidate countries, and the compare and control lists on supreme audit institutions (SAIs) prepared by OECD/SIGMA. In addition, the current Article 68 of the PFMC Law envisages that external audit shall be performed in line with the generally accepted international auditing standards.

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Structural Balance Policy in Chile

by
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Since 2001, Chile's fiscal policy has been built on the concept of a central government structural balance. The Fiscal Responsibility Law, approved in 2006, gave legal force to key aspects of the structural surplus and fiscal policy. This article assesses the results of the structural surplus rule in Chile over the past six years.

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1. Introduction

Since 2001, Chile's fiscal policy has been built on the concept of a central government structural balance. Unlike the effective balance, which indicates the current fiscal position, this balance reflects the medium-term fiscal outlook. In simple terms, the structural balance concept involves estimating the fiscal income that would be obtained net of the impact of the economic cycle, and spending only the amount that would be compatible with this level of income. In practice, this means saving during economic highs, when revenues known to be of only a temporary nature are received, and spending the revenues in situations when fiscal income drops.

The structural balance indicator used in Chile nets out the cyclical impact of three variables – the level of economic activity and the prices of copper and of molybdenum – that affect central government income. Thus the structural balance reflects the financial results that the central government would have shown in a particular year if gross domestic product (GDP) had been at its trend level and copper and molybdenum prices had been running at their long-term level. In this way, it is possible to distinguish between changes in the fiscal situation that are caused by policy decisions and those due to the cyclical impact of these three variables.

Since adopting this structural balance policy, the government has set itself the target of maintaining an annual structural surplus equivalent to 1% of GDP. The compliance with the rule has been particularly meritorious, given that it has not been a legal obligation but a voluntary undertaking on the part of the government.

This target was chosen for three reasons: first, because of the structural operating deficit and negative net worth of the Central Bank of Chile resulting from the bailout of the private banking system in the 1980s and the exchange rate policy of the 1990s; second, because of the existence of contingent liabilities relating principally to state-guaranteed minimum pensions and old-age benefits; and, third, due to the external vulnerability arising from currency mismatches and potential limits on foreign borrowing in local currency. After evaluating the recent performance of these three variables, the government announced that for 2008 the annual structural surplus will be equivalent to 0.5% of GDP.

Chile's six-year experience in applying the structural balance policy has revealed important benefits. In fact, there is consensus among analysts that it has had six principal advantages (Ministry of Finance of Chile, 2006). First, it has permitted the implementation of a counter-cyclical policy, attenuating the economy's swings and reducing uncertainty as to its medium-term performance. Second, it has meant an increase in public saving during periods of strong growth which has, in turn, helped to prevent currency appreciation and safeguard the competitiveness of the export sector. Third, it has reduced interest rate volatility and, fourth, has boosted the Chilean government's credibility as an issuer of international debt, reducing the sovereign risk premium it has to pay, improving access to foreign financing during negative external shocks and minimising contagion from international crises. Fifth, it has also reduced the economy's need for foreign financing and, sixth, it has ensured the financial sustainability of social policies, facilitating their long-term planning.

In the light of these benefits, there is widespread technical and political support for the maintenance of the structural balance policy, for continuing to improve some of its methodological aspects, and for its institutionalisation. Since the policy's adoption, the way in which the indicator is calculated as well as the definition of key parameters and assumptions have been made increasingly transparent, the disclosure of information to the public has been improved, and the methodology has been refined. In addition, in September 2005, the government presented a Fiscal Responsibility Bill to Congress which was approved in August 2006 (Law No. 20.128), giving legal force to key aspects of the structural surplus and fiscal policy that previously depended only on the voluntary commitment of the authority. However, this law does not bind future administrations to a specific structural balance target.

In this context, this article seeks to assess the results of the structural surplus rule over the past six years, during which it has served as the basis for drawing up and implementing the public sector budget. To this end, Section 2 describes the methodology currently in use to calculate the structural balance, looking particularly at the improvements introduced in the last few years, while Section 3 sets out the main results and implications of the six years during which the structural balance policy has been in force. In Section 4, the main aspects of the Fiscal Responsibility Law as it relates to the structural balance policy are summarised, while Section 5 identifies the future challenges for the implementation of this policy.

2. Structural balance methodology currently in use in Chile

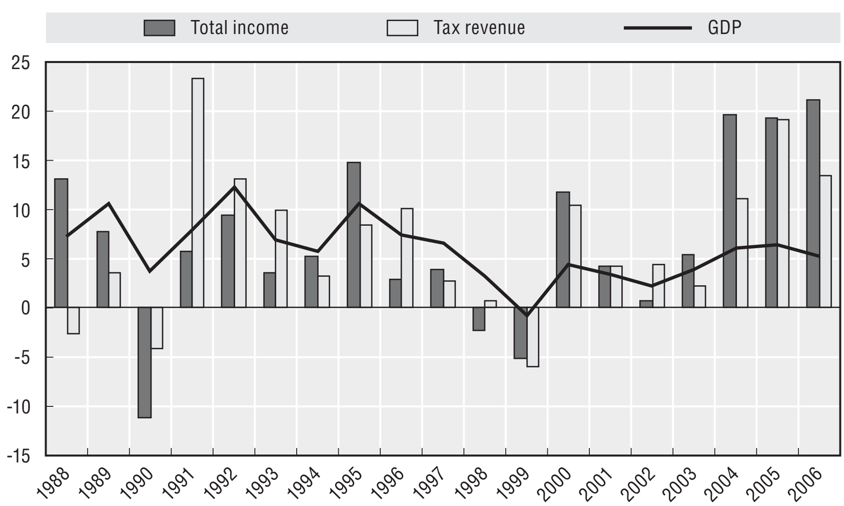
2.1. Conceptual framework

Chile's structural balance methodology is based on the criteria used by the International Monetary Fund (IMF) and the OECD, with some adjustments to take account of the specific characteristics of the country's public sector finances. Conceptually, the central government structural balance isolates the impact of the economic cycle on public finances, providing a long-term picture of the fiscal situation in contrast to the effective balance which reflects the situation prevailing at a particular moment.

In other words, the structural balance estimates the fiscal income that would be obtained independently on the phase of the cycle, whether it be positive or negative. This involves estimating the fiscal income that would be received if the economy were growing at its trend rate and, in practice, means adjusting income in line with a parameter that captures the gap between effective GDP and its trend level.

In the case of Chile, the cyclical impact of GDP on fiscal income is evident, as seen in Figure 1 which shows a strong correlation between total fiscal income – and particularly tax revenue – and economic activity as measured by GDP.[1]

Figure 1. **Total fiscal income, tax revenue and GDP, 1988-2006**
(annual variation, percentage)

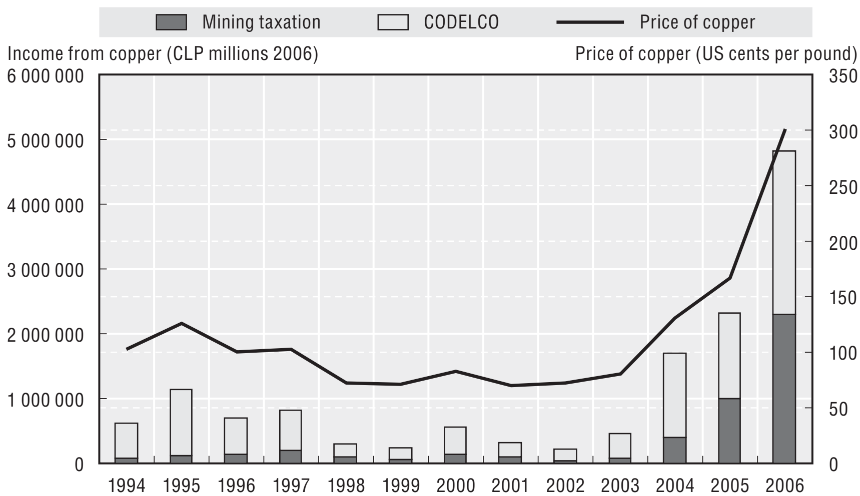


2006 = estimated.

Source: Calculated using figures from the Central Bank of Chile and the Budget Office (DIPRES) of the Ministry of Finance.

However, the behaviour of effective GDP is not the only important source of cyclical variations in fiscal income in Chile. Copper accounts for around 16% of fiscal income (some 10% from the sales of CODELCO, the state copper producer, and the remainder from taxation of private mining companies) and, as a result, the price of copper is also an important factor. As shown in Figure 2, fiscal income from copper is a direct function of the copper price, the behaviour of which is highly cyclical.

Figure 2. **Fiscal income from copper and the price of copper, 1987-2006**



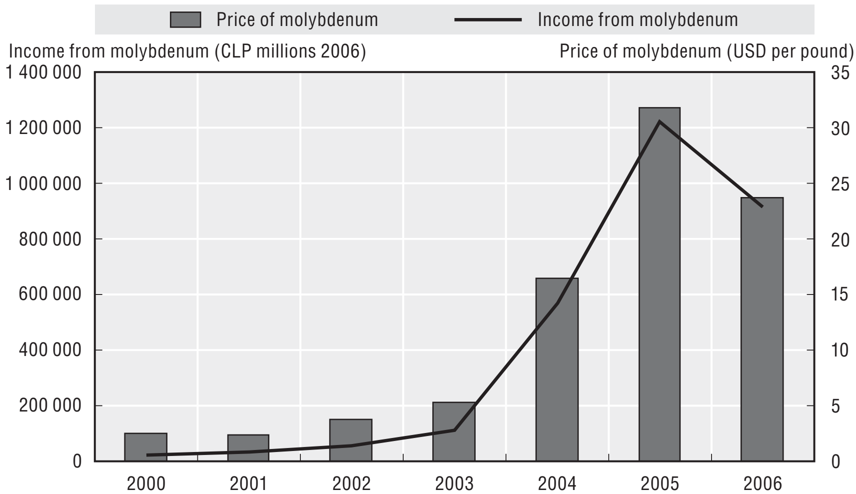
2006 = estimated.

Source: Calculated using figures from the Chilean Copper Commission (COCHILCO) and DIPRES.

A sharp increase in the price of molybdenum, a byproduct of copper marketed by CODELCO, meant that this mineral, which had previously been insignificant as regards fiscal income, also became a relevant factor as from 2005, accounting for close to 6% of total fiscal income. As a result, cyclical adjustment of fiscal income from molybdenum also became necessary since, as seen in Figure 3, there is an important correlation between its price and the income that the central government receives from the sales of CODELCO.

Therefore, in simple terms, the structural balance indicator used in Chile isolates the cyclical impact of three macroeconomic variables that affect central government income: the level of economic activity and the prices of copper and of molybdenum. In this way, it reflects the balance that the central government would have shown in a particular year if GDP had been at its trend level and copper and molybdenum prices had been at their long-term level.

Figure 3. **Fiscal income from molybdenum and the price of molybdenum, 2000-06**



2006 = estimated.

Source: Calculated using figures from Bloomberg and DIPRES.

2.2. Structural balance indicator

The structural balance indicator can be expressed as:

(1) $$BE_t = Be_t - TNMIN_t + \left[TNMIN_t * \left(\frac{Y_t^*}{Ye_t} \right)^{\varepsilon} \right] - TMIN_t + TMINE_t - ICC_t + ICCE_t - ICM_t + ICME_t$$

where:

BE_t = structural balance in period t

Be_t = effective balance (accrued) in period t

$TNMIN_t$ = net non-mining tax revenue and social security in-payments in period t

$TNMIN^*_t$ = structural net non-mining tax revenue and social security in-payments in period t

$TMIN_t$ = income from taxation of private mining companies in period t

$TMINE_t$ = structural income from taxation of private mining companies in period t

Ye_t = effective GDP in period t

Y^*_t = trend GDP in period t

ICC_t = effective transfers from CODELCO on account of copper sales in period t

$ICCE_t$ = structural transfers from CODELCO on account of copper sales in period t

ICM_t = effective transfers from CODELCO on account of molybdenum sales in period t

$ICME_t$ = structural transfers from CODELCO on account of molybdenum sales in period t

ε = GDP elasticity of tax revenue

The use of this indicator to put the fiscal policy rule into operation when drawing up the annual budget involves the following sequential steps:

- Estimation of the long-term copper price (following consultation with a committee of independent experts[2]).
- Estimation of the trend level of inputs to the aggregate output function (following consultation with a committee of independent experts[3]).
- Estimation of trend GDP using the results of the previous step and the estimated aggregate output function ($Y = A^* K^{\alpha} {}^* L^{\beta}$)[4].
- Estimation of the long-term molybdenum price.
- Adjustment of non-mining tax revenues[5] and social security in-payments according to the gap in level between trend GDP and projected effective GDP (using an estimated GDP elasticity of tax revenue [ε] of 1.05).
- Adjustment of tax revenue from mining companies (earnings tax and specific tax paid by large private mining companies).
- Adjustment of projected income from CODELCO on account of copper, net of production costs, adjusting the company's volume of sales for the difference between the projected effective price and the long-term price defined by the Committee of Experts.
- Adjustment of projected income from CODELCO on account of molybdenum, net of production costs, adjusting the company's volume of sales for the difference between the projected effective price and the estimated long-term price.
- Estimation of total structural fiscal income as the sum of revenues previously adjusted for cyclical variations.
- Calculation on the basis of structural income of the level of expenditure compatible with the structural balance target.

2.3. Recent methodological improvements

Since Chile's adoption of the structural balance policy, the way in which the indicator is calculated as well as the definition of key parameters and assumptions have been made increasingly transparent, the disclosure of information to the public has been improved, and the methodology has been refined.

The first improvements were introduced in 2004 with the migration of Chile's fiscal accounts to the methodology suggested by the IMF (IMF, 2001), adopting an accruals-based system instead of the cash-based system that had been used until then. This made it possible to use the official fiscal accounts published by the Ministry of Finance's Budget Office (*Dirección de Presupuestos*, DIPRES) to calculate the structural balance, rather than making the intermediate adjustments to cash-based data that were required under the original methodology (Marcel *et al.*, 2001). Subsequently, in September 2005, specific cyclical corrections were introduced for tax revenue from private mining companies, which had previously been adjusted in the same way as other tax income rather than on the basis of the copper price. In 2006, a cyclical correction was introduced for income from CODELCO's molybdenum sales which had until then been treated as part of income from copper. And in January 2007, a cyclical correction was introduced for the revenues from the additional tax payments made by foreign-owned mining companies on profits remittances.

2.3.1. Non-mining tax revenue

Cyclical adjustment to non-mining tax revenue is made using the original methodology – that is, on the basis of the gap between effective and trend GDP. However, as from 2005, a distinction has been made between tax revenue from the ten largest mining companies and that from other taxpayers so as to be able to correct the former for the cyclical impact of the copper price as described below.

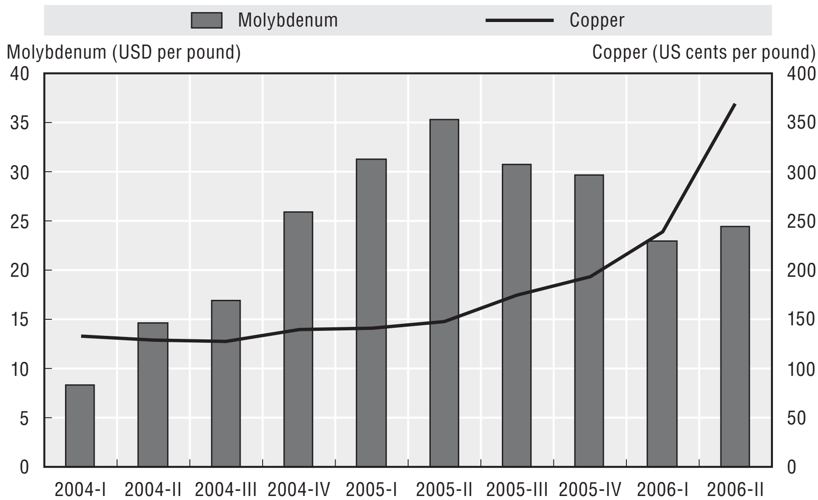
2.3.2. Income from mining

a. Income from CODELCO's gross copper sales

Structural income from CODELCO on account of copper sales is estimated adjusting the income effectively received for the gap between the effective and long-term copper price. Until 2005, no distinction was made between income from CODELCO that corresponded to copper sales and that which originated from the sales of byproducts such as molybdenum. However, under a methodological change introduced in 2006, income from the latter is now treated separately so as to be able to take account of cyclical variations in the price of molybdenum. This modification was called for both because of the high price of molybdenum and the relative weight that income from CODELCO's sales of this mineral began to acquire and because of the fact that the prices of copper and molybdenum are not totally correlated, as seen in Figure 4 for the period 2004-06.

Figure 4. **Copper and molybdenum prices, 2004-06**

Correlation coefficient (PCu, PMoly) = 0.16



Source: Calculated using figures from COCHILCO and Bloomberg.

b. Income from CODELCO's molybdenum sales

When the original structural balance methodology was designed in 2001, the price of molybdenum was 13.5 times lower than in 2005 (USD 2.4 per pound in 2001 *vs.* USD 31.7 per pound in 2005) and molybdenum sales accounted for no more than 8% of CODELCO's income. However, this situation changed radically in the latter months of 2005 when the price of molybdenum climbed to record levels, with sales reaching close to 15% of CODELCO's total income that year. This also had a decisive impact on the importance of molybdenum as a source of fiscal income received through both tax payments and the distribution of CODELCO's profits.

For the purpose of calculating the structural balance, this created the need for a cyclical adjustment reflecting the short-term deviations in the price of molybdenum with respect to its long-term trend. Introducing an adjustment of this type in calculating the structural balance is analogous to the cyclical adjustment made to CODELCO's copper sales. It involves identifying income from molybdenum that corresponds to a trend price and isolating the cyclical effect that can mean higher or lower effective income. The cyclical adjustment to income from CODELCO's molybdenum sales can be expressed as follows:

(2) $ICM_t = VFM_t * (PM_t - PREF_t) * 2\,204.62$

where:

ICM_t = cyclical income from molybdenum in period t (in USD)

VFM_t	= volume of CODELCO's molybdenum sales in period t (in tonnes)
PM_t	= average price of CODELCO's molybdenum sales in period t (USD per pound)
$PREF_t$	= trend or long-term molybdenum price in period t (USD per pound)
2 204.62	= pounds per tonne converter

This adjustment is simple in operative terms, but the key issue is determining the long-term price of molybdenum. In the case of copper, the original methodology envisages consultation with a committee of experts. In the absence of such a committee for the price of molybdenum, a mechanism that combines historic criteria with the opinion of experts has been used. In this way, a long-term price of USD 12 per pound was established in 2006, similar to the average monthly price for the previous four years. Using this same methodology for the estimation of the structural balance in 2007, a long-term price of USD 14.7 per pound was obtained.

c. Tax revenue from private mining companies

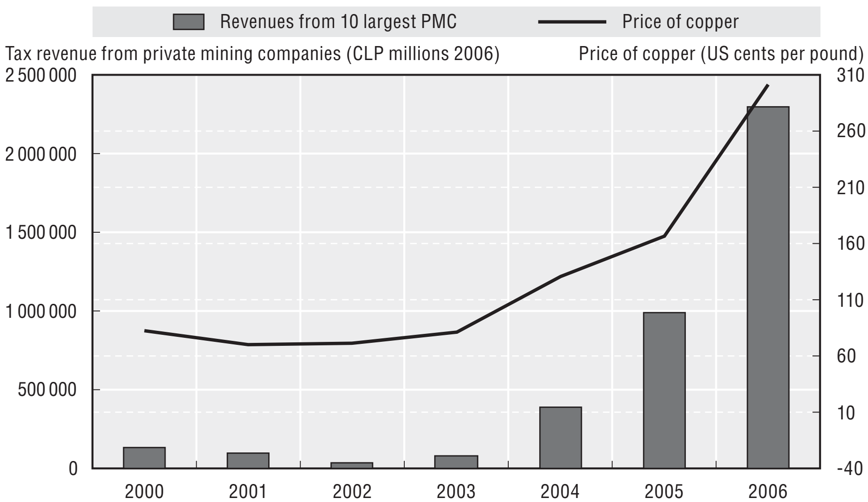
The original methodology for calculating the structural balance was reasonably successful in capturing the effect on fiscal income of cyclical variations in economic activity and the copper price through to 2004. However, a new link between the economic cycle and fiscal income then began to gain importance as most of the large investments carried out by private mining companies in the previous decade completed their phase of accelerated depreciation and the companies' accounting profits began to be reflected in important taxable earnings. As a result, central government tax revenue from this source has grown strongly in recent years, with a rise in the net income from the earnings tax paid by the ten largest private mining companies from CLP 79 229 million in 2003 (Chilean pesos, 2006 values) to CLP 390 621 million in 2004, CLP 993 116 million in 2005 and an estimated CLP 2 999 526 million in 2006, representing an average annual real growth of 207.3% in 2003-06.

It should also be noted that, as from 2006, a new specific mining tax was introduced and, although revenue from this tax in 2006 was confined to provisional monthly payments (PPMs), it is expected to show an important increase in 2007.

This trend and the resulting increase in the relative importance of tax revenue from private mining companies made it advisable to adjust this revenue for the cyclical effect of the copper price rather than of GDP as for tax revenue in general. This is logical because the impact of the copper price on the sales and profits of these companies means that only a part of this higher revenue is structural and the rest (the part explained by the difference between the effective and long-term price of copper) corresponds to the impact of the copper price cycle on the sales, profits and tax payments of these companies. This adjustment more accurately captures the cyclical impact of tax revenue from private mining companies since, as seen in Figures 5a and 5b, this revenue shows a closer correlation with the copper price than with GDP.

Figure 5a. **Tax revenue from private mining companies and the price of copper, 2000-06**

Correlation coefficient (revenues from the ten largest PMC; PCu) = 0.95

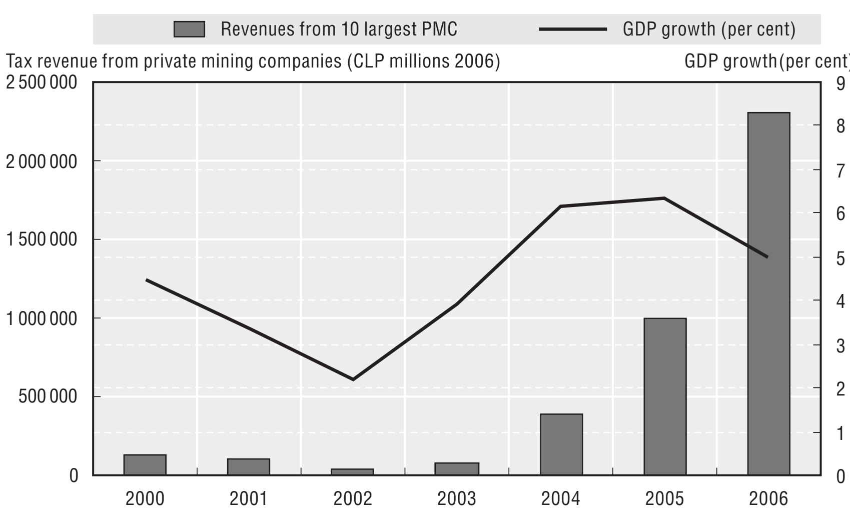


2006 = estimated.

Source: Calculated using figures from COCHILCO and DIPRES.

Figure 5b. **Tax revenue from private mining companies and GDP**

Correlation coefficient (revenues from the ten largest PMC; GDP) = 0.50



2006 = estimated.

Source: Calculated using figures from the Central Bank of Chile and DIPRES.

Therefore, the methodological improvement was designed for cyclically adjusting revenue from the earnings tax paid by private mining companies and from the specific mining tax. Like the cyclical adjustment of income from CODELCO's copper sales, both these methodologies are based on the difference between the effective copper price and the long-term price, the latter determined by the Committee of Experts.

c.1. Cyclical adjustment of earnings tax on private mining companies

The cyclical adjustment applied since 2005 to fiscal income from this source assumes that annual income from the earnings tax paid by private mining companies depends, in simple terms, on three components: *i)* the provisional monthly payments (PPMs) made in the corresponding tax year (PPM_t); *ii)* the result (positive or negative) of their annual tax return (OR_t); and *iii)* additional tax payments by foreign-owned mining companies on profits remittances (IA_t).

In other words, the methodology captures the lagged effect of the difference between the effective and long-term copper price on fiscal revenue that arises from Chile's system for payment of earnings tax. In practice, the cyclical adjustment for each year reflects the impact of the price gap on PPMs made by the companies in that year, that of the previous year's price gap on the profits they declare annually, and that of the PPMs made in the previous year on the result of their annual tax return. It should be noted that the methodology used up to December 2006 did not include cyclical adjustment of the additional tax these companies pay on profits remittances. This implicitly assumed that the profits remitted in a particular year were not a direct function of either the copper price or the economic cycle. Recent data, however, have shown a correlation between these tax receipts and the copper price. Therefore, in January 2007 a new cyclical adjustment was introduced to reflect this fact.

In line with the above, annual fiscal revenue from the earnings tax on private mining companies (R_t) can be expressed as:

(3) $R_t = PPM_t + OR_t + IA_t$

At the same time, PPMs in year t are an advance on the earnings tax that the companies will have to pay on the basis of their profits when filing their annual tax return in year t+1 and are a function of their sales in year t (expressed as $P_t{}^*Q_t$ or, in other words, of the quantity of copper sold in year t multiplied by its price) and of the tax rate applied to determine the amount of their PPMs ($Tppm_t$).

(4) $PPM_t = P_tQ_tTppm_t$

This rate, $Tppm_t$, is adjusted in May of each year to the level that would have been required in the previous year for the PPMs made by the companies to equal the amount determined on the basis of their annual tax returns. In other words, it is adjusted to the level at which advances in the form of PPMs would have exactly matched the result of their annual tax return, meaning that they would have neither had to pay tax nor received a reimbursement as a result of the annual tax collection process. This rate is then applied to PPMs as from May through to April of the following year.

The mean rate at which PPMs are made in year t is therefore a weighted average of the rate applied from January through to April (a third of the year), corresponding to $T_{(-1)}$ defined in May of the previous year, and the rate as adjusted after annual tax collection in April ($T_{(1)}$) which is applied to the sales of these companies from May through to December (two-thirds of the year). In other words, PPMs in year t can be expressed as:

(5) $$PPM_t = P_tQ_tTppm_t = P_tQ_t\left[\frac{1}{3}T_{(-1)} + \frac{2}{3}T_{(1)}\right]$$

Similarly, OR_t is the balance for or against the companies as determined in the annual tax collection process of year t, which corresponds to the difference between the earnings tax collected in year t and the PPMs made in the previous year (PPM_{t-1}). Therefore:

(6) $$OR_t = (P_{t-1}Q_{t-1} - C_{t-1})*17\% - PPM_{t-1}$$

where C_{t-1} are the unit costs in t-1 that can be imputed to taxes in the annual return of year t.

Replacing these expressions in equation (3) gives:

(7) $$R_t = P_tQ_t\left[\frac{1}{3}T_{(-1)} + \frac{2}{3}T_{(1)}\right] + (P_{t-1}Q_{t-1} - C_{t-1})\ 17\% - PPM_{t-1} + \mathrm{IA}_t$$

and analogously in equation (5):

(8) $$PPM_{t-1} = P_{t-1}Q_{t-1}\left[\frac{1}{3}T_{(-2)} + \frac{2}{3}T_{(-1)}\right]$$

where $T_{(-2)}$ is the rate at which PPMs were made in t-3 in advance of payments corresponding to the annual tax return of year t-2.

The above can be further simplified considering that:

(9) $$Tppm_t = \left[\frac{1}{3}T_{(-1)} + \frac{2}{3}T_{(1)}\right]$$

(10) $$Tppm_{t-1} = \left[\frac{1}{3}T_{(-2)} + \frac{2}{3}T_{(-1)}\right]$$

By again replacing in equation (3), fiscal revenue from taxation of private mining companies in year t can be expressed as:

(11) $$R_t = Tppm_tP_tQ_t + (P_{t-1}Q_{t-1} - C_{t-1})17\% - Tppm_{t-1}P_{t-1}Q_{t-1} + IA_t$$

A partial derivative of this equation for the price of copper (P_t) shows the effect of changes in the copper price on fiscal revenue, when other variables remain constant:

(12) $dR_t / dP_t = Tppm_t dP_t Q_t + 17\% * dp_{t-1} Q_{t-1} - Tppm_{t-1} dp_{t-1} Q_{t-1} + \partial IA_t / \partial P$

It should be noted that this result implicitly assumes that the unit costs of the previous year (C_{t-1}) are not a direct function of the price of copper, so that:

(13) $\partial C_{t-1} / \partial P_{t-1} = 0$

If the cyclical effect on the earnings tax payments by private mining companies is defined as the same as the effect that the difference between the long-term and effective copper price has on these payments, so that $\partial P_t = P_t^{ef} - P_t^{lp}$, it can be estimated as:

(14)

$$\underset{(a)}{C.Effect} = \underset{(b)}{TppmtQ_t (P^{ef}}_t \underset{(c)}{- P^{lp}}_t \underset{(d)}{)} + 17\% * Q_{t-1} (P^{ef}{}_{t-1} - P^{lp}{}_{t-1}) - Tppm_{t-1} Q_{t-1} (P^{ef}{}_{t-1} - P^{lp}{}_{t-1} + \partial IA_t / \partial P)$$

In equation (14), it can be seen that the cyclical impact of the copper price on the earnings tax paid by private mining companies in a particular year comprises four partial effects: *a)* the impact of the price gap on the companies' sales and on the PPMs they make in year t; *b)* the impact of the previous year's price gap on profits in that year as reflected in the result of their annual tax return in period t; *c)* the impact of the previous year's price gap on sales and PPMs in that year, which operates with a negative sign in their tax return in year t; and *d)* the impact of the copper's price gap on the additional tax receipt.

Regarding the additional tax receipts, it can be assumed that they depend on *i)* the additional tax rate(T_{IAt}), *ii)* the income tax rate (T_{IRt}) and *iii)* the remitted income to foreign countries before additional tax payments (REM_t). Therefore, these receipts can be described by the following equation:

(15) $IA_t = \dfrac{(T_{IAt} - T_{IR_t}) * REM_t}{(1 - T_{IR_t})}$

Defining the remitted income as a percentage ($\hat{z}$) of profits after income tax, we obtain:

(16) $IA_t = \hat{z} * (T_{IAt} - T_{IR_t}) * (P_t * Q_t - C_t)$

Assuming that for a determined period t, the expression $\hat{z} * (T_{IAt} - T_{IR_t})$ is equal to a specific α_t value[6] and applying a partial derivative of this equation with respect to the price of copper, we obtain equation (17) which shows the effects of a change in the price on the tax receipts of private mining companies' additional tax, keeping everything else constant:

(17) $dIA / dP = \alpha_t * dP * Q$

It should be noted that this result implicitly assumes that $dQ/dP = dC/dP = 0$.

Defining the cyclical effect on private mining companies' additional tax receipts as the impact made by the difference in the long-run copper price with respect to its effective price on these receipts (so that $dP = P^{Ef} - P^{LP}$), the cyclical component of the additional tax is estimated as:

(18) $dIA / dP = \alpha_t * Q^* (P^{Ef} - P^{LP})_t * TCN_t$

Therefore, replacing equation (18) in equation (14) determines the cyclical component of the income tax to private mining companies as:

$$(19)\quad C.Effect = TppmtQ_t(P^{ef}{}_t - P^{lp}{}_t) + 17\%Q_{t-1}(P^{ef}{}_{t-1} - P^{lp}{}_{t-1}) \\ - Tppm_{t-1}Q_{t-1}(P^{ef}{}_{t-1} - P^{lp}{}_{t-1} + \alpha_t * Q * (P^{Ef} - P^{LP})_t * TCN_t$$

c.2. Cyclical adjustment of revenue from the specific mining tax

As stated above, it became necessary as from 2006, when calculating the structural balance, to take account of the cyclical effect of the copper price on revenue from the specific mining tax approved in 2005. This tax is levied at a rate of 4% on the operating profits of large mining companies[7, 8] and, if it is assumed that operating costs do not depend on the copper price (an assumption equivalent to that made to determine the cyclical impact of the copper price on revenue from the earnings tax), the cyclical component of revenue from the specific tax can be calculated directly from the effect that the price gap has on copper sales and can be expressed as:

(20) $C.\ Effect\ Spec.\ Tax = 4\% * Q_t (P^{ef}{}_t - P^{lp}{}_t)$

However, it should be noted that the law established a two-year transition period for this tax (2006 and 2007) that is not reflected in the above equation, which will be valid once the tax comes into full operation. During the transition, companies are able to use 50% of specific tax payments as a credit against their annual earnings tax liabilities. As a result, both revenue and the cyclical effect of this tax are approximately 50% less than they would be were the tax in full operation, and the cyclical component of the specific mining tax during the transition period can be calculated as:[9]

$$(21)\quad C.\ Effect\ Spec.\ Tax\ in\ Trans. = \frac{4\% * Q_t(P^{ef}{}_t - P^{lp}{}_t)}{2}$$

2.4. Structural surplus target[10]

The policy target established for the structural balance indicator has been a key component of Chile's fiscal policy over the past six years. During this period, the target of an annual structural surplus equivalent to 1% of GDP was set with the aim of ensuring the accumulation of assets with which to meet future public sector commitments, including particularly the contingent liabilities generated by the guaranteed minimum pension and old-age benefit. A second argument for maintaining a surplus was the situation of the Central Bank of Chile which, at the time, was running a structural operating deficit and had a negative net worth as a result of losses arising from the bailout of the private banking system in the wake of the 1982 crisis and of its accumulation of international reserves in the 1990s. A third reason was the need to address the vulnerabilities relating to currency mismatches that can affect the cost of public debt servicing.

The presidential decree that established the principles of the government's fiscal policy for 2006-10, which were drawn up in accordance with the Fiscal Responsibility Law, stated that this target should be modified if the conditions on which it was based no longer prevail. Consistently, recent evaluations of these conditions resulted in reducing the structural surplus target for 2008 to 0.5% of GDP.[11]

3. Results and benefits of the structural balance policy after six years

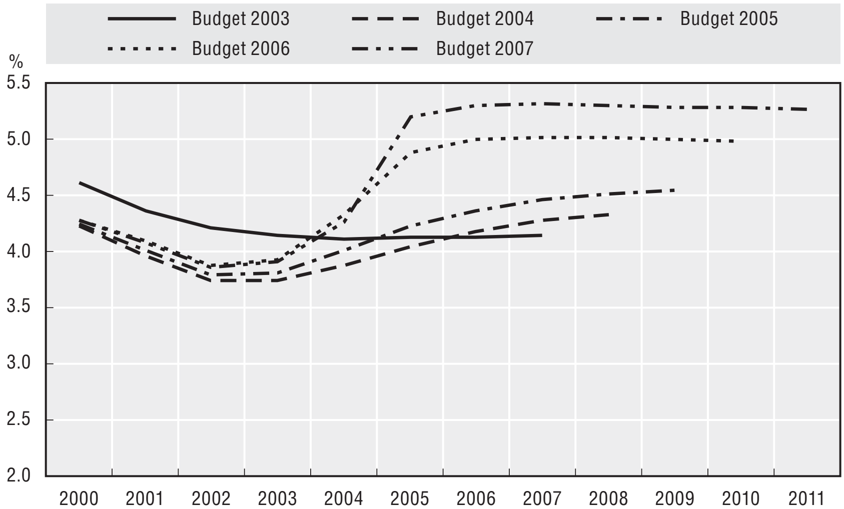
Six years after the structural balance policy was introduced in Chile, there is consensus among analysts that it has had six principal advantages. In the first place, it has permitted the implementation of a counter-cyclical policy, attenuating the economy's swings and reducing uncertainty as to its medium-term performance. Second, it has meant an increase in public saving during periods of strong growth which has, in turn, helped to prevent currency appreciation and safeguard the competitiveness of the export sector. Third, it has reduced interest rate volatility and, fourth, has boosted the Chilean government's credibility as an issuer of international debt, reducing the sovereign risk premium it has to pay, improving access to foreign financing during negative external shocks and minimising contagion from international crises. Fifth, it has also reduced the economy's need for foreign financing and, sixth, it has ensured the financial sustainability of social policies, facilitating their long-term planning.

The results in terms of the estimation of the parameters used to implement the structural balance policy and of the balance itself are presented below, along with a review of the six advantages outlined above.

3.1. Long-term and trend parameters

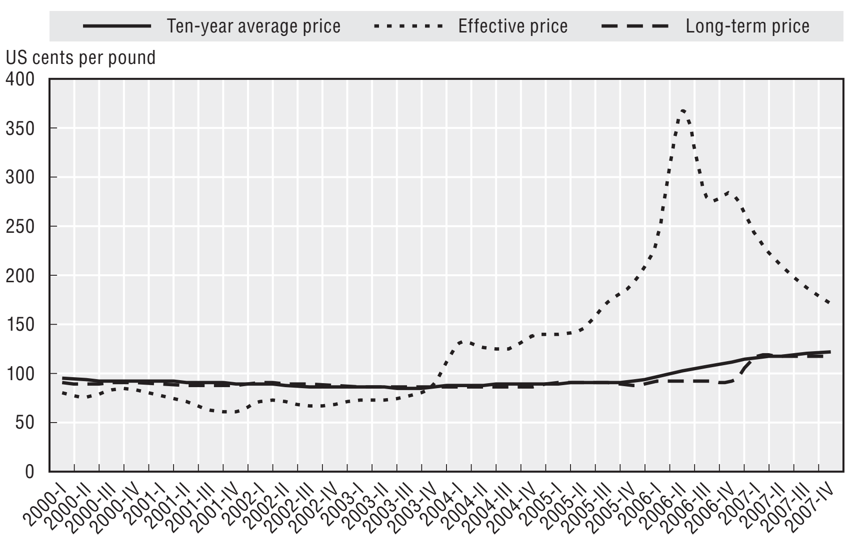
Figures 6 and 7 show how the structural parameters used to calculate the structural balance have evolved over time. Figure 6 shows the estimations of trend GDP made each year since the policy's introduction, while Figure 7 shows the effective copper price, its ten-year moving average and the long-term price since 2000. In the case of molybdenum, the first estimation of its long-term price, made in 2005, gave USD 12 per pound.[12]

Figure 6. **Trend GDP: annual review by Committee of Experts, 2001-07**



Source: DIPRES.

Figure 7. **Effective and long-term copper price, 2000-07**
(US cents per pound)



Source: Calculated using figures from COCHILCO and DIPRES.

3.2. Central government balance

The public sector budgets drawn up since the structural balance policy was introduced have adhered strictly to the pre-determined target, while the structural balances achieved at the end of each period have shown only some small differences with respect to the target.

As seen in Table 1, the average structural balance in 2001-05 was 0.9% of GDP, and the structural balance that differed most from the target was the 0.8% surplus registered in 2003, despite a spending cut of some USD 300 million, which was outweighed by the negative impact on structural fiscal income of CODELCO's decision to postpone the sale of 200 000 tonnes of copper and of the entry into force of Chile's Free Trade Agreement with the United States in January of that year.

Similarly, the average effective balance for the period during which the structural surplus rule has been in force confirms the long-term stability that this rule imposes on fiscal management. Now that the rule has been in operation virtually over a full cycle, it can be seen that, in the medium term, the average effective balance and the structural target tend to converge.

Table 1. **Central government balance, 2001-05**
(per cent of GDP)

	Effective (reported in June of the following year)	Cyclical component	Structural
2001	–0.6	–1.5	0.9
2002	–1.2	–2.0	0.9
2003	–0.6	–1.4	0.8
2004	2.2	1.1	1.0
2005	4.7	3.7	1.0
Average 2001-05	0.9	0.0	0.9

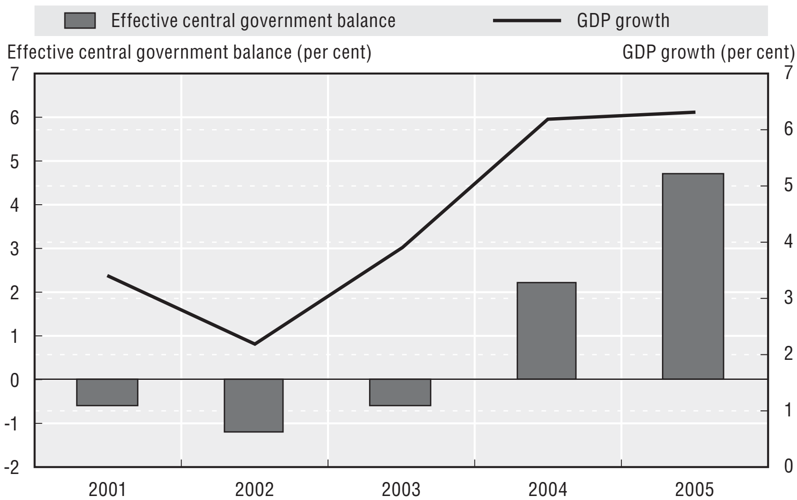
Source: DIPRES.

3.3. Most significant benefits

3.3.1. Counter-cyclical policy

The structural balance policy is intrinsically counter-cyclical in that it permits fiscal deficits when the economy is performing significantly below potential and surpluses when the opposite is the case. In this way, it serves to attenuate both the economy's highs as well as its lows. As can be seen in Figure 8, this is precisely what occurred in 2001-05, helping to reduce uncertainty as to the economy's medium-term performance with the resulting positive impact on productive investment and the welfare of the population.[13]

Figure 8. **GDP growth and effective central government balance,**[1] **2001-05**
(per cent variation and per cent of GDP)



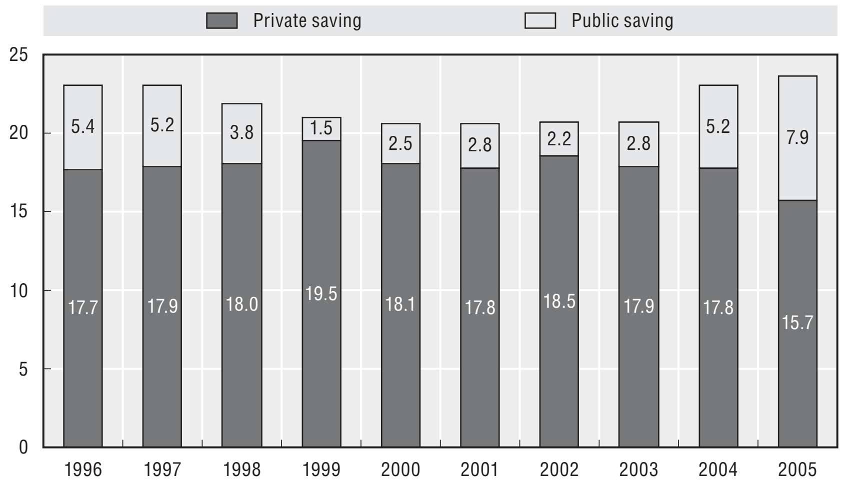
1. Reported in June of the following year.
Sources: DIPRES and Central Bank of Chile.

3.3.2. Export competitiveness

The counter-cyclical nature of Chile's fiscal policy has had a stabilising effect not only because it has enabled the government to maintain and increase spending in recessive conditions but also because it has implied the saving of fiscal income arising from a temporary boom. In fact, as shown in Figure 9, public saving in recent years has meant an increase in gross national saving as a percentage of GDP, taking it to, and even above, levels similar to those seen in 1996 and 1997. Most importantly, this occurred despite the fact that private saving remained relatively stable and even decreased a little as a percentage of GDP.

By helping to prevent appreciation of the currency in real terms, this increase in public saving during boom periods has safeguarded the competitiveness of the export sector. This was the case because public spending is intensive in non-tradable goods, putting upward pressure on their relative price which is, in turn, reflected in real currency appreciation.[14] In addition, when public saving is low, an increase in interest rates for the purpose of keeping inflation under control is more likely, prompting an inflow of capital and, therefore, an additional real strengthening of the currency. The structural balance policy and the public saving it implies during boom periods prevent cycles of this type and their potentially damaging effects on competitiveness.

Figure 9. **Gross national saving, public and private, 1996-2005**
(per cent of GDP)



Source: Calculated using figures from the Central Bank of Chile and DIPRES.

3.3.3. Interest and exchange rate volatility

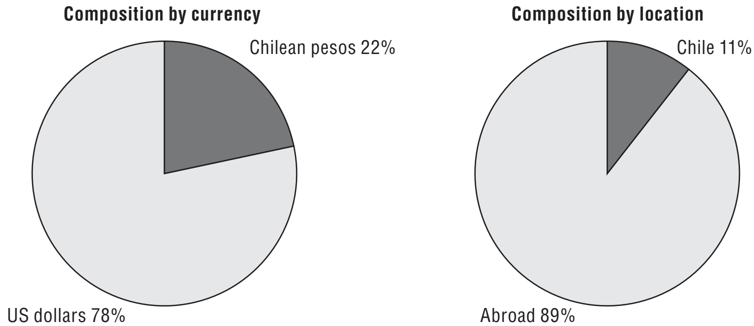
The portfolio management of fiscal assets has significant macroeconomic and financial consequences, particularly when the level of public saving is high. Financial market imperfections, asymmetries in access to information and different perceptions of risk make the currency in which public saving is held important because this affects interest rates and the exchange rate. If, for example, in boom periods with a high level of cyclical fiscal income, public saving is held domestically in local currency, this can generate downward pressure on the premiums associated with some financial instruments as well as pressure for currency appreciation.

However, despite the high level of public saving, these pressures have not been seen, and expectations as to the behaviour of interest rates and the exchange rate have been more stable than in the past. Indeed, one of the latest surveys of expectations carried out by the Central Bank found that a 3% depreciation over one year and 7% over two years were anticipated, indicating the absence of the abrupt changes that create a far more complicated macroeconomic situation.[15]

The paramount factor here was the government's portfolio management. As the Ministry of Finance has periodically reported since April 2006[16] and as shown in Figure 10, the assets accumulated as a result of high copper prices have mostly been held abroad and in foreign currency, helping to avoid pressure for currency appreciation.

Figure 10. **Fiscal financial assets**

Composition by currency and location, as of 30 September 2006



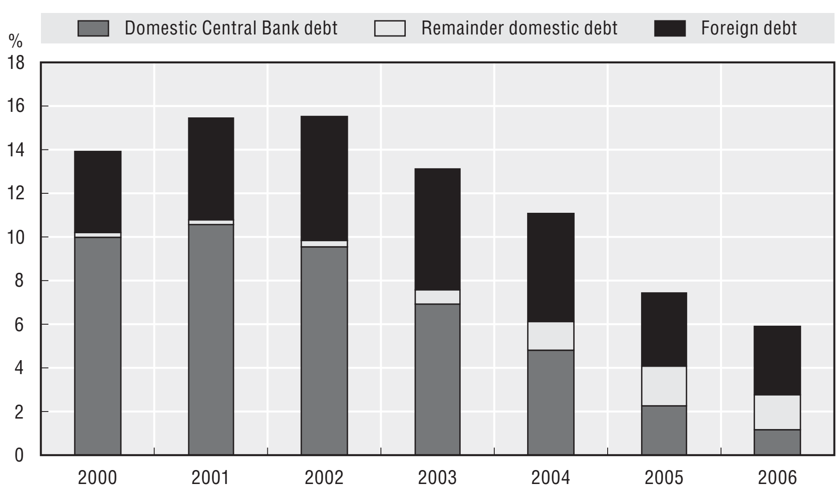
Source: DIPRES (2006b).

3.3.4. Government credibility as an issuer of international debt

From the point of view of the central government's financial situation, the structural surplus rule has meant a drop both in borrowing and in its cost. Thanks in part to the fiscal surpluses of recent years, it has been possible to prepay earlier borrowing and, despite adverse phases of the economic cycle (2001 and 2002), new borrowing has not been necessary, leading to a sustained reduction in debt level (Figure 11). In addition, fiscal discipline has made an important contribution to the drop in Chile's country risk (Figures 12, 13a and

Figure 11. **Gross central government debt, 2000-06**

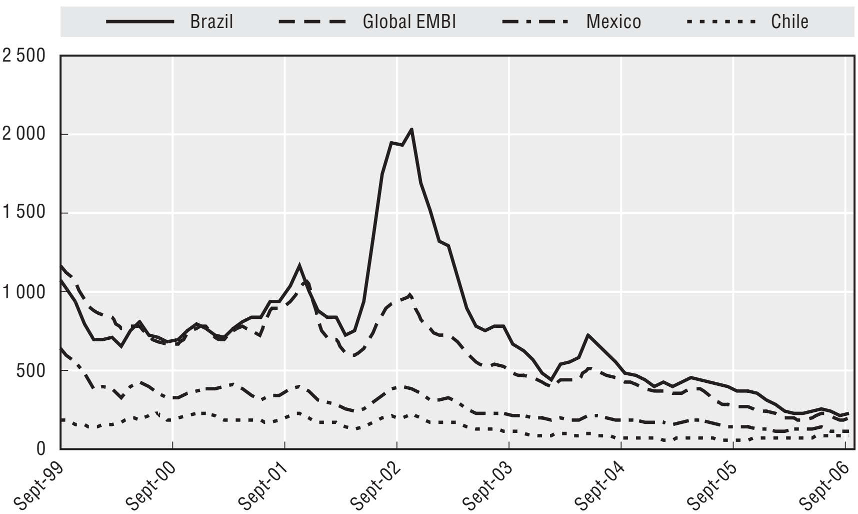
(per cent of GDP)



2006 = estimated.

Source: Ministry of Finance of Chile.

Figure 12. **Sovereign spreads: Chile and emerging economies, September 1999-September 2006 (basis points)**



Source: Ministry of Finance of Chile (2006).

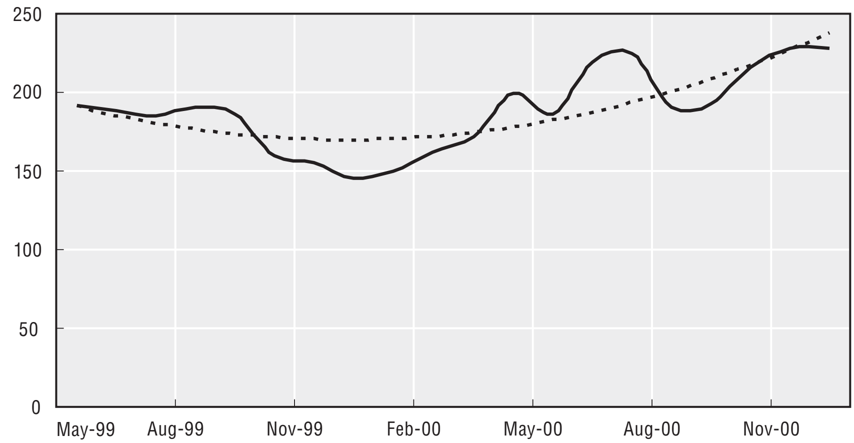
13b) and the interest rate on public sector liabilities and, therefore, expenditure on interest payments have dropped in recent years (Figure 14).

Figure 12 shows the evolution of Chile's sovereign risk as compared to the average for emerging economies (EMBI) and compared to Brazil and Mexico in the period from September 1999 to September 2006. In addition to being well below that of other economies, Chile's sovereign risk has, even more importantly, remained low throughout the period despite the shock to emerging economies' sovereign spread that resulted from the 11 September 2001 terrorist attacks and the Argentine crisis and moratorium of mid-2002. In the wake of these events, the sovereign spreads of emerging economies climbed sharply, particularly in the case of Brazil.

In this context, the evolution of Chile's country risk goes beyond the effect of the reduction in its borrowing level and suggests that its structural balance policy also had an impact by increasing the credibility of its fiscal policy (Lefort, 2006). An analysis of Chile's country risk before and after the introduction of the rule also indicates that this may have been the case. As shown in Figure 13a, the trend in Chile's country risk was upwards, or at least not downwards, before the announcement of the structural surplus rule but, as shown in Figure 13b, the trend started to move downwards once the rule came into operation.

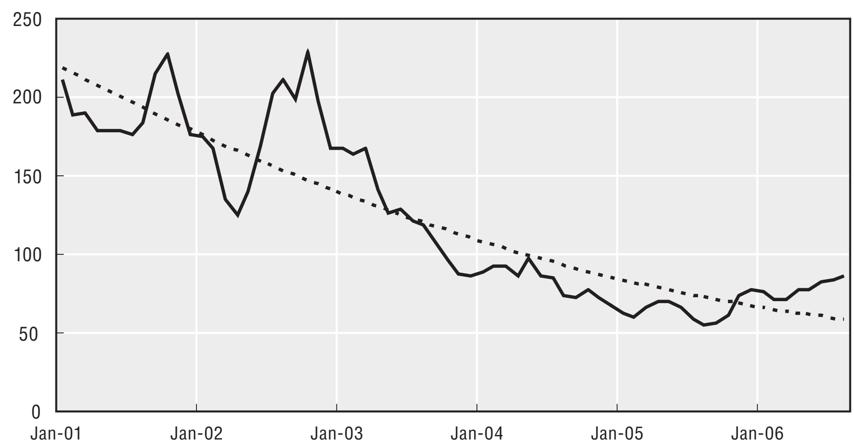
As mentioned above, gross central government debt showed an important decrease between 2004 and 2006. Together with sustained efforts to

Figure 13a. **Chile sovereign spread before the structural balance policy, May 1999-December 2000 (basis points)**



Source: Calculated using figures from JPMorgan.

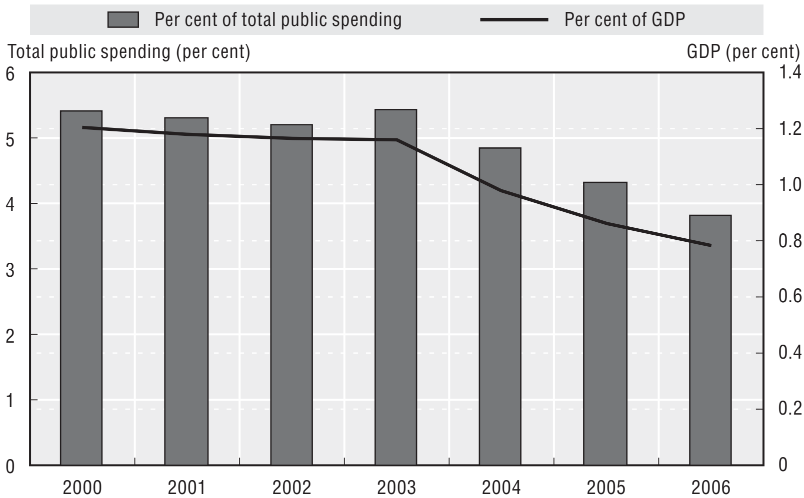
Figure 13b. **Chile sovereign spread after the structural balance policy, January 2001-August 2006 (basis points)**



Source: Calculated using figures from JPMorgan.

take advantage of improved financial market access to prepay earlier borrowing made at higher interest rates, this meant a sharp reduction in central government expenditure on debt servicing as from 2004 (Figure 14). Moreover, expenditure on interest payments as a percentage of GDP and of total public spending held steady between 2000 and 2003 despite an increase in gross debt during this period as a result of the access to better borrowing terms.

Figure 14. **Central government interest payments, 2000-06**



2006 = estimated.

Source: Calculated using figures from the Central Bank of Chile and DIPRES.

In other words, the increase in the credibility of the Chilean government as an issuer of international debt has reduced the sovereign premium it has to pay while, at the same time, reducing the effect of financial contagion from other countries in the region (as was very clear in the case of the Argentine exchange rate crisis of 2002). This has improved access to foreign financing during negative external shocks and reduced the borrowing costs of Chilean companies that issue international debt, for whom the country's sovereign debt serves as a benchmark.

3.3.5. *Dependence on external financing*

The structural balance policy has also helped to reduce the Chilean economy's dependence on external financing, which is an advantage given that this has historically been a volatile source of resources. This reduced dependence is a result of the policy's counter-cyclical nature and its capacity to boost public saving. At the same time, because it led to a reduction in the cost of foreign borrowing, the structural balance policy also meant that, when foreign borrowing was required, it could be obtained on far more favourable terms than when Chile's dependence on this source of financing was greater.

This advantage is clear when the effects of the 1982 crisis are compared with those of the crisis that occurred in 2001 under the structural balance policy. In both cases, as seen in the External Conditions Index (ICE) shown in Table 2, Chile faced adverse external conditions, but the impact in terms of access to financing was very different. A year after the 1982 crisis, the inflow of foreign capital showed a drop of 69%, while a year after the 2001 crisis, the reduction, although important, was significantly smaller. In the former case, this resulted in a 13.2% contraction of public investment in 1983 whereas, in 2002, it expanded by 7.8%, due – among other reasons – to the fact that the public sector had access to external financing at low interest rates.

Table 2. **External crises and foreign financing**

Variable	1982-83	2001-02
ICE[1]	–4.0	–5.1
Incoming foreign investment	–69%	–39%
Public investment (real growth)	–13.2%	7.8%

1. The External Conditions Index (ICE) is expressed as a percentage of GDP and reflects the effects of changes in terms of trade, export volumes and capital inflows.

Source: Calculated using figures from the Ministry of Finance and the Central Bank of Chile.

3.3.6. Financial sustainability of public policies[17]

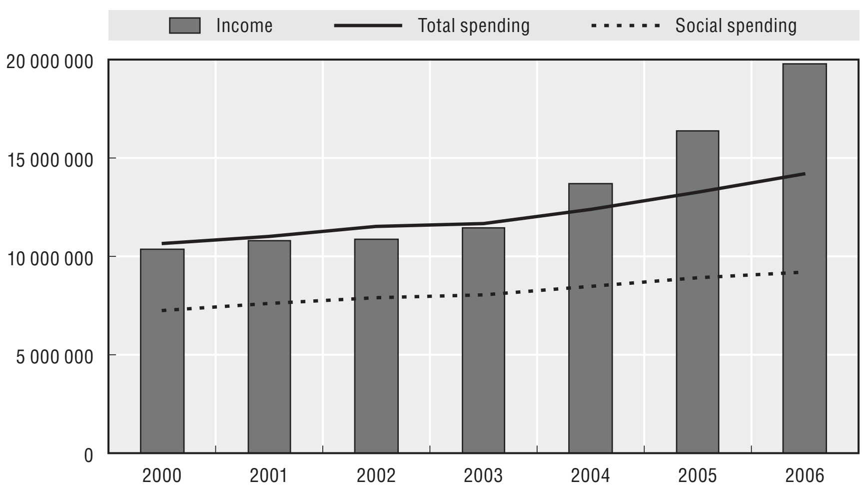
Finally, the sixth advantage of the structural balance policy is that it has made it possible to ensure the financial sustainability of public policies, permitting the long-term planning of social programmes. In this context, it is important to remember that, as a small and open economy, Chile is exposed to sporadic and often unpredictable events that affect its economic performance. Historically, events outside Chile's control have affected the welfare of its citizens because the country, in general, and the government, in particular, have had to adjust their level of investment and consumption in line with economic conditions.

One clear instance of this phenomenon occurred in the wake of the crisis of the mid 1980s, with social spending dropping from 15.7% of GDP in 1987 to 12.7% in 1990. However, since the structural balance policy was introduced, traumatic economic adjustments have not been required and, for example, in 2002, public spending was not drastically affected despite the fact that economic growth reached only 2.2% and copper was running at just USD 0.70 per pound.[18] In the absence of the structural balance rule, this scenario would have meant only minimal growth, or even a freeze, of public spending. However, although fiscal income rose by only 0.7%, total spending increased by 4.2% and social spending by 3.8% without producing macroeconomic imbalances, an increase in country risk or an increase in economic volatility, any of which would, in the medium term, have meant a negative impact on the population.

In the framework of the structural balance rule, the greater sustainability of public spending is a consequence of tying it to structural rather than effective income, which is far more volatile. In the period 2000-06, structural income expanded at an average annual rate of 5.8%, with a standard deviation of 2.5% and a minimum and maximum of 2.4% and 7.7%, respectively. By comparison, the average annual expansion of effective income in this period was 11.4%, but with a standard deviation of 9.2% and a minimum and maximum of 0.7% and 20.7%, respectively.

As a result, despite cyclical fluctuations in effective income, spending expanded steadily at an average annual rate of 4.9%, with a standard deviation of 2.2% and a minimum and maximum of 1.6% and 7.4%, while social spending rose at an average annual rate of 4.6%, with a standard deviation of 1.3% and a minimum and maximum of 2.2% and 5.8%. This indicates that the structural balance policy has served as a mechanism that stabilises public spending in that, as seen in Figure 15, spending has fluctuated less than income.

Figure 15. **Central government income and spending, 2000-06**
(CLP millions 2006)



2006 = estimated.
Source: DIPRES.

A similar conclusion is reached if central government spending is examined over a longer period. By measuring spending volatility as the gap between its effective level and trend level[19] (Table 3), it can be seen that, in the period 1970-2000, the average gap had an absolute value of 5.7%, reaching 7.1% in 1980-89 and 3.1% in 1990-99. By comparison, in the period 2000-05, under the structural balance policy, the average gap had an absolute value of just 2.2%.

Table 3. **Index of volatility of central government spending,**[1] **1970-2005**

Period	Volatility index
1970-89	7.1%
1990-99	3.1%
1970-99	5.7%
2000-05	2.2%

1. This index measures the average as the absolute value of the deviation of spending from its trend level, obtained through a trend regression of the data of the respective sample for each period.

Source: DIPRES (2006a).

A further way in which the structural balance policy contributes to the financial sustainability of public policies is through the protection it provides from the effects of external crises and, therefore, the lower probability that a drastic adjustment will be required. This stabilising impact of the structural balance policy can be seen when comparing the effects of the external shocks of 1982 and 2001. As shown in Table 4, these shocks were of similar magnitude but, in the period in which the structural balance policy has been in force, the economy continued to expand at a mean rate of 2.8% compared with an average GDP contraction of 8.2% in the period in which the policy was not in use. Similarly, in the former case, unemployment did not exceed 10% of the labour force while, in the latter, it reached over 20%. In addition, after the shock of 2001, public spending increased by 1.9% whereas, after the 1982 crisis, it contracted by 4.0%.

Table 4. **Macroeconomic results: external crises and fiscal policy**

Variable	1982-83	2001-02
ICE[1]	–4.0	–5.1
Variation in GDP[2]	–8.2%	2.8%
Average unemployment	20.4%	9.0%
Variation in public spending[2]	–4.0%	1.9%

1. The External Conditions Index (ICE) is expressed as a percentage of GDP and reflects the effects of changes in terms of trade, export volumes and capital inflows.
2. In the year following the respective crisis.

Source: Calculated using figures from the Ministry of Finance, the Central Bank of Chile and DIPRES.

However, the effect of the structural balance policy on the financial sustainability of public policies is not only due to the fact that it anchors public spending to the behaviour of structural fiscal income – a more stable and sustainable variable than effective income – and provides protection from external crises. It is also the result of the reallocation of public resources previously devoted to debt servicing and of the generation of additional income in the form of earnings on public savings.

Both the savings on debt servicing and this additional income can be used to finance social programmes and investments that stimulate economic growth. This can be clearly illustrated by comparing the fiscal budgets of 1991 and 2007. These are similar in that they represent the largest expansion of public spending since 1990 (8.9% in both cases) but, while in 1991, 14% of public spending corresponded to interest payments on debt, in 2007 this figure will be less than 2%. This important reduction in interest payments has allowed the reallocation of resources, which ultimately has meant that a greater percentage of the budget can be devoted to social spending. In fact, it is projected that in 2007 social spending will represent 68% of total public spending as compared to 62% in 1991.[20]

4. Institutionalisation of the structural balance in the framework of the Fiscal Responsibility Law

In view of the positive results of the voluntary application of the structural balance methodology and the consensus as to its advantages, the government presented a bill to Congress in September 2005 to institutionalise key aspects of the structural surplus and fiscal policy that previously depended exclusively on administrative decisions and the will of the authority. This bill, approved by Congress as the Fiscal Responsibility Law (Law No. 20.128), came into force in August 2006, reinforcing both the credibility achieved through the implementation of a disciplined and responsible policy as well as the policy's transparency.

It is important to highlight the wide and transversal support that this legal initiative received. It not only indicated that the policy's benefits are perceived and valued by a broad spectrum of opinion, but also demonstrated the responsible attitude of members of Congress and other politicians, the majority of whom considered that a further advance in fiscal discipline was appropriate.

The Fiscal Responsibility Law was envisaged in the Letter of Agreement, signed by the Ministry of Finance and Congress, as part of the process of approval of the 2005 budget. In addition, it drew on recommendations made by organisations such as the International Monetary Fund, the Inter-American Development Bank, the World Bank and the OECD as regards best international practices on fiscal responsibility and transparency.

In terms of the structural balance policy, the most important aspects of the Fiscal Responsibility Law are described below.

4.1. Establishment of principles of fiscal policy

Under the law, the President is obliged to establish the principles of the administration's fiscal policy within 90 days of taking office and to expressly declare the implications this will have for the structural balance. In line with this requirement, a decree was published on 29 November 2006 setting out the principles of the fiscal policy of President Michelle Bachelet's government.

4.2. Annual calculation of structural balance

The law also requires governments to provide information about the structural situation of public finances, reflecting the sustainability of the fiscal policy to be implemented and the macroeconomic and financial implications of their budget policy. The calculation of the public sector structural balance has, therefore, become an obligatory part of the programming of fiscal finances.

4.3. Contingent liabilities

Under the law, the state administration must disclose information about the undertakings it has entered into through fiscal guarantees, with the Budget Office (*Dirección de Presupuestos*, DIPRES) reporting annually on the total amount and nature of the liabilities for which a state guarantee has been provided. This information is important because these contingent liabilities are one of the factors currently considered in establishing the exact structural balance target.

4.4. Pension Reserve Fund

The law created a Pension Reserve Fund (FRP) against the future increase in expenditure on state-financed minimum pensions and old-age benefits. This fund seeks to spread over time the financial burden that these liabilities will involve for the state and, at the same time, to clarify and explicitly incorporate this responsibility, which is another of the factors currently considered in establishing the exact structural balance target.

For the FRP, the law established a contribution equivalent to the previous year's effective fiscal surplus, with an upper limit of 0.5% of GDP and a guaranteed minimum of 0.2% of GDP. Over the first ten years of its life, the fund cannot be drawn upon and can thereafter be used to finance up to a third of the increase in total expenditure each year on guaranteed pensions and old-age benefits as compared to total expenditure on these items in 2015. It is foreseen that the fund will be exhausted 15 years after the Fiscal Responsibility Law came into force, providing that, as assumed, withdrawals from the fund in a calendar year do not exceed 5% of the expenditure on minimum pensions and old-age benefits envisaged in the budget for that year.

With regards to the FRP's assets, which can be held in local or foreign currency, the law establishes that they may be invested in Chile or abroad in the same asset classes permitted for private pension funds, with the exception of shares. Portfolio management services for the FRP must be put out to public tender although, if the Ministry of Finance so decides, investments can also be made by the Treasury Service.

4.5. Economic and Social Stabilisation Fund

The law authorised the government to set up an Economic and Social Stabilisation Fund (FEES) to absorb the existing Copper Income Stabilisation Funds (created by Decree Law No. 3.653 of 1981 and by BIRF Loan Agreement No. 2625 CH), establishing norms for the operation and management of this fund, contributions and other matters. The FEES is designed mainly to serve as a complement to the fiscal rule based on the structural balance and to provide the government with a stable financial horizon by ensuring that part of fiscal surpluses are saved to finance the budget when it shows a deficit. In this way, the fund will serve to insulate social spending from the swings of the economic cycle and of the prices of copper and molybdenum, while harnessing public saving to the strengthening of the Chilean economy's competitiveness.

4.6. Capitalisation of the Chilean Central Bank

As a third use for fiscal surpluses, the law authorised the government, represented by the Ministry of Finance, to capitalise the Central Bank of Chile, using for this purpose part of the previous year's effective surplus up to an annual amount equivalent to 0.5% of GDP for a period of five years. In the third year after the law's entry into force, the Ministry of Finance must commission an economic and financial study of the impact of this capitalisation on the Central Bank's projected balance sheet over a period of 20 years. This is important because the negative net worth of the Central Bank is one of the factors currently considered in establishing the exact structural balance target.

Under the law, payments to the Central Bank are determined by the government, but cannot exceed the effective fiscal surplus that remains once the government has complied with its contribution to the FRP. In other words, the FRP has priority over other possible uses of the previous year's effective surplus. The remainder of the effective surplus, not used either for the FRP or to capitalise the Central Bank, can be paid into the FEES.

4.7. Investment portfolio

The law sets out general norms as to the powers of the Ministry of Finance to invest the assets held in these new funds and other fiscal assets. In line with the terms of the FRP, the law establishes that portfolio managers will be hired for the FEES or, if the Ministry of Finance so decides, investments may be made directly by the Treasury Service. In addition, the Ministry of Finance is also empowered to entrust management of part or all of these resources to the Central Bank which may manage them either directly or, following a tender, through third parties.

If the Ministry of Finance uses third parties for portfolio management or for some of the operations associated with the administration of these financial assets, it must periodically commission independent audits of the state of the funds and their management by these third parties. In addition, the law requires that the Ministry of Finance publish quarterly reports about the state of these funds.

Similarly, the law requires the creation of a Financial Committee to advise the Ministry of Finance on decisions regarding the investment of fiscal resources and the instructions it issues.

4.8. Management of public sector assets and liabilities, information on evaluation, and identification of investment projects

The law contains norms designed to improve the management of the public sector's assets and liabilities: 1) it made permanent a norm that had been incorporated into the budget law on an annual basis regulating operations which commit the government to future payments and, therefore, affect institutional financial responsibilities and those of the state as a whole; and 2) it introduced a norm empowering the Ministry of National Property to charge for the use of properties it manages in order to reflect the real institutional cost of their use and promote the more efficient use of state properties. The law also includes new norms for the homologation of information and evaluation systems that refer to investment projects.

4.9. Unemployment contingency programme

The Anti-unemployment Contingency Programme, which previously required annual approval under the budget law, became permanent with the law establishing its objective, conditions and financing in order to put the government in a position to address possible problems of high unemployment at a national, regional or local level. In practice, the programme can be activated whenever the conditions established by the law are met – that is, when the national three-month rolling average unemployment rate, measured by the National Statistics Institute (INE), exceeds its average for the previous five months, or when it reaches at least 10%. In addition, the programme can be activated when these conditions are not met but unemployment reaches at least 10% in one or more regions or specific provinces, in which case its resources can be used in those localities of the region or province with the highest unemployment rates, or when unemployment reaches at least 10% in a specific locality even though the rate for the corresponding region or province is less than 10%.

5. Concluding remarks

The transparent and rigorous use of the structural surplus rule in drawing up and implementing the government budget, as a public and credible commitment, has consolidated the principles of fiscal prudence, macroeconomic consistency and harnessing public finances to the service of the country's citizens. The entry into force of the Fiscal Responsibility Law represents a further step in the institutionalisation of key aspects of the structural balance and fiscal policy, reflecting widespread consensus as to the benefits of the fiscal rule.

This consensus arises from the fact that, during the six years it has been in use, the structural balance rule has proved to have a number of advantages. It has permitted the implementation of a counter-cyclical policy, attenuating the swings of the economy and reducing uncertainty as to its medium-term performance. It has meant an increase in public saving during boom periods, thereby helping to prevent currency appreciation and to safeguard the competitiveness of the export sector. In addition, it has reduced interest rate volatility and increased the Chilean government's credibility as an issuer of international debt, reducing the sovereign premium it has to pay, improving access to foreign financing in the face of negative external shocks and minimising contagion from international crises. Moreover, it has ensured the financial sustainability of public policies, facilitating their long-term planning.

These auspicious results are not, however, an argument for not continuing to refine the structural balance policy as, in fact, has been happening since it was introduced. In this period, the way in which the indicator is calculated and key parameters and assumptions are defined has been made increasingly transparent, the disclosure of information to the public has been improved, and the methodology has been refined. This practice of constant improvement must be maintained in the future and, as has been the case until now, must be based on technical criteria. In this context, the key current challenge is the practical implementation of the structural balance's institutionalisation under the Fiscal Responsibility Law. This law introduced a series of elements that must be taken into account when defining the specific structural balance target, in addition to the permanent challenge of assessing the real fiscal risk factors that affect this decision, as was done in the choice of modifying it for the 2008 budget.

Finally, there are a number of methodological challenges that need to be addressed. These include the determination of the best methodology for estimating the long-term price of molybdenum, a study of the correlation between the costs of mining companies and the copper price to determine whether these also require cyclical correction, and an assessment of the difference between the accrued and cash-based effects of cyclical and structural tax revenue.

Notes

1. For a more detailed statistical analysis of this relationship, see Chapter VII of DIPRES (2004).
2. The report of this committee for the 2006 budget can be found in Appendix I of DIPRES (2006a).
3. The report of this committee for the 2006 budget can be found in Appendix II of DIPRES (2006a).
4. In order to obtain these values, it is necessary to project the relevant variables that serve as inputs to this function. These are gross fixed capital formation (*K*), the labour force (*L*) and total factor productivity (*A*).
5. A distinction between revenue from mining and non-mining taxes was introduced in 2005.
6. Observed values of $\hat{z}$, T_{IA}, and T_{IR} are used for this purpose.
7. This is the rate consistent with the nature and size of the country's ten largest mining companies, given that the law distinguishes between sales brackets.
8. It should be noted that this rate does include an adjustment to take account of the fact that this tax is considered expenditure for the purpose of determining the earnings tax.
9. In this case, there is also a lag between payment of the specific tax and use of this credit. However, given the relatively low weight of this tax as a proportion of total tax revenue (0.4% in 2006), the estimation of its cyclical impact has been simplified by including both effects in the same year.
10. This section is based on Ministry of Finance of Chile (2006).
11. For further details see Velasco *et al.* (2007) and Engel *et al.* (2007).
12. In drawing up the budget for 2007, a long-term copper price of USD 1.21 per pound, trend GDP growth of 5.3% and a long-term molybdenum price of USD 14.7 per pound were used.
13. Larraín and Parro (2006) estimate that the introduction of the structural balance policy made it possible to reduce the volatility of GDP growth by between 32% and 33% in 2001-05.
14. García and Restrepo (2006) simulated the general equilibrium for an economy which exports a partially state-controlled commodity and applies a fiscal rule similar to the one used in Chile. They found that, in the case of a temporary positive shock in the commodity's price, most of the real currency appreciation and drop in exports that occur without the fiscal rule are avoided when it is used.
15. For more details, see De Gregorio (2006).
16. For more details, see DIPRES (2006b).
17. For a more detailed discussion, see Rodríguez C. (2006).

18. By comparison, the 2007 public sector budget was drawn up using an estimated copper price of USD 2.05 per pound.
19. This exercise is described in more detail in DIPRES (2006a).
20. In terms of resources, the 2007 budget represents an 11.2% expansion of social spending, the largest of the last 20 years.

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Integrating Current and Development Budgets: A Four-Dimensional Process

by
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For most developing and transition countries, the integration of current and capital (or "development") budgets is a major step towards improved budget management and more effective public finance institutions. Moving to a unified budget, however, can be a technically and managerially demanding task that involves legislative, institutional, budget presentation and expenditure management issues. Countries undertaking this step need to understand each of these dimensions, how they interact with each other, and how they may affect various aspects of the budget system.

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1. Introduction

Effective integration of current and development budgets is one of the hallmarks of a developed budgetary system. For this reason, presenting an integrated (or "unified") government budget is commonly recommended by international financial institutions as a priority task for improving resource allocation and public financial management in most developing, transition and post-conflict countries.

Although the integration of the current and development budgets is sound in principle and seldom controversial, this step is often more complex in practice than is widely understood. Recommendations to governments to proceed down this path are often made without clear guidance on how and where to begin. Moreover, integration is often proposed without recognising particular institutional and policy constraints in a government's budgeting system or without reference to the capabilities of their public finance officials for managing this important reform. For all of these reasons, the process of achieving full budget integration often proceeds more slowly and with greater difficulty than expected.

This article aims to assist governments and public finance managers in understanding the process and requirements for budgetary integration.[1] It starts by discussing how and why separate current and capital budgets have evolved and what is meant by their integration. It then describes the various "dimensions" of this task as it applies to most developing administrations. This includes identifying a number of interrelated steps and potential challenges which will need to be addressed in achieving full and successful transition to a unified budget.[2]

2. The origins of separate budgets

For many countries, separate current and capital budgets – *i.e.* a "dual budget" process – have their origins in the public financial management policies and structures established by colonial administrations. These administrations distinguished clearly between the recurring operational costs involved in maintaining a narrow range of government services and the "developmental" expenditures needed from time to time to establish new facilities or new administrative functions. Limitations on local revenue-raising capacities meant that approval for major capital expenditures often required special budgetary provisions including referral to the home treasury or supervising colonial authority.

Dual budgeting did not disappear, however, with the departing colonial administrations. The continued separation of current and development budgets also appealed to the new administrations in that it enabled them to separate the ongoing costs of government – and the associated raising of current revenues – with ambitious new development plans and their associated financing needs. Development assistance donors have reinforced this separation over time through their traditional preference for funding of "development" activities, while at the same time shying away from the "consumption spending" usually associated with current expenditures. This traditional view of current expenditures as being of lesser economic importance, or merit, has diminished in recent years, especially within the multilateral institutions, though it is still evident in the chronic underfunding of some government services relative to more easily acquired "development" financing.

For most transition and post-conflict countries, the origins of the dual budget problem have been slightly different. In these cases, the sudden volume of financing required for reform and reconstruction – involving an almost total dependence on external sources for financing and expertise, including the detailed budget planning and reporting requirements attached to those – has mostly dictated separate budget processes. Given that unified budgets are such a widely accepted principle of good budget management, it is a reflection of the power of these practical considerations, including the demands from donors and trust fund managers, that dual budget processes have been established or maintained in several post-conflict countries, such as Afghanistan and Timor Leste, in recent years.

In defending their dual budget systems, governments sometimes point to the different skills which are required to manage current and capital expenditures. Determining the required level of current expenditures is often perceived to be a relatively formulaic task in which various "norms" may be applied annually on a volume basis, combined with the possible adjustment of input prices. Capital or investment spending, on the other hand, is perceived as a higher status activity that requires more sophisticated cost-benefit analysis and project management skills. These perceptions may not only underpin the historical preference for separate budgets, but also for separate budget management institutions.

One of the basic problems with a dual budget process is that it seldom maintains a clear or consistent separation between current and capital spending. Over time, "development" budgets tend to include many project-related expenditures that contain significant current (operational) spending activities. Thus the dual budget process provides a separation of activities that often relates more to historical systems, political objectives, potential sources of financing and institutional capacities than to the actual nature and purpose, including correct description, of the expenditures themselves.

3. Principal characteristics of an integrated budget

Most OECD countries have achieved a high degree of integration of their current and capital budgets. This has usually occurred through a process of development in their public administration and budgetary systems that has taken place over many years. It is the result of a growing realisation by these governments that *a)* the distinction between recurrent and development spending is often quite arbitrary or uncertain, and *b)* that better resource allocation and management decisions can often be made within a single unified framework for revenues and expenditures.

While there are now few developed countries which maintain totally separate budgets, the extent and form of budgetary integration – particularly the management of capital spending – still differ significantly in some instances. For this reason, effective integration of current and capital budgets is perhaps best measured qualitatively by the extent to which the current (operational) and investment spending decisions of the government are "well balanced" in the sense of being logically consistent with, and mutually supportive of, a given policy framework or set of policy objectives. In practice, this means that the activities and outputs, including goods and services, for which government departments and spending agencies are responsible are delivered as effectively and efficiently as possible, given the budget resources available. In particular, the operational activities and outputs of each agency are not reduced or impaired by grossly inadequate (or over-specified) capital, by technologically inappropriate facilities or equipment, by insufficient provision for maintenance costs, nor by inefficient combinations of capital and labour inputs.

Examples of an unsatisfactory balance between current and capital spending can often be found in the education sector – *e.g.* many teachers but too few or poor quality classrooms and teaching facilities. Conversely, in the health sector, there may be large new hospitals but with insufficient trained staff or inadequate maintenance and utilities funding. More general imbalances may also develop between expenditures on administrative services of government (especially salaries and allowances) and infrastructural development needs, or more specifically between large public investments in, say, electricity generation, relative to the quality of policies and regulations relating to pricing and supply (where the latter is determined in part by current spending on the staffing and capacity of the relevant policy agencies).

Although many developed administrations may not **consciously** seek to optimise this current/capital spending balance, they nonetheless aspire to achieve consistency and efficiency within the context of their ongoing resource allocation and budget management decisions. In fact, getting the right balance between current and capital spending across the whole range of budget interventions and activities will depend substantially on the quality of financial and managerial (including budget planning) systems and capabilities – and hence their capacity to design and conduct strategic interventions. While these issues may involve a much wider range of factors than simply the extent of budgetary integration *per se*, there is no doubt that a unified budget generally makes it easier to develop better systems, policies and capabilities in these areas.

The budget systems of countries with a high degree of integration between current and capital expenditures exhibit several key features:

- a single (combined) annual budget law and appropriation process;
- clear and unified responsibilities for budgetary preparation and implementation within the relevant public sector institutions;
- a unified budget presentation, with supporting classification and accounting systems; and
- budget planning and management techniques within individual spending agencies that encourage and enable the effective use of financial resources.

Most budgetary systems incorporate some of these features. However, the full benefits of a unified budget can only be achieved where each of these conditions is present. And although each of these features is important, it is often in the last area – the budget planning and management within spending agencies – where the most challenging reform measures, and greatest gains, are to be found.

4. The four dimensions of budget integration

The features of a unified budgetary system described above provide a useful framework for designing the guidance required by most developing countries in determining how and where they should begin the task of integrating their current and capital budgets. Experience from developed country budgeting systems suggests that these attributes correspond broadly to four dimensions in which budget reforms may be required, as described below. It must be recognised, though, that a particular strategy for budget integration in any single country will depend on a range of local factors, including the stage of budget development already achieved. Finding the right approach therefore requires careful assessment of the current political and institutional environment, including determining where the greatest or most achievable gains from budget unification can be made.

4.1. The legislative dimension

Budget laws in many developing and transition countries often require the preparation of two separate budgets – *i.e.* one for current expenditures and one for capital expenditures. These two budgets may be presented separately to the parliament (or supreme appropriation authority) each year under their respective budget appropriation laws or they may be presented as separate components of a single budget law. In either case, they may require annually of the parliament separate processes of consideration and debate, and possibly enactment. The specific requirements of this dual process are invariably stipulated in the country's public finance (organic budget) law. However, these organic laws are not only updated infrequently, but seldom identify, much less explain, the justification for maintaining the dual budget process.

A major and essential step in budget integration therefore involves moving to an appropriation process that requires all expenditures to be unified within one budget document and presented and approved under a **single budget appropriation law**. This step is likely to require an amendment to the public finance legislation and may require significant consultation (and explanation of purpose) within the parliament. The basic provisions of the amended law are, however, unlikely to be complex: as a first step, the law should simply require that all of the budgetary operations of the government (revenues and expenditures) are presented within a single appropriation. The detailed format of this presentation within a single appropriation will depend on the approach to other dimensions of budget integration as discussed below.

Amending any law, especially an organic budget law, may take considerable time and it is therefore desirable that at least some of the other dimensions of the budget integration task are advanced during this period. While a single unified budget appropriation law and approval process often represents a necessary and highly visible step towards budget integration, this achievement on its own can only bring limited improvements in the quality of fiscal management.

4.2. The institutional dimension

4.2.1. Central agency level

Separation of responsibility for current and development expenditures between two ministries – typically the ministry of finance and the ministry of planning (or economy) respectively – is often a major obstacle to effective budget integration. This arrangement is generally more common in developing and transition countries than in post-conflict administrations and, again, may have its origins primarily in donor interests and/or colonial administration systems. Nonetheless, a long history of institutional separation of budgetary responsibilities can make these structures politically resistant to change.

Internationally, there is increasing recognition and acceptance of the principle that budget planning, presentation, management and accounting and control functions can be conducted more effectively within one central agency: typically a ministry of finance. In practice, however, ministries of planning often have greater power and capability with regard to economic analysis and policy development, including especially the design and management of public investment policies. Traditionally, these ministries are often more effective in securing technical assistance to support their role in the planning and management of the development budget. As a result, they tend to possess superior capacity for analysing and managing public expenditures, especially investment programmes, and for negotiating the required financing with donors and lenders. In many cases, they may be unwilling to concede these functions – including the power and career opportunities that accompany them – to another ministry.

Common strategies for relaxing the grip of planning ministries on their development budget responsibilities involve either amalgamating with the ministry of finance or re-defining their functions to focus on higher level economic policy analysis and advice, including the design and implementation of economic regulations. These strategies have been employed in many transition countries over the last two decades. At the same time, the budget management capacities of these ministries of finance have needed to be strengthened, often with substantial support from donors, to enable them to assume their increased functions and responsibilities for capital expenditures.

In many developing countries, however, ministries of finance remain weak and under-resourced. The speed at which they should be encouraged to absorb new responsibilities for development expenditures is therefore a matter for careful judgment. In some cases, many of the more effective expenditures of the government are contained within projects administered under the development budget, and it is important that these are not jeopardised by rapid change in institutional mandates.

Apart from supporting long-term capacity building in the ministry of finance, there may be relatively little that international agencies or external advisers can do in the short term to hasten this institutional dimension of budget integration. Political factors, including portfolio responsibilities of ministers, may simply override consideration of these changes for improving budget management. At the very least, however, it is often possible to establish a broadly agreed timetable for the consolidation of budget management functions within the finance ministry and to define the transfer of resources and capability that will be required to achieve this. Moving to a single annual budget appropriation law, as described above, may also be a necessary step in encouraging and facilitating this process.

4.2.2. Budget department level

In parallel with the consolidation of budget management functions within the finance ministry, it is crucial that the "budget department" within that ministry is re-organised in a way that supports the integration of financial planning and monitoring for both current and capital spending. In practical terms, this will require that the budget officers responsible for designated spending agencies, or sectors, have budget oversight responsibility for **both** forms of expenditure. Any internal separation of responsibility for current and capital expenditures between budget office staff – despite the internal and external pressures that may be applied to maintain this distinction – can only impede the integration process. The logic of this consolidation of budget responsibilities becomes further evident as the various spending departments move towards greater use of the kind of policy-based expenditure programmes described below.

4.2.3. Spending agency level

The institutional dimension for budgetary integration extends beyond the role and structure of central agencies and their budget-related responsibilities. Within line ministries and other spending agencies, the establishment of separate management units for the execution of current and capital (development project) budgets has also created problems.

This structural separation of budget execution functions at the spending agency level is in some cases a direct result of donors seeking greater assurances of administrative capability before committing their funds to development activities. Newly created units responsible for development budgets generally offer significantly higher rates of remuneration and therefore have the ability to attract superior quality and better motivated staff. As a result, the resources and capability of these units may greatly exceed those of their current (operational) budget colleagues "down the hall". This phenomenon has been particularly evident in many developing and transition countries where line ministries have established "project implementation units" (PIUs), in some cases ostensibly for procurement purposes, as a means for ensuring more effective management of donor-financed projects or sector loan operations. These PIUs invariably present a long-term obstacle to more integrated and effective budget management.

Separation of current and capital expenditure management functions within departments also raises the potential for an increasing proportion of financial resources to flow into so-called "development expenditures". To the extent that even core operational activities become increasingly dependent on this funding source, this may further drive down the quality, effectiveness and relative priority of these activities. In the medium term, if not sooner, separate budget management entities within spending agencies tend to lower and distort the overall performance of the organisation and the quality or impact of its expenditure activities.

There can be situations, however, where distinct funding and payments processes **necessitate** some separation of budget implementation responsibilities at this level. In these cases, it is important that the management capacity for both categories of expenditures receives the same or very similar levels of donor support, especially in the form of administrative facilities and resources and staff training and remuneration. Where possible, though, donors should be actively discouraged from establishing or supporting these dual structures and should focus instead on helping to equip a unified budget management structure in each line agency with capable and effective staff.

Finally, it is sometimes argued that budget integration objectives relate primarily to **budget policy and planning** tasks and do not necessarily require the consolidation of **budget execution** responsibilities within a spending agency. The problem here is that many important budget allocation priorities are actually established during the execution process. A much higher degree of co-ordination and consistency in current and capital expenditure rationing decisions is therefore likely under a unified management structure, compared to a situation in which institutional structures reinforce competing budget units, policies and individuals.[3]

4.3. The presentational dimension

4.3.1. Budget summary tables

A basic but visible and readily achievable step towards integrating current and capital budgets involves the combined presentation, or consolidation, of aggregate budget data in a "budget summary table". This table should present a summary of the total planned (current plus capital) fiscal operations – *i.e.* cash flows[4] – of the government for the next budget year, plus for at least a further two years. Although current and capital revenues and expenditures may be presented as separate lines within the consolidated summary table, they should sum to a **single fiscal balance** – *i.e.* to a net surplus or net financing requirement.[5] Sources of financing for a budget deficit – *i.e.* expected "below the line" financing flows – will typically include a mix of domestic borrowing and external grants and loans.

The main purpose of a unified budget summary table is to show all planned fiscal operations for the year and their associated financing implications. As such, the table is a small but important step in presenting a consolidated or integrated picture of all current and capital spending, plus the associated financing decisions. It is likely that at least some of the planned external financing shown in this table may be tied to, or conditional on, approval and implementation of specific "development" projects or capital spending activities.

The exact format of a consolidated budget table, as outlined above, will depend on existing conventions and procedures for the presentation and appropriation of public revenues and expenditures, including budget classifications, as understood and approved by the parliament. However, the table can and should be formulated and presented routinely with the annual budget documents, **even where separate current and capital budgets have been prepared, and even if they remain subject to separate appropriation laws**. Although, in the latter case, the summary table may have no specific legislative standing or approval function, it may still assist the authorities to understand and manage better some of the macroeconomic and total debt servicing implications of their planned fiscal actions.

4.3.2. Budget classifications

Notwithstanding the importance of the legislative, institutional and budget presentation steps outlined above, effective integration of current and capital budgets in an **operational** sense really only begins to occur at the next level down: *i.e.* in the detailed classification of budget revenues and expenditure. The choice of budget classification structure is therefore important since it provides the budgetary framework for integrated planning and management of current and capital spending as discussed under the final dimension below.

Budget classifications assist governments to present, manage and report their fiscal activities in terms of a range of fiscal objectives and management needs. Typically, the most important classifications for meeting these objectives are:

- **Legislative:** a breakdown of the total budget into separate appropriations (or votes), usually, though not necessarily, aligned with administrative agency mandates.
- **Administrative:** this defines responsibilities and accountability for managing these appropriations according to administrative (spending)

agency, typically line ministries and sub-agency units, but including regional or local government authorities and other budgetary entities, as appropriate.

- **Economic:** application of an economic classification[6] structure for supporting improved analysis, in particular, of the economic nature and impact of budgetary decisions.
- **Functional:** application of a functional classification[7] for assessing the volume and composition of revenues and expenditures across the core functions of government compared with previous years and with other countries.
- **Policy, or programme, management:** for preparing and implementing budgetary activities within the relevant administrative agency and sub-units in relation to ongoing or new policy objectives and functions of the government. (Increasingly, specific programmes, or other policy-based groupings of expenditure within this classification, tend to be supported by performance objectives and indicators.)

Budget classifications even in developing countries vary considerably in structure, comprehensiveness, and quality of design and implementation.[8] Most countries have developed classifications of budget revenues and expenditures that support existing administrative structures and basic operational and reporting requirements for line item (object code) expenditures. However, the introduction of economic, functional and performance management classifications is necessary to support more sophisticated levels of budget analysis, preparation and policy implementation. Steps for integrating current and capital budgets in any country will need to be carefully formulated and aligned with the existing classification systems and capabilities, but also with a longer-term view to the future development of budget management capabilities, including the range and structure of classifications needed to support a more sophisticated policy environment.

Most developing and transition countries have already embarked on the implementation of improved budget classification structures. These new classifications should enable their fiscal activities to be analysed, managed and reported in terms of the five budget management categories listed above. For some countries, further classifications may also be appropriate where there are other, possibly more sophisticated, budget management objectives or where there is a need to recognise other federal, state or local budget activities and accounting frameworks. Examples of the former may include cross-agency budget appropriations – including a variety of budget programmes – that are focused on **outputs** and/or specific policy **outcomes**.[9] Of course, reporting of actual expenditures against each budget classification implies a supporting expenditure coding and accounting system that provides the required structure and level of detail in each case.[10]

4.4. The managerial dimension

Development of the budget classification system to include the economic and functional categories outlined above is an important step in helping the authorities move towards better analysis and reporting of current and capital spending activities. However, truly effective integration of current and capital budgets can only occur through co-ordinated resourcing and management of expenditure policies by each spending agency. Most international experience suggests that this integration objective can seldom be achieved by leaving it to donors to decide where development activity is needed and what level of current or other budget resourcing should accompany it. Rather, spending agencies themselves need to develop budget programmes that explicitly combine current and capital spending decisions within a single policy-based implementation framework. The development of these programmes within each appropriation is probably the most important task, but also the most institutionally demanding one, that these governments face in strengthening their budget management capabilities. It is also the key to full and effective budgetary integration.

The development of a **basic** programmatic framework for budget management in spending agencies is not a difficult technical exercise – at least in principle. There is ample guidance and experience internationally on how major "expenditure programmes" can be formulated around key policy objectives within each of the major sectors. However, the development of these programmes, including appropriate sub-programmes, cannot simply be imposed. An effective structure must be achieved in consultation with budget managers in each of the respective line agencies. This enables the rationale behind their financing and implementation – and the measurement of their achievement – to be embedded within day-to-day expenditure management decisions.

In practice, implementing detailed, effective and integrated programme-based budgets has proved difficult in many of the countries of the former Soviet Union, for example, where line ministry staff have had little experience in managing policy-oriented or results-based budgeting. Over time, these problems are gradually being overcome. As a result, well-designed programmatic frameworks have assisted line agency staff to comprehend better the linkages between current and capital spending and to begin to see that effective policy implementation requires a careful, strategic balance between the two. This understanding is much more difficult to achieve within a dual budgeting framework.

In practical terms, policy-based programmes should be designed so as to incorporate capital expenditure needs immediately alongside related current activities and outputs. For example, a programme for secondary level education – within an overall education sector appropriation – should incorporate capital needs within the objectives and resources assigned to individual sub-programmes. Thus, the capital spending requirements for, say, rural (public) secondary schools should be specifically identified and budgeted under that sub-programme. This differentiates it from the capital spending required within other sub-programmes – such as urban schools, mixed public/private schools or special needs schools, etc. – and will help to ensure that decisions about the required level of capital spending are considered in relation to parallel current expenditures on rural secondary teacher salaries, classroom materials, utilities and maintenance needs.

Financing for each of these elements within the rural secondary schools sub-programme should of course be determined on the basis of relevant government policies, competing education priorities, and forecasts of rural demographic trends, etc. This kind of programme (and performance) approach may also help to define better the specific expenditure responsibilities under local and central government fiscal mandates within a given area of public policy. In this way, both current and capital expenditures will contribute jointly to the achievement of the government's policy goals and performance indicators in this area.

Exceptions to the programme-based approach described above are possible, but preferably rare. Occasionally, capital expenditures may involve substantial donor-funded projects that focus on a dominant facility or activity that affects, or supports, a wide range of economic activities, possibly extending beyond any one sub-sector, or even one sector. The size, complexity and limited time duration of these investments may argue for special project management structures. Examples include the construction of major infrastructural facilities, such as ports or airports, a teaching hospital, or perhaps a network of courthouses which are substantially different or additional to any existing facilities.

In such cases, and for sector-wide projects, it may be desirable to create a special budget programme, within the relevant sector appropriation, that comprises all of this developmental expenditure. However, the format should be similar to other programmes in that it is assigned unique objectives and performance criteria for the period of its duration within the budget. Any local operational costs and non-capital items associated with such investment "programmes" should be correctly identified and classified accordingly.

The decision on which of these two approaches should be used to ensure effective operational integration of current and capital spending within a programmatic framework will depend on a number of programme-specific considerations. However, capital expenditures should, wherever possible, be contained within the appropriate policy-based programmes. This will help to ensure that current *versus* capital resource allocation decisions are more consistent and complementary over the longer term.

5. Conclusions

The integration of current and development budgets is a necessary and important step towards improving budget management. However, the technical and managerial complexity of this step tends to be underestimated, leading in many cases to disappointment with the speed and quality of this reform. These challenges can be overcome successfully by addressing each of the legislative, institutional, presentational and managerial dimensions of budgetary integration. To achieve this, public finance officials and advisers must first be willing to consult carefully with ministers and parliament on the benefits of budget integration and on the need to adjust financial laws and organisational mandates and structures to support it. Officials in line ministries must also be trained and engaged in the design of new budget management methods that will support improved analysis of needs and more detailed reporting of current and capital expenditures. Only then can a unified budget process fully contribute to better budget allocation and management decisions.

Notes

1. Budget integration usually refers to both revenues and expenditures, though it is in the management of public expenditures that the most important gains from this development are usually expected to occur.
2. "Development budgets" are mostly composed of capital expenditures, but they may include operational costs associated with capital items. In this article, the terms "development budget" and "capital budget" are used interchangeably, as are the terms "current", "recurrent" and "operational" expenditures.
3. In practice, the management structures within some spending agencies may be a little more complex than implied by this discussion on "dual administrative units". In most cases, management structures are likely to be aligned with policy or programme activities, or sub-sector organisations, within which there may be separate management units for current and development expenditures. However, the desirability of combining the management of both types of expenditure within these programme-based structures remains.
4. The discussion in these paragraphs refers particularly to a cash accounting environment.
5. The exact presentation of revenue, expenditure and net lending aggregates within the summary table may vary significantly between countries depending, for

example, on the structure of their fiscal activities, their budget appropriation requirements and their public sector accounting methods.

6. Such as the government finance statistics standard as described in IMF (2001).
7. Typically also on a GFS basis; see IMF (2001).
8. For a more detailed discussion of classification issues, see Chapter 4 in OECD (2001).
9. For example, the more output/outcome-based budgeting and accounting frameworks used by Australia and New Zealand.
10. Transition, developing and post-conflict countries may also require a facility within the budget classification system for **donor reporting**, *i.e.* an ability to present budgets and financial statements that show how the financial assistance received from various donors has been committed to – and expended on – the agreed items, projects or policy objectives.

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Performance Budgeting and Accrual Budgeting: Decision Rules or Analytic Tools?

by
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Performance budgeting and accrual budgeting are analytic tools that provide information and insights which are not available through conventional approaches. But neither innovation is ready for widespread application as a decision rule in the budget process. This article urges fuller understanding of these innovations and their implications, and more systematic use of performance and accrual information for policy makers.

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Budgeting is a process that transforms information into decision. Requests submitted by spending units or generated by central budget staffs are inputted into the process, and allocations to entities, projects and other recipients are outputted. The quality of these decisions depends on the data available to decision makers, as well as on the analytic tools they use to process the information. One of the perennial aims of budget innovation has been to influence the decisions that flow from the process by modifying the classification or content of budget data and by introducing new analytic methods. At one time, most countries classified expenditures by organisation units and items to be purchased. Nowadays, most have economic and functional classifications, and many also classify expenditure by programmes, activities or outputs. As the stockpile of budget information has grown, the means of analysis have multiplied. Innovative countries strive to measure performance, medium-term fiscal impacts, exposure to contingent liabilities and other financial risks, the unit cost of producing government services, the long-term sustainability of the government's fiscal position, the revenue forgone through tax preferences, the distribution of expenditure by region, social class and gender, and other contemporary issues in budgeting.

The surge of data has spurred budget innovators to devise new rules for shaping the decisions that emerge from the process. They want information to be more than available: they want it to transform the way governments go about budget work. They want different information to produce different outcomes. This article focuses on two contemporary efforts to convert information into rules. One is performance budgeting, which seeks to base spending decisions on actual or projected results; the other is accrual budgeting, which calculates expenditure in terms of resources used or liabilities incurred. The first shifts budget decisions from inputs to outputs or outcomes; the second shifts them from disbursements to cost. Performance budgeting and the accrual basis are among the most prominent reforms on the budget agenda. Neither is new, and neither has made as much headway as reformers would like, but both are likely to be promoted within governments and by some international organisations in the years ahead.

Performance budgeting and accrual budgeting are analytic tools that provide information and insights which are not available through conventional approaches. Both can also be framed into decision rules that dictate the way governments allocate resources. One decision rule might specify that government should spend money to purchase outputs; another might require that government appropriate funds to cover the cost of goods consumed or liabilities incurred. Although both may seem to rationalise budget choice, this article argues that governments should move cautiously in codifying performance and accrual budgeting into decision rules. It is essential to develop a fuller understanding of these innovations and their implications before mandating that they be the basis of budget decisions. The article also urges, however, that governments incorporate performance and accrual information into the mainstream of data available to policy makers.

The critical difference between analytic tools and decision rules lies in the discretion permitted to politicians and officials when they make allocations. When information is only an aid for analysis, governments may opt to apply or disregard the proffered data, and they may interpret the data as they deem appropriate. For example, armed with data showing that one entity's unit costs are lower than another's, governments may nevertheless provide more money to the high-cost operation. Or, presented with accrual information, they may appropriate funds to cover cash outflows rather than incurred liabilities. However, when information is codified into decision rules, budget makers are required to base allocations on it. To put the difference simply: analytic tools empower budget makers, whereas decision rules constrain them. The former allow full scope for judgment and subjectivity, the latter make budgeting less judgmental and more objective.

The distinction between analytic tools and decision rules may be explained by considering the approaches taken by national governments in incorporating medium-term projections into budget work. As recently as two decades ago, few governments formally projected the future budget impacts of the decisions they made for the fiscal year immediately ahead. Nowadays, however, many governments construct forward estimates or baselines that project expenditures and other budget elements for each of the next three or more years. These projections typically assume that current policies will be continued without change; they thereby provide a basis for government to forecast the fiscal situation that will ensue if the budget policies already in place are maintained. With this information at hand, governments can estimate the impact of proposed or approved policy changes on future budgets. Using information in this way gives government a powerful analytic tool to take account of future implications before it acts.

Some governments have gone further by constructing medium-term expenditure frameworks (MTEF) that limit spending in each of the next three or more fiscal years. This "hard constraint" bars government from taking actions that would cause estimated future spending to rise above the preset limit. When it is used effectively, the MTEF converts projections from analytic tools into decision rules. The MTEF greatly increases the probability that medium-term projections will be used, but it also limits the budget options of government.

Experience with budget projections and the MTEF suggests the rationale for converting analytic information into budget rules. It also indicates why doing so may not be a good idea. Medium-term projections tend to be ignored by politicians who are pressured by the exigencies of budgeting to focus on the year immediately ahead, even when their decisions adversely affect future budgets. In response, reformers (including international organisations) have campaigned for governments to adopt MTEF-type arrangements that compel them to take account of future impacts before they decide spending levels. The MTEF thus becomes a decision rule that limits the freedom of cross-pressured politicians. But just imposing a decision rule may not suffice to change budgetary behaviour or outcomes. Many – probably most – countries that have a formal MTEF regard it as a technical exercise that is separate from the annual budget process. The rule exists on paper, but is breached in practice. Disappointing experience with medium-term expenditure frameworks and other budget reforms has led this writer to conclude that changing budget rules may not suffice to change budget behaviour.

Over the years, budgeting has evolved through innovations that have introduced new types of information and/or have prescribed new rules. One obvious consequence is that both information and rules have accreted. But this evolution has generated informational overload and decisional complexities. The more information that is provided, the greater the likelihood that some of it will get in the way of completing budget tasks on schedule; and the more rules that are in place, the greater the likelihood that some will be in conflict or be treated as technicalities. Those who would add to tools and rules should be cognisant of a fundamental limitation of budgeting: it is a time-pressured, deadline-saturated process in which making decisions on schedule often is more urgent that getting the analysis right.

With this limitation in mind, Section 1 of this article traces the evolution of budget tools and rules. The key development has been modification in the classification of expenditure data which has transformed budgeting from an insular process whose main task was to finance ongoing operations into an expanded process that contributes to economic stabilisation, programme planning and efficient management. Section 2 seeks to identify criteria for determining when new types of information should form the basis of new decision rules. This is a difficult assignment because budgeting lacks generally accepted standards for estimating and reporting public expenditures. Significant progress has been made in the past decade in devising codes of good budgetary practice, but most of the standards pertain to matters that have long been recognised as essential to good budgeting. Recent codes, such as those developed by the OECD and the IMF, are generally indicative rather than prescriptive with respect to the types of innovative practices discussed in this article. Section 3 discusses performance measurement as an input into budgeting, and concludes that it would be premature to base decision rules on these data. Much more work has to be done on linking resources and results before performance measurements can be turned into rules for allocating money. Section 4 concludes that shifting the budget to a full accrual basis would be inappropriate at this time, but that governments should be encouraged to deepen their experience with accruals, especially in balance sheets and other financial reports. The final section briefly points the way to future development of analytic tools and decision rules in budgeting.

1. Classification is the most important decision rule

The history of budgeting is the history of reform. The two cannot be disentangled, because practitioners are basically always tinkering with the machinery of budgeting. They do so by modifying either the classification or the informational content of the budget – that is, they change either the way information is structured for decision or the information available to decision makers. In general, reforms that merely add to the stockpile of data tend to be more successful than those which aim to establish new decision modes. The evolution of budgeting teaches that it is much easier to increase the flow of information than to change the way resource decisions are made.

Changing classifications is hard work that has a high failure rate. But it is essential work because budgeting operates through classifications which both organise information and shape decisions. Half a century ago, Jesse Burkhead observed that "there is an almost infinite variety of ways in which budgetary data may be classified" (Burkhead, 1956, p. 112), and he argued that the search for the ideal classification is mistaken and fruitless because classifications serve multiple purposes in budgeting. In this writer's view, Burkhead's comment is valid only to the extent that classification is a means of presenting budget information; it is not valid, however, when classification serves as the structure for budget decisions. There are many ways to tell the budget's story, but there can be only one way to decide the budget. The government cannot allocate money one day on the basis of organisational units, the next day on the basis of programmes, the day after to regions, and so on. It cannot first set spending levels in terms of the items to be purchased and afterwards in terms of the outputs to be produced. Each of these methods is an appropriate means of displaying the budget, but only one can be the means of deciding the budget.

In almost all countries, the organisation chart is the decision structure. Spending units bid for resources, budget ministers and officials negotiate with those who have political or managerial responsibility for the spending organisations, funds are appropriated to organisations, these organisations spend the money, and financial reports are structured by organisation. Within organisational units, funds may be sub-allocated to particular items of expenditure such as personnel, supplies, equipment, travel, and so on. Over the years, as public expenditures grew, most governments consolidated these "line items" into broad categories. Instead of itemising each type of equipment, the budget lumped all equipment into a single category. Nevertheless, spending units have remained the central decision structure, and their budgets are still compiled by adding up estimated expenditure for personnel, supplies and other items.

Two paths are open to challenge organisations as the key unit of decision. One is to establish specialised classifications for particular types of decisions; the other is to replace organisations as the basic structure. The first is often successful, the second rarely succeeds. The first one works because it retains the organisational structure; the second fails because it attempts to uproot that structure. The most prominent example of a specialised decision classification is the capital or investment budget which allocates resources to projects rather than organisational units. It is important to note that the capital budget coexists alongside the budget for current expenditure, which is still decided by spending units. Another widespread approach is to segregate the budget by source of revenue (general fund, trust funds, and other earmarked revenue) with somewhat different decision rules for each source. In effect, government has multiple budgets, each with its own classification and decision rules.

Over the years, governments have added many classifications. It is quite common to classify expenditure by economic category (consumption, transfers, subsidies, investment, etc.) as well as by function (agriculture, health, education, transportation, and so on). Some governments classify expenditure by geographic units or by socio-economic groups. The common feature of these classifications is that they provide supplemental information; they do not displace classification by spending units. They are a means of displaying data, not of making expenditure decisions. After the budget has been decided, the government disaggregates spending by these supplemental schedules. The United States government publishes more than two dozen special classifications in a budget document that is aptly called *Analytical Perspectives*.[1] The document provides data on federal grants to states and cities, spending on research and development, tax expenditures, and other special categories. Many national governments have similar presentations which supplement the main decision structure. In the language of this article, they are analytic tools, not decision rules.

In contrast to these specialised classifications, some reforms have taken the second path: they have sought to establish an entirely new decision structure in place of organisation-centred budgeting. The most important of these initiatives has been programme budgeting, which was first introduced in the United States during the 1950s and has been attempted in many developed and developing countries. Although programme budgeting comes in many versions, its core idea is that expenditures should be grouped and decided in terms of governmental objectives, not according to the organisations spending the money. All activities contributing to the same objective should be placed in the same programme, regardless of the organisational entity to which they are assigned. To do so, governments seeking to budget by objectives construct a programme structure, which is supposed to serve as the basis for formulating the budget. For example, to safeguard citizens against crime, many governments maintain a police force, a prosecutor's office, a court system, a parole or probation agency, and prisons. Each of these is managed by a different entity, but all would be grouped in the same programme because they share a common objective. A programme structure would enable government to analyse the budgetary impact of more vigorous law enforcement on the courts and prisons. It also would enable government to trade-off among the different elements of the law enforcement programme. The government might decide that allocating more funds for police patrols would reduce the incidence of crime and thereby enable it to spend less on prisons.

Because it groups similar activities together, programme budgeting would seem to be a sensible means of decision, superior to systems that allocate resources on the basis of organisational structure and items of expenditure. In fact, however, governments have had great difficulty implanting a true programme budget. With few exceptions, governments that claim to have a programme budget use it to display spending decisions that have already been made. Having decided how much each spending unit should be allocated, they reclassify expenditures by programmes. Quite often governments label organisational units as programmes and pretend to have programme budgets. When this occurs, the only thing that is programmatic is the label.

The disappointing record of programme budgeting is due to many factors. Arguably, the most important is that it stirs up conflict over government objectives, generating protracted strife over the objectives of programmes. To take one example of many: suppose schools have nurses on duty to deal with routine medical problems and to teach students proper hygiene. This activity may legitimately be classified as serving both health and education objectives. Government ministries fight over the proper classification because it affects the resources they receive and their control over the activity. To mitigate conflict, governments either abandon programme budgeting or turn it into a supplemental presentation.

In line with the argument advanced here, programme budgeting also fails because it cannot dislodge organisations as the basic decision units in budgeting. Organisations and programmes are fundamentally antagonistic bases for structuring budget allocations. In the former, similar functions are grouped together regardless of the objectives they serve; in the latter, activities that serve the same objective are grouped together regardless of the organisation in which they are located. The former are structured for efficient provision of goods and services, the latter to facilitate the analysis of policy options. As sensible as it is to budget for objectives, governments cannot disregard the financial needs of the organisations that provide public services.

Organisations have another important advantage: they are a means of accounting for public funds. One of the difficulties faced by governments when they try to implement programme budgeting is determining who is responsible for the use of public funds. Governments usually solve this problem by classifying programmes within organisations, which robs programme budgeting of its essential purpose.

Organisations and programmes are compatible classifications when the latter serve only as instruments of analysis. Programme budgeting and other innovations have provided many national governments with much more information on objectives and policies than they had a generation ago. They have more data on the effectiveness of programmes and on the outcomes ensuing from them. Often, however, available data are not used in budgeting. The underutilisation of analytic data has more to do with the time compression and rigidities of budgeting than with the failure to implement programme budgeting. When decisions have to be made under tight deadlines, and almost all budgeted resources are claimed by past commitments and ongoing activities, there is not much space in the process for analytic work.

The survival of organisations as the basic decision unit imparts a vital message for performance budgeting. The path to better performance in government runs through the departments and agencies that produce public services. If they are mobilised to perform, performance budgeting has a foothold to spawn better results – more output and improved outcomes. The essential task of performance budgeting is not to produce better measurement but better organisations. Information is an instrument of analysis; organisations and those who work in them are the wielders of these instruments.

2. Criteria for establishing new budget rules

Budget rules determine how spending decisions are made and reported. Some rules, such as annuality and comprehensiveness, have been accepted practice since the emergence of modern budgeting more than a century ago.

Some are of recent vintage and rely on new techniques such as the medium-term expenditure framework (MTEF). In general, the older the rule, the more widely it is applied. Some rules are inherently country-specific and include the forms and schedules on which spending units bid for money. Many rules are formal and are codified in budget law and manuals, but some of the most important ones are informal, such as the conduct of negotiations between the finance ministry and spending entities. In every country, a vast body of rules dictates the compilation of the budget by the government and its review by the legislature. Many rules pertain to the implementation of the budget and determine the scope for virement and other modifications of the purposes and amounts of expenditure. Most rules are procedural but some, such as those which constrain fiscal aggregates, are substantive.

Although rules have accreted, stability is important in budget procedure. Having routine procedures that recur with little or no change year after year stabilises budgetary roles and relationships and drains the process of much of the conflict that inheres in the competition for limited resources. Frequent changes in procedure complicate the tasks of calculating expenditures and resolving conflict. Nevertheless, changing circumstances and the development of new techniques make it appropriate for governments to modify budget practices from time to time. The two innovations discussed in Sections 3 and 4 have the potential to introduce new budget rules. The case for performance budgeting and for accrual budgeting rests in part on new forms of information processing – performance measurement and accrual accounting – as well as on new conditions facing budget makers, such as rising expectations and fiscal pressures. Before examining these reforms, it would be useful to specify criteria for assessing the appropriateness of proposed changes in budget rules.

One seemingly logical criterion must be discarded. While it might seem sensible to reject proposed rules that would bias budget decisions, it should be apparent that all significant changes in budget rules have the potential to alter budget outcomes. Rules matter because they affect the behaviour of those who exercise authority in budgeting. The essential purpose of new decision rules is to produce allocations that differ from those that would otherwise occur. Performance budgeting aims to give more money to activities that produce wanted results and less to those that do not. Accrual budgeting intends to make governments more cautious in taking on long-term commitments that may have a negligible impact on the current budget but would adversely affect future ones.

Occasionally new rules are substantive: they purposely change the decisions that emerge from the process. Europe's Stability and Growth Pact is of this sort, as are rules that require a balanced budget or some other predetermined fiscal outcome. Most new rules, however, are procedural: they modify the way decisions are made, but do not dictate any particular outcome.

Performance budgeting changes the focus from inputs to outputs; accrual budgeting requires that spending be measured on a cost basis rather than on a cash basis. The following paragraphs specify a number of criteria for assessing these and other procedural changes.

2.1. Government's ability to complete its budget responsibilities

Formulating the budget is one of the few tasks that every government must complete, regardless of how difficult the choices or deep the conflicts. Often, new procedures are introduced in disregard of their effect on budget work. They overload the process, require more information than can be handled in the confined timetable, and ultimately fall into disuse because they get in the way of formulating the budget. Zero-based budgeting (ZBB), which was popular in the United States and some other countries a few decades ago, illustrates this problem. It multiplied the number of decision points for government, requiring additional information and analysis for each decision. While ZBB had laudable intentions, it was unworkable and had to be discarded by governments that made earnest efforts to implement it.

Formulation of the budget may also be impeded by reforms that stir up budget conflict. This appears to be one of the unavoidable side effects of programme budgeting, for it requires that policy makers agree on objectives in addition to deciding the amounts to be spent. It also impels them to review a broader range of options than is normally considered in formulating the budget. Politicians and managers often fight harder over the purposes of expenditure than on the amounts allocated. Friction over the programme structure retards efforts to budget on the basis of objectives. A similar problem sometimes besets governments which embrace performance budgeting and become entangled in protracted argument over the definition of outputs and outcomes. Getting the definitions right becomes more important than getting the government to perform.

2.2. Availability and use of information

Effective implementation of budget rules depends on information. If the government is called upon to budget for tax expenditures or contingent liabilities, it must have reliable data on these transactions. Many governments do not. In this writer's experience, reformers have rarely taken account of the cost, availability or use of the requisite data. They assume that once the requirement is in place, the government will take appropriate steps to inform itself. Things do not always work out this way. Quite a few governments that have been pressured to maintain an MTEF lack reliable projections of future revenue, spending or economic conditions. Similarly, governments that nominally have a performance budget may have insufficient data on the outputs they produce or the social outcomes deriving from public policy. It is not reasonable to expect a government that accounts for public finances on a cash basis or lacks timely, audited financial statements to produce credible accrual-based budgets.

In building robust budget institutions, it would be logical to prepare the way by developing necessary information resources first and establishing rules afterwards. Would-be reformers should study the sequence by which Australia made forward estimates the centrepiece of budget policy. As recounted by John Wanna and associates (Wanna *et al.*, 2000, pp. 319-322), development of forward estimates as a decision rule proceeded in a series of steps over several years. At first, the estimates were internal projections used exclusively by the Department of Finance and Administration in its budget work. They were not deemed sufficiently reliable for public dissemination. However, before long, the Department realised that it would have a stronger case for budgetary discipline if others had access to the forward estimates, and it upgraded them for publication. Once they were public, government leaders decided to use them to frame medium-term expenditure decisions.

The high cost and limited availability of new data are serious impediments to budget innovation in developing countries. But the issue affects all countries because major reforms add to the informational burdens of those who bid for or allocate resources. Far-reaching reforms may be more successful when the government purges some old informational requirements to make room for new ones than when it layers new data on the old. When Australia made forward estimates the basis for policy and fiscal decisions, it eliminated much of the line-item detail that previously dominated budget decisions. And when New Zealand adopted output-based budgeting, it removed almost all mention of inputs from the budget, appropriations act, and supporting documents. In many countries, by contrast, budgeting is an amalgamation of multiple waves of reform, each of which has deposited its residue of informational requirements.

When governments add budget rules, they facilely assume that the new information will be used. This assumption leads to the overproduction and underutilisation of budgetary data. For example, requiring governments to compile data on contingent liabilities does not itself assure that they will regulate these financial risks. Even if they were required to publish the data in the budget, governments may lack the incentive or the opportunity to make effective use of the data.

2.3. Relevance of budget rules

New budget rules must make sense to those who are supposed to produce the data or use them. Often they do not make sense and they come to be regarded as a technical exercise, one of the many chores that must be done to get through the annual budget cycle. This has been the fate of many of the reforms prescribed by international financial institutions for developing countries. It is highly likely that this fate will befall accrual budgeting if it is adopted by governments that do not understand it and have no plans to use the information in managing public finances.

Innovative rules acquire relevance when they are integrated into ongoing budget practices and are not hived off to the periphery of the process. Australia made a success of forward estimates when they became the central instrument for setting budget policy. In many countries, however, an MTEF is irrelevant because it stands apart from the annual budget. Relevance is promoted when governments decide in advance how new rules and the resulting information will be applied. It is often assumed that requiring a particular practice or report suffices. Innovations in budget practice that are not viewed by practitioners as useful do not survive.

2.4. Enforcing the rules

Budget rules are not self-enforcing. Just because a procedure is mandated in law or regulation does not mean that it will be applied. In budgeting, as in other activities, there are numerous ways to sabotage unwanted innovations. When budget rules are deemed important, the means of enforcement should be built in from the outset. In some countries, enforcement is assigned to the audit office or to a legislative committee, such as the Public Accounts Committee in the United Kingdom. In other countries, courts have become involved in enforcing budget rules.

The reforms discussed in Sections 3 and 4 diverge in terms of enforcement. When the accrual basis is embedded in accounting rules and auditors are armed with independence and resources, failure to comply with the rules may result in qualified financial statements and impaired access to capital markets. With rare exception, government pronouncements on performance are not systematically audited. Citizens and interest groups have little recourse when results are misstated or disregarded. For performance budgeting and accrual budgeting to take root, it is essential that governments have formal procedures for reviewing reported results, including accepted standards for measuring outputs and outcomes and for reporting costs and liabilities.

2.5. Learn from past efforts that failed

The spread of budget rules has been propelled by stories of successful innovations in *avant garde* countries. Relatively little attention is paid to how the reforms were introduced, the obstacles that had to be surmounted, the special conditions that enabled success, and the features that did not work out quite as expected and were discarded along the way. When it comes to emulating other countries, failure is usually a better teacher than success. But who knows or cares about reforms that were launched with much fanfare only to be abandoned with barely a notice? Australia's ambitious strategy to thoroughly evaluate all programmes was accorded much publicity, but no announcement was made when the strategy was terminated. Britain's "Next Steps" initiative, which led to the creation of more than 100 agencies with broad operating independence, is well-known around the world, but the retaking of managerial control by ministries and central agencies during the Blair regime is hardly known. Sweden is rightfully regarded as an innovative country, but it is hard to find information on why its results-budgeting initiative of the 1980s barely got off the ground. Even more important than absolute failure is the necessary tinkering to take a reform from blueprint to practice, to get a promising concept to work within the demanding realities of budgeting.

Performance budgeting is a case study of repeated failure. The concept was introduced in the United States shortly after World War II, but it disappeared with hardly a trace. Governments attempting performance budgeting today would learn much by studying why this American innovation, and many others like it, lapsed into obscurity. Why did a reform that is so sensible survive for no more than a few years, and why is a new version invented every decade or so? What are the political, organisational and informational prerequisites for making a success of performance budgeting? Addressing these types of questions would shed light on the conditions needed for performance-based innovations to work.

2.6. The architecture of reform matters

Governments that move to performance budgeting or accrual budgeting often have a broader reform agenda that may include lengthening the timeframe of budgeting, undertaking programme evaluation, changing the format of the budget, and other innovations. Quite often the various initiatives are disconnected from one another, giving rise to confusion and reform fatigue. Whether innovations are intended to be decision rules or analytic tools, it is important that the government link the pieces together so that those who have to make them work understand how they are connected.

The two reforms discussed in Sections 3 and 4 illustrate this problem. While they are typically depicted as separate innovations, both performance budgeting and accrual budgeting require reliable attribution of costs to activities, including apportionment of indirect and overhead costs. But when each reform is entrusted to a different entity, each entity may define and measure costs differently, leading to inconsistent rules and widespread confusion. The problem occurs when innovation is an analytic tool, but is significantly more damaging when it is promoted as a new decision rule. The solution, which is rarely achieved, is to pay attention to the overall architecture of reform, so that performance budgeting and accrual budgeting are designed as one set of innovations rather than as discrete changes.

2.7. The internationalisation of budget rules

Not long ago, budget rules were specific to each country. Although they were influenced by practices in other countries and there was an active exchange of ideas, governments charted their own course. This is now undergoing change, as international organisations recommend or dictate country practices. The rules are strongest with regard to fiscal outcomes, but they also pertain to other budget practices. The European Commission has an elaborate set of rules, including the close review of annual budgets and multi-year spending plans of member countries. The IMF has issued a "Code of Good Practices on Fiscal Transparency" and has converted its government finance statistics (GFS) to the accrual basis. Although it will take considerable time, one should not be surprised if international organisations were to devise rules for measuring and reporting programme results. Once rules are established to account for expenditure, it is only a short distance for them to migrate to the making of expenditure decisions. This has been the path taken by the accrual basis, which is moving from a rule that pertains to financial reporting to one that covers budget decisions as well.

It is important that international organisations be mindful of the distinction between analytic tools and decision rules and, except where there is compelling justification, that they leave rules to the discretion of national governments. It also is important that they distinguish between good and best practice, internationalising practices which have been implemented in a broad swath of countries, not only in the most advanced ones.

3. Performance budgeting

Performance budgeting is easy to explain but has been hard to implement. The basic idea is that governments should budget for actual or expected results (typically labelled as outputs and outcomes) rather than for inputs (personnel, supplies and other items). When deciding the budget, governments should be informed of the services that public agencies will provide and the expected benefits and social conditions that will derive from spending public funds. As appealing and sensible as this idea is, putting it into practice has been exceedingly difficult. Governments have many things on their minds when they allocate resources; performance is only one preoccupation and usually not the most urgent.

While it appears to be simple, performance budgeting comes in as many varieties as there are governments that have applied it. Each government has its own approach and each has distinctive definitions and methods for feeding performance data into the stream of budget work. The many approaches can be aligned along a spectrum ranging from the loosest concept to the most stringent, with numerous shadings in between. Loosely defined, any system that provides information on the volume of outputs, the activities of government agencies, their workload, indicators of demand or need for public serves, or the impact of expenditure qualifies as a performance budget. Strictly defined, only the budget systems which formally link increments in spending to increments in results would qualify. Under the first definition, many governments could claim to have performance budgets; under the second, few could. With such a wide range, one may justifiably argue either that performance budgeting has been truly successful or that it has dismally failed.

The difference between the two definitions corresponds precisely to the distinction drawn in this article between analytic tools and decision rules. If all that performance budgeting does is to inform policy makers, it serves as an aid to analysis, though like all analytic instruments, it risks falling into disuse. On the other hand, if it is deployed to decide budget allocations, performance budgeting functions as a rule that can be stated in the following form: the government should consistently allocate resources on the basis of evidence or reasoned expectations of results. To do so, each increment in expenditure should result in an increment in results, defined as a greater volume of output or additional improvement in social conditions.

Both versions of performance budgeting depend on information concerning the services or results of public expenditure. Their data requirements overlap but are not identical: those deriving from the stringent version are much more demanding. For most analytic purposes, it suffices to disaggregate data to the programme or activity level; for budget decisions on marginal results, data on cost and results must be attributed to discrete units of output or results. Lacking robust cost accounting systems, most governments cannot allocate costs so as to connect incremental resources and results.

For all versions, the dependence on information explains why governments have invested in measuring performance. It is not feasible to budget for performance without measuring it, but it is feasible to measure and not budget for performance. In many countries, defining and compiling data on performance is not only the first step, but the last one as well. As discussed below, analysts and managers often engage in heated and protracted argument over the definition of outputs and outcomes, leaving insufficient opportunity to apply the data in the budget practices.

It is technically feasible to measure and budget for incremental results, but few governments have actually done so. Although they may want to budget for performance, governments must take other considerations into account when they set spending levels. Foremost is the necessity to pay for past commitments as well as for ongoing activities and the operating costs of government departments and agencies. In drawing up the budget, policy makers must also be mindful of political promises, interest group demands, and the overriding need to complete budget work by curtailing conflict over objectives and resources. When all powerful claims on resources have been satisfied, not much is left over to allocate on the basis of results, and performance is crowded out altogether or recedes to the margins of the budget.

Progress has also been hindered by lack of a strong performance ethic in public management. To anticipate an argument that will be elaborated later in this section, the government cannot budget for performance if it does not manage for performance. Managers and rank-and-file civil servants must care about delivering good services and improving the efficiency of operations, and they must pay attention to the outcomes that flow from government policies. They must be willing to take a hard look at what works and what does not, and to reallocate resources from less effective to more effective activities. If they are not willing, no dose of performance data will make much of a dent in their agency's performance. This argument has far-reaching implications, for it portends that the reform of budgeting must be part of a larger transformation of government.

3.1. Analytic tool or decision rule?

The principal theme of this sub-section is that most governments would do well to deploy performance budgeting as an analytic tool because few have the capacity to ground budget decisions on it. Governments usually fail when they conceive of performance budgeting as the key instrument for allocating resources. Failure often leaves governments with a robust supply of relevant information that can enhance public policy. It is important, therefore, to consider both the opportunities and impediments for applying performance information to budget decisions.

The notion that the government should purposely spend money to purchase results has considerable appeal. It is reasonable to expect that the government is informed of the increase or decrease in outputs or of the changes in social conditions that are expected to flow from its decisions. For many budget issues, it is technically feasible to link incremental resources and results in the manner called for by the strict definition of performance budgeting. In fact, a small number of governments operate this type of budget, but it is definitely beyond the reach of all but the most innovative. Few governments have both the political will and the necessary data to link increments in resources to increments in results.

One government that has the requisite conditions is Sunnyvale, a small city in the state of California in the United States, which has operated a true performance budget for approximately two decades. Sunnyvale's approach, which in this writer's judgment is among the most advanced in the world, presents policy makers with a series of options in each major area of public activity. For example, in budgeting for fire services, the city allocates money so that response time from receipt of an emergency call to arrival of fire equipment on the scene should be no more than 7 minutes, 20 seconds. Before taking this decision, city officials consider alternatives that would lengthen or reduce response time by spending less or more money than the amount agreed in the budget. In this example, outputs have a qualitative dimension and are not defined solely in terms of volume.

Although it is two decades old, the Sunnyvale model lies at the cutting edge of performance budgeting. It illustrates the potential for deploying this reform as a decision rule that drives budget allocations. Doing so would transform budgeting into a process for allocating resources at the margins. Indeed, this is almost always the question that confronts budgeting: Should government spend a little more or a little less? But there is one big difference: Sunnyvale explicitly decides more or less in terms of marginal changes in outputs or outcomes. This has the effect of making performance budgeting the key rule for deciding how much to spend on each government activity.

Transforming performance budgeting into a decision rule would require at least the following capabilities: *i)* the government would need information and expertise to disaggregate activities or outputs into standardised units; *ii)* it would then allocate costs to these units; and *iii)* it would acquire capacity to measure results contributed by each unit. These are truly challenging tasks, for few governments have robust cost accounting systems that enable them to measure marginal costs by distinguishing between fixed and variable costs, as well as between marginal and average costs. It is also essential to allocate costs among the units producing outputs and other benefits. Without reliable cost measurement and assignment, Sunnyvale would have no legitimate basis for determining that the amount budgeted would enable the fire department to respond within 7 minutes, 20 seconds. Without more detailed knowledge, one can only imagine the large amount of analysis and measurement that underlies Sunnyvale's budget decisions. Inasmuch as the unit cost of producing the next increment in results usually differs from the unit cost of producing the previous increment, it has been necessary for Sunnyvale to develop tools of marginal analysis for government.

Governments which embrace performance budgeting as a decision rule face another handicap. When it appropriates money, the government usually acquires the entire output of each spending unit for a fixed sum. Except in entities financed by trading income, the amount spent by the government does not vary if fewer or more outputs are produced. The Sunnyvale fire department receives the same appropriation whether it responds to 50 fires or 500. This critical difference between public sector budgeting and commercial budgeting is one of the main reasons why it is not normally advisable to define performance budgeting as a decision rule. Most large businesses have variable budgets: the resources available to operating units vary automatically with the volume of goods and services they produce. If they produce more, they have more to spend. For innovative governments, such as Sunnyvale, it would be necessary to shift from fixed to variable budgeting. This poses difficult questions pertaining to appropriations as legal limits on expenditure.

Additional considerations weigh against deploying performance budgeting as the basis for budget allocations. One is that results are not a sufficient guide for spending decisions. In some situations, poor results may compel the government to spend more, while favourable results may enable them to spend less. In order to budget for results, governments require a deeper understanding of programmes and options than is provided by output and outcome measures. Moreover, when the government is the sole or dominant supplier of an essential service, it may be compelled to spend even when favourable results are not forthcoming. Few governments have the option to close low-performing public schools.

Sound budgeting is as much a matter of political and managerial judgment as of results measurement. These judgments are especially important when the concept of performance moves from outputs to outcomes. There is rarely a linear connection between the amounts spent and the outcomes that ensue. For this reason, the strict version of performance budgeting emphasises outputs, not outcomes. This was the path taken by New Zealand when it reformed public finance in the early 1990s, and it is the path taken by governments such as Sunnyvale.

In assessing the suitability of performance budgeting for decisions, it is essential to keep in mind that governments finance ongoing organisations, not just programmes and results. This is why organisational units have survived as the main classification scheme in budgeting. As will be elaborated below, organisational performance is defined not only by substantive results but also by its capacity to innovate, its responsiveness to clients, and the morale and skills of its workforce.

The foregoing arguments lead conclusively to the finding that, in all but exceptional circumstances, performance budgeting should be regarded as analytic input into the budget process. The impact of performance information on the budget will vary from one cycle to the next, as well as among programmes within each cycle. A sensible way of thinking about performance information comes from the United States Office of Management and Budget (OMB) which has made significant progress implementing the Program Assessment Rating Tool (PART) that evaluates approximately one-fifth of all federal programmes each year through a menu of questions covering four dimensions of performance: programme purpose and design, strategic capacity, programme management, and programme results. The responses are weighted into an aggregate score for each programme, which is then used together with other information by the OMB to recommend budget allocations. The OMB cautions in its guidelines that "program performance will not be the only factor in decisions about how much funding programs receive. However, the Congress and the President, equipped with information about program performance, can consider performance to a greater degree in their decision making…".[2] In sum, PART is an analytic tool, not a decision rule.

3.2. Measuring performance

Over the years, governments have invested more effort in measurement than in any other feature of performance budgeting. As already noted, measurement has been the only step in many countries. Efforts to measure the activities and results of government expenditure date back many years. One of the earliest was launched more than 70 years ago when Herbert Simon (a future Nobel Laureate in Economics) teamed with the head of the International City Managers Association to devise a measurement scheme based on the concept that "the result of an effort or performance indicates the effect of that effort or performance in accomplishing its objective" (Ridley and Simon, 1943, p. 2)[3]. Since then, thousands of articles and reports have been published, each providing its own language and approach. Perhaps because of the large volume of such studies, management guru Donald Kettl has observed that "measuring government performance is like the weather. Everybody talks about it…but there is no consensus on how to do it."[4]

Because definitions and measures have not been standardised, most governments invent their own, striving to produce the right measurement system for themselves. The novelty and inflated importance of the task often generates interminable argument over whether a particular measure is an output or an outcome, a target or an indicator, a goal or an objective, an end outcome or only an intermediate outcome. In this writer's view, something is amiss when, after decades of research and experience, governments struggle with basic concepts, as if ordinary words such as outputs and targets are so obscure that they need their own dictionary. Protracted argument conveys the impression that measurement is an end in itself; getting government to perform better is secondary to getting better measures.

In the measurement industry, relatively little forethought has been invested in how the new data are to be used in managing government and allocating resources. It is assumed that once data are available, they will be used. Judging from past experience, this is an unwarranted assumption; the more likely action is that they will be ignored. Especially when the aim is to influence budgetary behaviour, it is important to think through the means by which such measures might be invested with greater relevance. To the extent that budgeting entails choices at the margins, it would be sensible to measure performance in terms of the different results that would ensue from different budget allocations. If this were done, the tools of analysis would be aligned with the structure of budget decisions. In fact, however, most performance measures are snapshots: they display outputs or outcomes under only one policy. Although they may yield useful insights, snapshots do not shed light on what budget makers need to know about performance. From the vantage point of politicians and managers, the key performance questions are: what difference will it make if governments adopt this policy option rather than another one? And what difference will it make if spending is raised or lowered? For example, how many more children might complete schooling because the budget is subsidising hot lunches? How many more would continue on to secondary education if the school were staffed with guidance counsellors? As these questions indicate, it is feasible to frame performance measures in terms of the differences in outputs or outcomes that would result from changing the amounts spent.

The next few paragraphs suggest one approach for focusing performance measures on the issues facing budget makers. It is not the only feasible approach, but it is set out here because it fits in well with budget practices in many countries, though the approach itself is not yet used in any country. The core idea is for the government to construct a baseline of the services that would be provided if current policies (including budget allocations) were continued without change. This services baseline would parallel the expenditure baseline that is widely used to prepare and analyse budgets. The expenditure baseline is an essential component of the MTEF; it enables governments to project future spending under current policy. The baseline is usually updated annually (or more frequently) for changes in prices and other economic and programme variables. Once these adjustments have been made, any change in spending – defined as a variance from the baseline – must be the result of policy change. A similar baseline would project the types and volumes of services for the next year or the medium term. Linking the two baselines would greatly enhance the utility of performance measurement as a tool of budget analysis by showing how changes in spending and services are linked.

Many technical issues would have to be resolved in constructing a services baseline, but these are not inherently more difficult than those that arise in estimating baseline expenditures. Both the expenditure and services baselines would rely on assumptions about prices, workload and other variables; both would require rules for estimating future amounts; and both would rely on procedures for adjusting the projections and measuring policy changes. In much the same way that it estimates the spending implications of policy changes, the government would estimate the service implications of these changes. In effect, this is what Sunnyvale must do to compile its annual budget. How else could it estimate the impact of spending levels on response time in the fire department?

The purpose of suggesting the services baseline is not to recommend a particular course of action, but to urge that much can be done to strengthen performance measurement as an analytic tool. Change-oriented performance measurement is relevant because it focuses on the issues governments deal with when the budget is being formulated. Some might object that a services baseline entrenches incrementalism – the tendency to consider only marginal changes – in budget work. The objection is valid, but half a century of warring against incrementalism has left budget reformers with nothing but failure. The most fruitful path to successfully deploying performance measurement is one that recognises and exploits incrementalism's hold on budget decisions.

3.3. Managing for performance

Both as a decision rule and as an analytic tool, performance budgeting is effective only when the managerial culture is supportive. Previous waves of reform assumed that budgeting drives management; if the budget is oriented to results, government entities will be managed for results. This premise was grounded on a simplistic notion: government entities need money to operate. Therefore, if the money they receive is conditioned on performance, they will be motivated to perform better. This reasoning is flawed in this writer's view, and dooms performance budgeting to failure, for it does not recognise that budgeting is shaped by the managerial context within which resources are spent and services provided. If managers do not care about results or if employees are indifferent to how well they perform, installing performance budgeting or similar techniques will hardly make a difference. One of the most important lessons from half a century of disappointment is that budgeting cannot be transformed in isolation from the management practices and culture in which it is embedded. Only when they manage for results will managers be able to budget for results.

One corollary of this theme is that it is necessary to measure or otherwise gauge the performance of public organisations. Good performance is not manna from heaven; in every instance, it has the fingerprints of organisations that are doing their job and producing results. Focusing only on outputs and outcomes ignores fundamental questions about how results materialise. Why do some organisations perform well and others poorly? What are the characteristics of high-performing organisations? How can organisations improve results? These and similar questions have a common answer: public agencies have to be organised, motivated, managed and financed to perform the tasks expected of them.

Some governments have attempted to build organisational characteristics into performance measurement. New Zealand has one of the most interesting systems, for it distinguishes between the government's role as a purchaser of the outputs of state entities and its role as owner of the agencies. There is a tension between the two roles that pulls the government in opposite directions. Its interest as a purchaser is short-term: the government aims to buy outputs for the current or next year at a low price. Its ownership interest is long term: the government is concerned with the capacity of public agencies to respond to future demands and changing conditions, and it is impelled to sell outputs at a sufficiently high price so that agencies can invest in training, research and development, and other actions that capacitate it.

In New Zealand, the purchaser role overwhelmed ownership, with the result that inadequate attention was given to organisational health. The balanced scorecard, which was in vogue a few years ago, attempted to redress this imbalance by treating outputs as only one of four sets of interdependent performance measures. The other three pertain to internal processes and practices, staff quality and morale, and customer needs and satisfaction. In calling attention to this approach, this writer's aim is to encourage governments to think in organisational terms when they invest in performance budgeting. As an analytic tool, performance budgeting works only when the tool is wielded by agencies that know how to use it and are motivated to perform.

4. Accrual budgeting

To assess the accrual basis, it is necessary to distinguish between *ex post* reporting of financial results and *ex ante* specification of revenue and expenditure policy. While it may be appropriate to prescribe the accrual basis in financial reporting, extension of this principle to budget statements raises critical questions that must be addressed by each country through its political-administrative machinery. It is essential to standardise financial statements, but it may still be appropriate for countries to establish their own budget conventions. Thus, the case for accrual budgeting must be made independently of arguments used in support of accrual accounting.

The recent development and dissemination of public sector accounting standards have impelled many national governments to accrue assets and liabilities on the balance sheet, as well as income and expenses on operating statements. However, few governments systematically accrue revenues and expenditures in the budget. The short list of countries that have full accrual budgets is Australia, New Zealand and the United Kingdom. Other countries have adopted accruals for certain types of transactions. These countries include Iceland, Sweden and the United States. All these countries differ from one another in applying accrual principles to the budget. Some of the countries set aside money for depreciation or a capital charge, others do not. Some book all taxes due as current revenue; others recognise revenue when it is received. These and other differences indicate that accrual budgeting is still in the testing stage, and that it would be premature for all but the most *avant garde* countries to shift their budgets to this basis.

All of the national governments that have implemented accrual budgeting have two distinguishing characteristics. They are regarded as among the best managed countries in the world, and they generally give public managers broad operating discretion. These characteristics may be necessary preconditions for accrual budgeting. Strong management is essential because the accrual basis adds to the complexity of financial management and requires both skill and probity in valuing assets and liabilities. Operational discretion is also important to enable managers to efficiently use available resources. Without appropriate discretion, managers are likely to regard accruals as technical entries that have no bearing on the resources available for expenditure.

4.1. Reporting and budgeting

The disparity between the wide application of accrual accounting and the limited implementation of accrual budgeting suggests that the factors which have induced governments to present their financial statements on the accrual basis are not as compelling in determining how governments go about estimating future revenue and expenditure flows in the budget. Financial statements are subject to audit, budgets are not, though it is possible that they will be in the future. Financial statements are a means of communicating the government's condition to interested outside parties; budgets traditionally have been a means of communicating within government. The fact that some cutting-edge governments have embraced accrual budgeting indicates that the traditional differences between the two types of statements may be narrowing. But the two types of statements still serve different purposes, and the methods suitable for one might not suit the other.

The distinction between financial reporting and budgeting bears directly on the central question of this article: When should a particular form of information be cast as an analytic rule or a decision tool? Prescribing the accrual basis for financial statements gives a government valuable insights that may enhance the formulation of budget policy. With current information on assets and liabilities, a government can more clearly assess how changes in budget policy would impact its future financial condition. But as long as the budget itself is not on the accrual basis, these insights are only analytic tools, even though they are mandated for financial reports. However, if the budget were put on an accrual basis, this would become a decision rule for estimating the receipts and expenditures expected for the next or subsequent financial periods.

The fact that many governments report but do not budget for accruals indicates a preference for treating information on assets and liabilities as aids to analysis rather than as categories for decision. This is exemplified by the latest reforms in France. Much of the literature on the accrual basis, however, ignores the differences between reporting and budgeting and assumes that what is appropriate for the former also suits the latter. For example, a report published in 2003 by the Asian Development Bank devoted more than three-quarters of its 85 pages to accrual accounting, but then argued that if it were applied only to financial reporting, accrual information may not be taken seriously. The budget is the key management document in the public sector, and accountability is based on implementing the budget as approved by the legislature. If the budget is on a cash basis, that is going to be the dominant basis on which politicians and senior civil servants work. Financial reporting on a different basis risks becoming a purely technical accounting exercise in these cases (Athukorala and Reid, 2003, p. 51).

No claim is made here that accruals add value to budgeting; rather, the case rests on the value that would be subtracted from financial reporting if the budget were on a cash basis.

It should be noted that even when both reporting and budgeting are on the accrual basis, they may show different financial results either because they apply different accounting rules or because they value things differently. For 2005, the State of Queensland in Australia reported a budget surplus of approximately AUD 3 billion, but the balance sheet reported an AUD 18 billion increase in net worth. This increase was due principally to revaluation of existing assets, not to the accumulation of additional assets during the financial year. The difference between the balance sheet and the budget is justified because one measures financial stocks and the other measures financial flows. A much stronger case can be made for applying accruals to stocks, because they provide a full accounting of an entity's assets and liabilities, rather than applying accruals to flows, which measure financial transactions during a fixed time period. The accrual basis would transform the budget from a statement of flows to a statement of fiscal impact. In fact, one of the aims of those who advocate accrual budgeting is to turn the budget into a fiscal impact statement.

Before endorsing this transformation, it would be useful to consider the evolution and purposes of budgeting and how accruals might affect budgetary practices. Modern budgeting emerged in Europe more than two centuries ago as a means of planning and regulating the cash flow of government during a fixed period, typically a single fiscal year. Budgeting supplemented appropriations, which were already on the cash basis and restricted the amounts that the government was authorised to spend. Because it is inherently a political statement, the budget had its own country-specific rules and conventions. The fiscal balance was calculated as the arithmetical difference between cash received and cash paid out during the financial year. This calculation only covered accounts and funds that were included in the budget; it did not include off-budget or extrabudgetary items.

Operating within their own rules, budgets were subject to manipulation, as opportunistic politicians sought to project or produce fiscal outcomes that suited their interests. In many countries, the manipulations were marginal, such as adding a bit to revenue by selling assets, or subtracting a little from expenditure by delaying certain payments. Although they were not good practice, the manipulations enabled cross-pressured politicians to muddle through from one budget year to the next. In some countries, however, manipulations became so common and significant as to undermine the integrity of budget accounts. Whether marginal or major, these practices highlighted deficiencies in cash-flow budgeting.

During the past two decades, several factors have converged to challenge cash-flow budgeting. One has been the internationalisation of accounting rules and the auditing of government financial reports. The IMF shifted its government finance statistics (GFS) to the accrual basis at the start of the 21st century, and the International Public Sector Accounting Standards Board (IPSASB) has been busy promulgating accrual-based rules for public entities. In addition, various international organisations have co-operated in shifting the system of national accounts (SNA) to a modified accrual basis. A second, related, influence has been the rapid spread of fiscal rules which constrain budget options and outcomes. Effective enforcement of these rules depends on objective information concerning the government's fiscal performance. Moreover, without accounting standards, these rules would provide politicians with fresh incentive to manipulate the timing or recognition of various transactions to make the government's fiscal position appear more favourable than it actually is. Finally, the successful conversion of pioneer countries such as New Zealand to the accrual basis has spurred other countries to follow suit.

In business firms, the budget is an internal document that is not bound by accounting rules. Each firm can prepare its budget in the format and on the basis that fits its interests. However, government budgets are not internal documents; they are presented to parliament for approval and are one of the major instruments for informing citizens of public policies and priorities. Arguably, citizens should have transparent, tamper-proof statements of the government's budget plans that comply with accepted accounting standards and are not manipulated for political advantage. Despite these considerations, cash-flow budgeting has several compelling advantages. It is better understood by citizens and the government than accrual budgeting; it may be less prone to manipulation; and it may provide a more reliable indicator of the government's near-term fiscal condition.

Shifting to the accrual basis transfers budgetary power from elected leaders to technical experts. Cash is the everyday currency of private and public transactions. Governments take in cash and spend cash, and the amounts reported are actual rather than assumed. Accruals are grounded on complex assumptions that can befuddle experienced politicians. One should not be surprised if technocrats get into the habit of soothing the concerns of ministers, assuring them that "these are only technical entries that do not affect the resources you really have to spend". One entry adds money to pay for depreciation or a capital charge; another entry withdraws an equivalent amount of money. In some instances, this new form of double-entry budgeting might change political or managerial behaviour. In most, it will not.

One of the reputed advantages of accruals is that they are less subject to manipulation than cash. Under accruals, the government does not increase its net worth by selling assets for cash, nor does it improve its fiscal position by accelerating tax collections or delaying bill payments. But under the accrual basis, governments can manipulate fiscal estimates or results by changing assumptions about interest rates or tax arrears, adjusting discount rates, revaluing assets, or altering some of the myriad assumptions made in the course of accruing revenues and expenditures. It is often much harder to detect manipulations that are buried under layers of assumptions than those linked to cash transactions.

Finally, cash is sometimes a more reliable indicator of an entity's current financial condition. As the accrual basis becomes embedded, accounting authorities produce more rules which increase the variance between cash flows and accrued results. In recent years, the International Public Sector Accounting Standards Board (IPSASB) has issued more than 20 accrual-based rules for public sector entities, and more can be expected in the years ahead as new financial instruments are devised or new conditions arise. In some circumstances, cash may be a more accurate indicator of fiscal performance. It is well known that the shares of companies whose reported earnings are depressed by negative accruals tend to outperform companies whose earnings are boosted by accruals. This "accruals anomaly" (the term applied to the phenomenon in finance studies) indicates that investors who pay attention to cash earnings will do much better than those who focus on reported earnings.[5] Although one should be wary of generalising from business accounting to government finance, the clear implication that cash is a useful measure of financial performance does pertain to public entities.

4.2. Accruals as an analytic tool

Accruals warrant a prominent place in financial reporting because they provide insights into government finance that are not yielded by cash alone. The three most salient claims for accruals are that they provide better measures of the government's current fiscal condition and of long-run sustainability, and they encourage managers to operate efficiently. Each is important, and each warrants close review.

When the government's **fiscal condition** is measured in cash, it is likely to be incomplete and subject to manipulation. Cash accounts do not include depreciation of assets and can be made to appear more favourable by manipulating the recognition of transactions. The shorter the timeframe, the greater the scope for manipulation. In a one-year budget cycle, the government need only defer expenditure or advance tax collections by a few days (or weeks) to produce more favourable outcomes. In a medium-term frame, shifting from one year to another may make little or no difference. Yet, even on an annual basis, there is often little difference between cash and accrual accounting. In New Zealand, for example, for the 2004 financial year, there was less than a 0.8% variance between revenues recognised on the cash and accrual bases. The variance was also very small for current expenditure, with expensing of depreciation under the accrual basis largely offset by deferring recognition of capital expenditure. In fact, in some circumstances, the accrual basis yields a lower deficit (or higher surplus) than in cash accounting.

It may be argued that New Zealand has an elevated degree of probity in public finance and does not purposely manipulate transactions to improve cash flows. Countries lacking this ethic are likely to show much larger variances between cash and accruals, as would countries which do not efficiently maintain public infrastructure or have significant leakages in tax collections. All this may be valid, but it leads this writer to the conclusion that countries (such as New Zealand) which are best prepared for accrual budgeting get rather little out of it; and countries that need it the most because they have the greatest variances between cash and accruals (such as those which finance deficits through asset sales) probably lack both the technical skill and the political will to operate accrual budgets.

Governments can guard against the manipulation of accounts in a cash system by establishing rules concerning certain types of transactions. Some governments treat income from asset sales as a means of financing rather than as a cash inflow, while some exclude savings due to timing adjustments from baseline projections. It may be argued that these rules introduce accrual-like rules into budgeting, yet they do so within a cash framework. In other words, the government avoids both the cost of moving to accrual budgeting and the principal distortions of cash budgeting.

The second claim shifts the focus from the short (or medium) term to long-term **fiscal sustainability**. The key concern is that governments that budget on a cash basis tend to ignore the accumulation of liabilities that will be paid in the distant future typically for pensions and health care. But accounting rules significantly diminish the utility of accruals as indicators of long-term fiscal soundness. While they provide for governments to recognise future payments for their own employees, accounting rules preclude the recognition of liabilities for social security and other non-employee benefits.[6] Whatever the rationale for including one type of liability and excluding the other, the result is that accrual-based statements do not provide sufficient insight into the government's future fiscal position. Some well-run national governments have supplemented official financial statements with long-term fiscal sustainability studies which do include social security and other liabilities excluded from accrual accounts. The United Kingdom Treasury publishes an annual long-term fiscal forecast, and the government of Australia publishes an intergenerational report every five years. These sustainability analyses can be conducted regardless of whether the budget is cash or accrual based.

The third claim is that accrual budgeting establishes conditions for **managerial efficiency and accountability** because it budgets all the costs associated with carrying out particular activities or services. Managers are accountable for all costs, including those paid out of other accounts (such as employee pensions and the imputed cost of accommodation in public buildings). Operating accounts are charged for the depreciation of physical assets and (in some countries) for the capital invested by the government in the entity. Capacity and incentive to manage costs depend on managers having broad discretion to spend operating funds as they deem appropriate. When managers lack operating freedom because the funds they spend are earmarked for designated purposes, making them responsible for full costs is counterproductive, for they are charged for matters over which they have no control.

At present, few national governments give managers sufficient operating discretion to make effective use of accruals. Those governments that do risk complications when managers take money appropriated for depreciation and spend it on other items instead. This has occurred in Australia which, in contrast to some other countries that have accrual budgets, makes cash appropriations for depreciation. In the countries that do not, depreciation and some other accrued charges are regarded as technical matters that have little bearing on how public funds are managed.

Thus far, there is little evidence that accrual budgeting has made much difference in managerial behaviour. It can be argued that accrual accounting and budgeting work only when they are accompanied by performance management and budgeting. Without these management capacities, it is prudent for countries to continue to upgrade their existing cash-based systems. In other words, accrual budgeting may only be ripe for the small cohort of best managed governments. Many countries would achieve greater progress by improving cost allocation and measurement systems, broadening managerial discretion, and enhancing the quality of performance measurements than by moving to accrual budgeting.

In line with the earlier discussion, countries that have adopted accrual budgeting claim that it has strengthened short-term fiscal performance. But programme managers rarely use accrual budgeting to manage operations. Although it has strongly endorsed accrual budgeting, the Asian Development Bank has also concluded that accrual "information does not necessarily change results". Drawing on New Zealand's experience, the ADB found that the improvements achieved by government were primarily due to political will. A less sophisticated system could have achieved a great deal in the presence of that political will, and an even more sophisticated system would achieve very little if the political will to use it were not present (Athukorala and Reid, 2003, p. 51).

This conclusion has profound implications for the central issue of this article. The essential purpose of new decision rules is to compel changes in budgetary behaviour. But if the changes sought depend on the will of those who manage the budget, the new techniques serve only as analytic tools.

5. Concluding remarks

Neither performance budgeting nor accrual budgeting is ready for widespread application as a decision rule. Both have unresolved issues and are costly to implement. In performance budgeting, the key issue is the extent to which resources should be linked to results; in accrual budgeting, the issues are much more complex and pertain to the valuation of assets, recognition of revenues, treatment of depreciation and capital charges, and other unresolved questions.[7] The few countries that have adopted accrual budgeting have taken different approaches; their experiences should provide a firmer basis for assessing accruals in the future.

Although they are distinct innovations, performance budgeting and accrual budgeting share a dependence on robust, results-oriented management and full cost attribution. Because these qualities are absent in most countries, the suitability of performance and accrual systems is limited. It is not surprising, therefore, that the countries which have good performance-based management are most likely to have adopted features of accrual budgeting. For the vast majority of countries, performance budgeting and accrual budgeting suffice as analytic tools. This is a second-best solution that promises greater gains in budgeting than would be forthcoming from the pursuit of cutting-edge innovations.

Notes

1. The *Analytical Perspectives* for the fiscal 2007 budget is a document of 400 pages. It is published by the United States Government Printing Office together with the main budget documents.
2. PART instructions and results are published on website of the Office of Management and Budget, *www.omb.gov*.
3. This book was drawn from monthly articles published in 1937 and 1938.
4. Quoted in Osborne and Plastrik (2000), p. 249.
5. The seminal study on this subject is Sloan (1996).
6. Under generally accepted accounting principles, a liability is recognised when an event has already occurred, a future payment is probable, and the amount can be reliably estimated.
7. The main issues are presented in Blöndal (2004).

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Engaging the Public in National Budgeting: A Non-Governmental Perspective

by
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This article explores how citizens are being engaged in an important area of policy making – the budget – and suggests ways in which budget officials can use the powerful resource of the Internet to further that involvement.

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1. Introduction

Budget experts everywhere complain that citizens' seemingly unending appetite for more public services and benefits is not matched by a corresponding willingness to pay for them. The public does not seem to understand the need for short-term fiscal trade-offs, let alone grasp the potentially serious impact that demographic changes may have on long-term budget outlooks. While citizens welcome spending that provides them with visible and immediate benefits, many seem blind to the need for essential public goods and resist paying for them.

Many public officials, academic researchers, civil society organisations and government experts view public engagement as one solution to the absence of popular support for responsible fiscal policies. Public engagement in civic affairs is both "means" and "ends" of well-functioning democratic government. It is a necessary element of efforts to improve official accountability: it results when citizens feel connected to their government. An engaged public demands that government be efficient, responsive, transparent and accountable. Government, in turn, becomes more open to the public's input and participation. Thus, public engagement creates mutual benefits: citizens become better educated about public policies and government activities; and by tapping into the experience and expertise of their constituents, officials can build more effective and responsive government.

The alternative to an engaged public is not an apathetic one, but one that is cynical and mistrustful of government. Public officials in many countries are concerned that disengaged voters could make it more difficult to undertake constructive policy changes. In response, many of those concerned with improving government, including multinational institutions such as the OECD, the United Nations and the World Bank, as well as government officials, civil society organisations and academic scholars, have established the goal of increasing public engagement as a top priority.[1] Although civil and political contexts differ from country to country, public engagement activities share the same basic objectives of making government work better by bringing it closer to citizens, improving the accountability of the public sector, overcoming mistrust between people and their elected leaders, and instilling a stronger sense of national purpose and common direction.

This article explores ways in which citizens can be and are being engaged in an important area of national policy making – budgeting – and suggests ways in which budget officials can use a powerful resource – the Internet – to be supportive.

Budgeting is a fundamental activity of government, symbolising an explicit agreement between people and their government: private resources in exchange for the public services and benefits that fulfil national priorities and objectives. Citizens rightfully expect governments to deliver on that promise. They further expect that public budgets be fair, equitable and transparent. If citizens believe that the management of government finances is subject to corruption, inefficiency and waste, they question the motives of their leaders and are less willing to accept tough policy choices such as structural programme reforms, tax increases and spending cuts. Their resistance is further hardened if they feel that government does not represent their interests or respect their opinions about how to allocate public resources.

Strengthening the transparency and openness of public budgets can help promote social accountability and restore the public's confidence in overall government. That will enable citizens to become more engaged and, in the process, learn more about the budget and fiscal policy concerns. As they do, cynicism should dissipate and trust in government should improve.

Globally, there is increasing recognition of the importance of public engagement in budgeting. There is growing experience, particularly in Latin America and in Europe, with different approaches to incorporating citizens in budgeting at sub-national levels of government. Municipal and regional public authorities, often in partnership with civil society organisations, are actively involving citizens in the budget process and are achieving promising results. Some have gone as far as adopting participatory budgeting measures that allow citizens direct influence over selected budget categories and fund allocations.

At the national level, however, the citizens' ability to participate in budgeting (as with other areas of policy making) is limited to periodic elections of representatives who will act on their behalf. The direct approaches used by sub-national public authorities clearly are not workable at the national level. The very barriers that inhibit local initiatives are magnified at the national level. For example, physical distance, even given technological assistance, constrains the number of people who participate; the numbers of citizens who want to be involved limit meaningful participation by single individuals; and the time required to understand the complex issues excludes all but the most committed members of the public.

In addition, some elected leaders, policy officials and budget experts may prefer to maintain distance between voters and the national budget process.

Budgeting is already one of the most difficult tasks of government. More public participation would further complicate the process. Few voters have the time – even if they have the inclination – to become sufficiently knowledgeable about the complex economic, social and political issues embedded in national budgets. Some experts fear that if voters become more involved, they will not appreciate the need for essential public goods and, if given the choice, would not agree to pay for them. In any case, the practical challenges of securing representative and widespread public participation in the budget process would be significant. For those reasons, among others, greater civic engagement in budgeting might seem to offer public officials a great deal of political pain with very little gain.

Or would it? Direct participation by citizens in the national budget decisions may not be feasible or desirable, but this article argues that other forms of engagement can promote good government objectives. Moreover, budget officials can be supportive with relatively little effort. Governments create and control budget and accounting information. They are in the unique position of being able to provide access to the information required by civil society to understand fiscal policies and performance. By improving the quality and presentation of budget information, budget officials can enable non-expert audiences to become more informed about the budget. As they do, citizens can become more thoughtful about government, more realistic in their expectations, and better prepared to exercise their oversight of elected representatives.

With the rapid expansion of technology, governments are no longer dependent on intermediaries – such as the public media – to communicate with constituents. Official websites provide unfiltered information directly to the public on a cost-effective basis. Many public agencies already make good use of their websites to communicate information about their activities, programmes and benefits. Budget office websites, however, seem to ignore the wide range of users inside and outside of government that now have access to them. That may reflect the inwardly-focused nature of government budgeting and accounting. As a result, budget officials are missing a valuable opportunity to communicate with wide audiences about fiscal policies and budget realities.

In Section 2, this article discusses the merits of greater civic engagement in budget policy. The discussion looks beyond the direct government-to-citizen approaches that are the focus of rather extensive study by the OECD, the UN, the World Bank and participatory governance experts. That is because such initiatives involve municipal or regional governments. Although the experience at the national level with public engagement activities is thin, there is evidence that they hold promise.

Section 3 focuses on online approaches to public engagement, the most efficient approach to national efforts. Using a small number of examples[2] this article illustrates how budget officials are already making use of the Internet to educate and engage the public. Some are pursuing more effective techniques of presenting budget information while others are utilising innovative approaches that entertain while they educate. The article also provides examples of organised and unorganised non-governmental activities to engage the public, which are crucial to reaching national audiences.

The annex provides suggestions for improving the accessibility of budget office websites for users who are not budget experts.

Engaging the public in budget policy is by no means an easy goal. Policy makers are not likely to change national budget processes to involve citizens in budget deliberations, but budget officials can provide support for the efforts of non-governmental and individual efforts to inform and become informed. Access to accurate, reliable and comprehensive budget information can raise the quality of the public debate. Its absence allows misinformation to go unchallenged, potentially feeding public mistrust and cynicism about government. By assuring that good information is readily available, budget officials can make an important contribution that benefits the public at large as well as the independent analysts, academic researchers, investors, civil society organisations and media that serve as intermediaries between citizens and government.

The goal of public engagement is to empower citizens, thereby enabling them to make their governments more open, responsive and effective. Governments, however, should not encourage greater engagement by citizens because they expect immediate and measurable improvements in budget outcomes. Instead, changes are far more likely to take the form of gradual improvements in popular understanding of policy issues. However, government-sponsored activities that raise expectations that cannot be fulfilled, that are purely partisan or that create the illusion of participation without real impact may be counterproductive and damage the government's credibility. They could increase levels of public cynicism instead of promoting greater trust in government.

2. The case for public engagement

> "For we alone regard the man who takes no part in public affairs not as one who minds his own business, but as good for nothing: and we Athenians decide public questions for ourselves or at least endeavour to arrive at a sound understanding of them, in the belief that it is not debate which is a hindrance to action, but rather not to be instructed by debate before the time comes for action." (Speech delivered by Pericles in 430 B.C. according to historian Thucydides; quoted in Dunn, 2005, p. 27.)

Today's governments have little in common with the ones that ruled ancient Greek city-states. Apart from elections, our democracies do not require the direct participation of citizens. Simple scale – the size of the national political unit in terms of population and geography – rules out direct democracy and hampers the ability of ordinary citizens to participate in public discourse. Consequently, modern democracies are built on representative principles.

Nevertheless, Pericles' description of ideal civic behaviour is still valid. Representative democracy rests upon the premise that citizens collectively are reasonably informed about public matters and thus can exercise their votes responsibly. The electorate must be well informed if citizens are to hold elected officials accountable for their decisions. Clearly not all people will be equally concerned or will possess the same amount of knowledge to contribute constructively. But a large enough percentage must be capable of exercising good public judgment if government is to succeed.

Most public officials endorse the idea that modern government should actively seek to strengthen itself by supporting citizens' efforts to make their public institutions reflect their interests, views and values. Public distrust and cynicism provide compelling evidence of distance between government and the people it should serve. Increasing the public's engagement can help close that gap and lead to stronger democratic government, one that is more open and responsive to the needs of its people. Over time, an engaged public should lead to better public policy and budget outcomes, including more equitable and efficient allocation of resources and greater long-term fiscal stability.

There is an important relationship between civic engagement and fiscal transparency. Citizens are more likely to trust government if they know that public funds are well managed. When governments disclose fiscal information, citizens can determine whether budget execution is consistent with their national priorities and can demand changes to policy if it is not. That oversight creates a virtuous cycle: disclosure, scrutiny, understanding and policy adjustment lead to further disclosure, more scrutiny, etc.

The ability to promote public engagement extends beyond official activity. Non-governmental resources can play a strong role in bringing the public closer to the policy-making process. Some civil society organisations provide independent analyses of public policies and serve as outside monitors of government programmes and operations. Other groups educate citizens and help bring them into the public debate. All of those non-governmental efforts need timely access to good information. Thus it is essential that government provide full and accurate information about the budget and programme performance. Anything less creates barriers to public involvement with policy making.

To date, most of the experience with civic engagement in public budgets is at the level of municipalities or regional governments. Some localities have adopted participatory budgeting, which allows citizens direct influence over selected budget categories and fund allocations.[3] Sub-national experience produces important insights into such issues as timing, scope and scale required for successful engagement processes:[4]

- **Potential for unrealistic expectations:** Citizens must understand how their input will be used. If their views are merely advisory, they should know the extent to which they will be taken into account by decision makers. Otherwise, popular expectations could result in demands that cannot be fulfilled.
- **Timing is critical:** Public participants will have greater confidence in engagement efforts if they are consulted early in the decision-making process. Otherwise, they will perceive that their input has little chance to influence decisions.
- **Competition with existing processes:** Government officials and policy makers are key to successful civic engagement strategies. They will be more responsive and co-operative if they do not feel that they are being bypassed or threatened by engagement activities.
- **Non-representative participation:** The most vocal public participants may not be truly representative of the overall population. Unorganised citizens are vulnerable either to "capture" by organised special interest advocates or to being co-opted by government officials and experts. Civic engagement activities must attract a broader spectrum of participants to represent all segments of society.
- **Free rider problem:** Popular resistance to funding essential public goods could harden if participants cannot be convinced of their importance.
- "**Bad**" **outcomes:** Officials should decide how to respond if citizens misunderstand the issues, express unwise choices or fail to appreciate the consequences of their preferences. Those results may signal the need for greater public education about the issues, or they may demonstrate areas where decision makers are out of step with the electorate.

The self-reinforcing benefits of public engagement can be summarised as follows:

- Overall improvements consistent with good government:
  - ❖ Engaged citizens feel empowered. They have more input into the establishment of priorities and feel that they have a stake in outcomes.
  - ❖ Citizens feel that government works for them; as a result, they place greater trust in government and public officials.

- ❖ The interests of under-represented and vulnerable groups (including the poor, women and children) can be better protected, and there is greater equity in the allocation of public resources.
- ❖ Government can exhibit greater transparency, making it more accountable to citizens.
- ❖ Government can be more open, allowing expanded access to information.
- ❖ Opportunities for waste, fraud and abuse decrease as accountability improves and public awareness and scrutiny increases.

- Improved climate for the development and pursuit of good fiscal policy:
  - ❖ Citizens' access to information and participation in the public debate leads to more accurate understanding of public finances, particularly basic questions like where the money comes from and where it goes.
  - ❖ Voters confront fiscal realities and acknowledge the need to make trade-offs.
  - ❖ Citizens become aware of issues related to intra- and inter-generational equity and are able to cultivate a stronger sense of stewardship.
  - ❖ Public thinking becomes more realistic, providing expanded opportunities for negotiation, compromise and consensus.

2.1. What is public engagement?

Work by the OECD and the World Bank focuses on interaction between the government and citizens: the government engages citizens either directly or through intermediary civil society organisations or interest groups. Engagement generally implies that citizens participate in the policy-making process, whether as part of the formal governmental process or in a parallel civic process. The OECD endorses civic engagement as a strategy to promote good government practices, close the gap between the government and citizens, improve citizens' trust, and reduce their cynicism towards government. For the World Bank, public engagement can also promote economic development, encourage a more equitable allocation of public resources, and provide greater relief from poverty.

The OECD identifies three types of government-citizen interaction used by governments to strengthen relationships during the policy-making process (OECD, 2001a, p. 21):

- **Information:** The government uses passive or active means to disseminate information to the public. The flow of communication is one way, from the government to citizens. Interested parties must seek out passive information, which is available upon request. Examples include official records and archives and publications. Or the government can work actively to distribute other information through, for example, websites, press conferences and press releases, and official speeches.

- **Consultation:** Consultation involves a two-way exchange of information between the government and citizens. The government defines the issues and solicits feedback from the public. Examples of consultative processes include hearings, town hall meetings, and polls and surveys.
- **Active participation:** This category includes the types of activities the OECD considers as public engagement. The government provides structured opportunities for citizens to become involved in defining the policy-making process and its content. The government acknowledges citizens' standing in the discussion but generally retains the responsibility for policy formulation and final decisions. Examples, which occur primarily at sub-national levels of government, include participatory budgeting, popular referenda, citizen representation on government commissions and panels, and citizen juries.

The World Bank uses a broader concept of civic engagement, which it defines as "…the participation of private actors in the public sphere, conducted through direct and indirect interactions of civil society organisations and citizens-at-large with government, multilateral institutions and business establishments to influence decision making or pursue common goals" (World Bank, 2003a, p. 1). That definition incorporates the efforts of non-governmental actors in organising and encouraging wider citizen participation in the decision-making process.

Integrating citizens into the budget process is becoming more common in municipalities and regional governments, but it is less likely to be found at the national level. That is because the characteristics of civic engagement that make it effective at the local level are difficult to replicate at the national level. For example, geographic proximity, which allows citizens to deliberate on a face-to-face basis with each other and with lawmakers on local budgets, cannot be easily reproduced at the national level. Similarly, participants in local processes, when deciding between competing needs, generally consider tangible questions such as public investment projects about which they have or can easily gain some direct knowledge. Those advantages would be largely absent at the national level.

Consequently, the broader concept used by the Philanthropy for Active Civic Engagement (PACE, a United States organisation of private foundations that support civic engagement) appears more relevant to the national policy process. It defines civic engagement as "…activities by which people participate in civic, community and political life and by doing so express their commitment to community" (PACE, 2005, p. 6).

The common elements that emerge from the three concepts of public engagement are:

- Citizens' involvement is **constructive**.

- Participation is intended to **influence public decisions**.
- The goal is to **improve community and further the common good**, not advance immediate self-interest.

Those themes form a concept of civic engagement that accommodates the complexity and the difficulty of public involvement in national policy making. It recognises that the principal benefit of public engagement is educational, not decision-oriented. It is more likely to involve the other forms of government-citizen interaction – the information and, to a lesser degree, consultation categories of the OECD described above – than direct participation. The government's role is not limited to direct activities. It can also facilitate a range of efforts by non-governmental organisations and even unorganised individuals. Those third-party activities will then help to generate a more active public discussion about national issues.

As the government works to enable citizens to become engaged in national issues, its role is twofold:

- To provide timely, accurate and comprehensive information in a user-friendly format. Information sharing improves transparency and allows public scrutiny.[5] The information that citizens receive, whether directly or through intermediaries such as the media, civil society organisations, or public policy researchers, stimulates thought, discussion and debate.
- To open channels for the public input that results from informal engagement activities. When citizens are provided with opportunities to communicate with policy makers and when they are actively consulted in formal sessions or through other means, they advance their understanding of the issues and options. Policy makers, too, become better informed by hearing alternative perspectives.

2.2. Why engage the public in the budget process?

Public understanding and scrutiny of government budgets is of paramount importance. The budget provides an explicit expression of the government's role in the economy and the society. The budget identifies public priorities by allocating resources and distributing the responsibility for financing those activities. In addition, budget outcomes send strong signals to the public about how well or poorly the government is operating.

When reporting on the budget, mainstream media tend to concentrate on stories of corruption and waste, as well as the political winners and losers in budget debates. Headline stories trumpeting public misuse of funds have a corrosive impact on public opinion and contribute to the perception that the government does not represent people's interests and is poorly managed. As a result, the general public may have few sources of positive, let alone comprehensive, information about the budget. That narrows their perspective on how budget decisions affect their lives and their communities.

Citizens have rare opportunities to consider national budget issues. The typical budget process produces a debate that is largely conducted among experts, including representatives of special interests, who communicate in terms that are incomprehensible to anyone beyond their circles. That leaves the public with little voice and even a lesser role as the national budget is formulated, legislated and executed.

It is more difficult to achieve progress on complicated public issues when the public is not engaged. Raising the public's level of engagement could help overcome popular resistance to important fiscal strategies.

In the United States, budget experts are concerned that the gulf between citizens and policy makers has created an environment that prevents constructive action on the budget, particularly where long-term fiscal imbalances are concerned. Unengaged and uninformed citizens favour policies that appear to be in their immediate self-interest, and they believe in overly simplistic solutions. Budget officials and elected leaders tend to mistrust the public's views and underestimate the public's potential to participate meaningfully in the decision-making process.

Research by Viewpoint Learning on public attitudes towards the budget indicates the serious schism that exists between citizens and leaders regarding the United States budget (see Table 1). A public with the attitudes shown is likely to hold inconsistent and contradictory views, be prone to "wishful thinking" (*i.e.* budget deficits result from waste, fraud and abuse), be focused more on self than the larger public good, be inattentive to issues, and provide little evidence of common ground (Yankelovich and Wooden, 2004). Closing the gap can improve trust, discover common ground, resolve conflicts and generate feelings of ownership in ultimate policy choices.

In Europe, voter turnout rates for national elections in many countries are declining while expenditures for social programmes are growing. That is contrary to the expectation that a positive relationship should exist between citizens' voting behaviour and the government's ability to affect their lives in direct and meaningful ways. At the supranational level, the voter turnout rates are worse. In 2004, fewer than half of the electorate voted for the European Parliament, a body that will oversee the economic integration of the European Union. According to some, the low voter turnout rate reflects distrust of government and a feeling that elected officials do not care about their constituents (Rose, 2004).

A greater level of citizen engagement in the process of integration would help build confidence in the legitimacy of the public institutions that are charged with complicated questions related to public welfare at the national and supranational levels.

Table 1. **Divergent views of the budget in the United States**
A wide – and serious – disconnect between citizens and leaders

What citizens see	What leaders see
"Black box" of budgeting and decision making	People "wanting it all" but unwilling to pay for it
Powerful special interests and partisanship	An uninformed public that has little of value to offer policy making
Little of value being done to address challenges	Apathetic citizens who do not want to be engaged
Experts are running the show	Activists hijack all attempts at public dialogue

Source: Yankelovich and Wooden, 2004.

In developing countries, the World Bank promotes social accountability to counter corruption, clientelism and capture, which misallocate resources, lead to leakages and waste of resources, and interfere with the delivery of public services (Malena *et al.*, 2004). Social accountability – which the World Bank defines as "an approach towards building accountability that relies on civic engagement, *i.e.* in which it is ordinary citizens and/or civil society organisations that participate directly or indirectly in exacting accountability" – can produce meaningful change in the way government operates. Furthermore, when people – particularly those who are under-represented and excluded from governing processes – become engaged, they are empowered. They are then better able to achieve a more equitable allocation of public resources.

2.3. What are the potential benefits of an engaged public?

Budget experts and public officials may fear that engagement activities will confer too much weight on the opinions of a public that is insufficiently knowledgeable about the issues and thus incapable of making informed choices. Work by two non-governmental organisations in the United States proves that an engaged public is fully capable of making and supporting responsible decisions. Their efforts provide insights into the public's ability to engage in constructive and beneficial discussions about complex issues.

2.3.1. ChoiceDialogue™ on the United States budget

Viewpoint Learning conducted eight-hour sessions or ChoiceDialogues™ with three groups comprised of statistically representative cross-sections of the United States population (Rosell *et al.*, 2006). The sessions probed participants' views on federal budget issues by leading them through structured discussion and dialogue about policy options. The methodology is designed to go beyond "snapshot" readings of people's "top-of-the-head" opinions and "predict the future direction of people's views on important issues" once they have the opportunity to consider information, talk with each other and rethink their views.

The ChoiceDialogues™ confirmed the public's cynicism and mistrust of government, but identified specific problem areas that policy makers could address in order to restore trust. The ChoiceDialogue™ report contains the following comments and observations:

- The main obstacle to building public support for difficult choices on the nation's finances and future is not public opposition to tax increases or programme cuts, nor is it lack of interest; the main obstacle is deeply felt and pervasive mistrust of government.
- "The public is ready for this conversation." Participants (a random sample of citizens) were thoughtful and serious, not apathetic or unwilling to consider difficult choices, "and it was clear that beneath their mistrust and dissatisfaction was a deep desire to address the problem".
- Public engagement is the key to overcoming mistrust. Although government's accountability and transparency must be improved, those actions alone will not be sufficient to overcome mistrust. Most participants do not believe that leaders and governments are interested in their views. To overcome mistrust, government must find better ways to communicate with citizens and convince them that their views are heard and are important to decision makers.

On the critical issue of improving trust and accountability, participants indicated:

- Government must use performance as the basis for funding or changing programmes. Citizens would like to see greater focus on measuring and reporting outcomes.
- Citizens have responsibilities, too. They should play an active role in making government more accountable by participating directly in the political process or through exercising stronger oversight and endorsing stronger "watchdog" mechanisms.

2.3.2. "The Exercise in Hard Choices℠"

The Committee for a Responsible Federal Budget is a bi-partisan organisation dedicated to educating the public about the budget and the budget process. It created a participatory budget simulation exercise called "The Exercise in Hard Choices℠" (*http://crfb.org/html/exercise.htm*[6, 7]). Unlike most budget simulations and games, the exercise is conducted in groups to provide participants with insight into the need to compromise and make trade-offs. Exercises are offered free of charge to the public and publicised through local media, civic and business organisations, area colleges and universities that serve as co-sponsors. Members of the Congress and other public officials often co-host exercises and use the events to discuss the budget with their constituents. The Committee compiles the results of exercises into a report that is sent to each participant, every member of the Congress, budget officials in the executive branch, and the media. The Committee is currently working to put the exercise on line and to make it more accessible, particularly for use by high schools and universities.

The exercise materials are updated regularly to stay current with issues and options affecting the budget. Results gathered from over 20 years of exercises allow the following general conclusions:[8]

- Citizens are eager for opportunities to become engaged in serious and substantive discussions about the budget.
- Non-expert citizens have the ability and desire to address complex public policy issues, and they enjoy being asked to do so.
- People are able to set aside initial biases and opinions and to listen, learn, discuss, argue and compromise.
- Participants, irrespective of their political affiliations and demographic characteristics, are willing to vote for unpopular tax increases and benefit cuts and will agree to options that go against their own immediate self interest if they believe that those actions will: *a)* solve the problem; and *b)* be shared fairly among all segments of the population and all parts of the country.
- Participants protect education and poverty programmes, but still expect those parts of the budget to make small contributions to the overall solution.
- Participants will agree to raise their own taxes and cut their own benefits and services once they are convinced that there are no easy answers.

The ChoiceDialogues™ and the exercises are examples of citizens' deliberative capacity. Work in deliberative polling and other experiments in deliberative democracy provide similar promising results. All demonstrate that, given the right resources, individual citizens are interested, able and willing to engage constructively in solving complex budget challenges. The activities indicate that successful public engagement can be achieved when:

- People have access to unbiased and credible information that outlines the issues, options and consequences.
- Participants have ample time for dialogue and discussion so that they can understand the issues, clarify values and exchange views.
- Individuals have an opportunity to identify the common purpose and appreciate what is at stake for the community at large.

What participants repeatedly report as missing are sufficient opportunities for normal citizens to become engaged and to stay engaged in the larger public discourse.

3. Online public engagement in budgeting

The examples described in this section are intended to illustrate different types of governmental and non-governmental activities related to public engagement. They do not represent a survey of all such engagement initiatives.

3.1. Governmental initiatives to engage citizens in national budgeting

There are a number of actions governments can take to make national budgeting more accessible to citizens. A sampling of budget office websites finds that most already provide information about the budget and the budget process. Some go further and conduct public consultations. The following sub-sections describe some of the measures being implemented by budget officials to make budget information available to citizens and to encourage public interest in and knowledge about fiscal policy.

3.1.1. Top-down information sharing: budget office websites

It is accepted good practice for governments to communicate openly with citizens about programmes, policies and procedures. Such communications will be more effective if the information provided is timely, accurate and comprehensive. Fortunately, the Internet has made it easier for the government to fulfil its responsibility to share information. Governments can now reach a global audience by posting or publishing documents electronically.

Government websites are relatively young, but have rapidly become a powerful means of communication. Over time, websites are evolving away from passive electronic filing systems for agency-generated information and reports. Many are taking better advantage of the medium's sophisticated communications capabilities. Many sites are becoming attractive locations that go beyond simply making information available, and now present information in ways that stimulate interest and encourage visitors to learn more about the topics presented.

Perhaps because budget websites were initially designed to meet official needs, many are still ill-suited to external audiences. They exhibit two basic problems in the way they present budget information: organisation and presentation.

- **Organisation:** Website organisation is always challenging because it involves a three-dimensional array of information that allows users to jump from page to page on the web. Budgets involve large quantities of detailed information. Perhaps in response to criticism about a lack of transparency, governments may be inclined to post everything. Unless well organised, the website can become a confusing and overwhelming repository of documents. It may take a discouraging number of clicks and fruitless searching within websites to find answers to simple questions. Moreover, the website becomes so complicated that it is hard to maintain, leading to many instances of broken links, data inconsistencies, and other problems.

- **Presentation:** Budget websites must serve the needs of government officials, legislators and their staffs. Knowledgeable users, including reporters, academic researchers, interest group representatives and private sector investors who participate in or closely follow budget deliberations, use websites to access data that they need to produce their own analyses. Non-expert audiences, however, can be quickly intimidated by the technical presentations and language of the budget. They may not be able to find the information they seek or they may misunderstand the information they do find.

Budget officials who are concerned about improving their websites for use by public audiences might consider ways to accommodate the needs of those users (see the annex for more concrete suggestions):

- General audiences need more user-friendly, appealing and interesting presentations. Creating "citizen space" on the website has advantages for users and budget officials. A welcoming entry point can quickly orient visitors and familiarise them with basic information before directing them to more detailed information. Budget officials benefit from an important first opportunity to frame issues and options. In addition, the presentation can address many frequently asked questions, freeing up budget office staff who otherwise must answer repeated inquiries. The appearance of the website can also cast the government as open, welcoming and interested in communicating with the public. Users may retain a healthy skepticism about government policies, but over time will grow to trust the website if the factual information it contains is accurate and reliable.
- Third-party intermediaries – civil society organisations and independent researchers – require access to extensive data to support analyses and scrutiny of the budget. Allowing timely access to databases and spreadsheets facilitates more accurate and extensive non-governmental research. In addition, the website ideally should be organised so that historical, current, and projected data are presented in consistent formats. Because other participants in the budget process (*i.e.* government agencies and legislators) are likely to require access to the same information, providing those materials should not place many additional demands on budget office staff.

As access to technology becomes universal, citizens – especially younger generations – expect to be able to find information with a few clicks of the mouse. If the information they need from the government is not provided, red flags are raised. Budget office websites can serve as a fact-checking resource that is available to verify information provided by other non-official sources, a function that is of growing importance in our electronic age that makes so much information and misinformation readily available. Motivated and knowledgeable researchers will search for accurate information. But officials should also take advantage of the opportunity to make good information more accessible to broader audiences.

- **The United States Office of Management and Budget (OMB)** (*www.whitehouse.gov/omb*). The United States OMB home page is an example of top-down, passive information. It is organised to showcase the President's budget proposals, not to provide the public with information about the budget and the budget process. It contains a large amount of budget information, including account-level detail, but site users either have to be knowledgeable about the budget or be strongly motivated. For example, tables showing total receipts by source (individual income taxes, corporate income taxes, etc.) and spending are available, but can only be found by hunting through the website. Information about the budget process appears on page 391 of a secondary volume called *Analytical Perspectives*. The website does however provide important support for researchers through links to spreadsheets and access to a public electronic database on the budget.
- **The Australian Government, Commonwealth Budget** (*www.budget.gov.au*). The home page of the Australian Treasury provides a direct link to the budget site of the Australian government. Through the budget home page, users have quick access (two clicks) to pie charts showing the size and composition of spending and receipts. (Pie charts are highly effective in presenting budget information to non-expert audiences.) The Treasury home page also contains a link to the 2007 intergenerational report, which is issued every five years and focuses on the impact of demographic changes on the budget and economy over the next 40 years.
- **The Ministry of Finance, Japan** (*www.mof.go.jp/english/index.htm*). The Japanese Ministry of Finance home page is a third example of top-down, passive information. Based upon the pages translated into English, the site is accessible to non-expert audiences while still providing expected information about the Japanese budget and fiscal conditions. Factual information about the budget is easy to find and is presented in a colourful format. Visitors can download a document called *Current Japanese Fiscal Conditions and Issues to be Considered* that provides concise information about

overall budget conditions, including the problems posed by an aging society (*www.mof.go.jp/english/budget/pamphlet/cjfc2006.pdf*).

- **The Department of Finance, Canada** (*www.fin.gc.ca/fin-eng.html*). The Canadian Department of Finance has a long tradition of actively seeking to making information accessible to citizens and disseminating it widely. The department used public focus groups in 1998 and 1999 to help transform its website from a passive repository of documents to a more engaging and useful source of information. The department continues to experiment with the electronic presentation of information, including the use of multimedia presentations and public consultations (see Section 3.1.3 below). This year (2007), some information is available through podcast (currently ranked 14th in government and organisation downloads from iTunes Canada). The staff analyses website traffic to determine what pages are attracting visits. The staff estimates that nearly one out of every 60 Canadians visited the website following the April release of the 2007 budget.
- **The Ministry of Economics, Finance and Industry, France** (*www.minefi.gouv.fr*). The home page of the French Ministry of Economics and Finance includes a link to an interactive website designed especially for citizens (*www.performance-publique.gouv.fr*). The interactive website invites users to play Cyber-Budget (an online budget game; see below), provides animated information about the budget (BudgetFlash), and asks users to provide their suggestions for improving the site.

3.1.2. Interactive information: online budget games and simulations

Online games and simulations can provide an effective and entertaining means of conveying budget concepts and dynamics, particularly for younger audiences. Government-sponsored online games, however, appear relatively rare for budgets at any level of government. Game design is not easy. It requires trade-offs between the simulation's complexity and its accuracy. Simpler instruments are easier to follow but run the risk of oversimplifying the issues and the difficulty of the trade-offs involved. In addition, the game's content may be viewed in politically charged terms. Some games allow actions that governments cannot take without serious repercussions (for example, defaulting on the public debt). Complex designs require more support for users and are costlier to develop and maintain. Because budget numbers and policy issues change frequently, games can become out of date quickly, which can raise substantial cost considerations.

- **Cyber-Budget, France** (*www.cyber-budget.fr*). Cyber-Budget[9] begins by introducing players to budget terminology.[10] It presents them with a number of tasks that test knowledge of the budget and familiarise them with the political consequences of decisions. The player makes decisions, presents and defends the budget in parliament, and is then responsible for managing it as unanticipated events take place and affect fiscal outcomes. The player receives simulated criticism from the press, an accounting of the impact of his or her decisions on the deficit and debt, and a final score. As of April 2007, an estimated 400 000 people played.

- **HM Treasury, United Kingdom.** The United Kingdom Treasury home page links to the 2007 Comprehensive Spending Review microsite (*http://csr07.treasury.gov.uk*) which contains several interactive features:
  - ❖ A section addressing long-term challenges provides information about the projected impact of trends such as globalisation, demographic and social change, and climate change on the United Kingdom economy and the implication for public services. Site visitors are also invited to take a brief quiz to test their knowledge about those trends.
  - ❖ A budget simulator allows users to decide whether to change projected spending for major areas of the budget. Participants can review the results of their decisions and are provided with feedback on the implications of their choices. The site provides background information on spending areas that helps inform the decisions of game players.
  - ❖ Site visitors are invited to submit their views on the information provided. Based upon some of the comments submitted, a few lobbying groups have discovered this feature and are using it to advocate for increases in individual budget areas.

  The site drew 200-300 visitors per day when it was first activated in January 2007. Although the comprehensive spending review concludes in the fourth quarter of 2007, Treasury staff are considering whether to maintain components of the site for their ongoing educational value. In addition they are looking into ways to raise the site's accessibility and prominence.

- **Ryedale District Council budget simulator, United Kingdom** (*www.budgetsimulator.com/ryedale*). The Ryedale budget simulator is a simple instrument. It was developed by and is hosted by a private firm. The simulator allows players to increase or decrease expenditures for public services, providing positive arguments for increases and negative arguments for decreases. The simulator calculates the impact of decisions on the council tax, but there are no consequences (positive or negative) for any changes in revenues. As a result, taxpayers might easily conclude that the best option is to increase spending in order to gain more public services.

3.1.3. Consultation: active listening

Top-down delivery of information is the most common form of interaction between the government and the public, but there are examples of national governments using consultation to inform the decision-making process.[11] Consultation activities can take the form of surveys, polls, virtual or face-to-face discussions, and asynchronous electronic forums.

Online consultations are relatively new. They have the potential to reach a much larger audience than face-to-face meetings or hearings. But they lose the element of proximity and common purpose that many people seem to enjoy. Online interactions also provide an anonymity that at first seems contrary to the sense of community that civic engagement creates. Over time that concern may become less important as the public gains more experience with online interaction. An additional concern is that there is no assurance that the views gathered are representative of the overall population. They may reflect organised efforts by advocacy groups. The input, however, can be useful in that it may identify "hot button" issues where the government policies are at serious odds or have struck a responsive chord with segments of the population.

Broad consultation efforts have potential advantages and disadvantages:

- Where the public's views are scattered across a range of options, the government is likely to find enough support for its position to be able to use the consultation as "political cover" for taking whatever action it planned to take prior to the consultation.
- Where there is a lack of public consensus, the government can point to the consultation as evidence of its willingness to address issues while also using it as a rationale for inaction.
- The consultation provides an opportunity to educate the public and gain its support for policy action. However, there is the danger that public opinion may coalesce in opposition to the government's preferred approaches.

When asking for the public's input, officials must decide what purpose the information will serve and how it will be incorporated into eventual decisions. Consultation during the agenda-setting stage allows citizens to provide input at the earliest and most flexible point in the process. Citizens will be more willing to participate if they believe that their input matters and if they know that the results of their efforts will be publicly reported. They will also become cynical if they think that the process is designed as anything other than a sincere attempt to solicit to their views.

- **Les Forums: Online public debate (France).** The French government hosts online public discussions. In early 2007, a forum about the need to reduce the public debt ran for a little over five months and generated 874 responses. While the forum was active, the moderator posted a summary of each week's comments. A final summary was posted on the site at the conclusion of the forum with links to other government web pages containing related information (*www.forums.gouv.fr/article.php3?id_article=175*).

- **Online pre-budget consultations for budget (Canada)** (*www.fin.gc.ca/activty/consult/prebud_e.html*). The Canadian Department of Finance has initiated online pre-budget consultation as part of its annual budget process. In 2006, nearly 6 000 individuals submitted views on the three open-ended questions posed:
  - ❖ What would citizens like to see in the 2006 budget and future budgets?
  - ❖ If proposing further tax cuts – or spending increases – where should the government spend less?
  - ❖ How can the government deliver programmes more efficiently and effectively?

  An estimated 7 000 Canadians responded to the invitation to submit advice, ideas and insights for the 2007 budget. The submissions were analysed, sorted into categories and forwarded to relevant departments. In reviewing the submissions, staff believe that the overwhelming majority comes from unorganised citizens, not interest groups.

  In 2006, the Department of Finance also conducted a separate online consultation on restoring fiscal balance and issued a report on the results (*www.fin.gc.ca/activty/consult/fiscbal_2e.html*). The report summarised comments received from the online consultation as well as face-to-face consultation events, and promised to take those views into account in the formulation of the 2007 budget.

- **Citizens' Health Care Working Group (United States)** (*www.citizenshealthcare.gov/recommendations/dialogue.php*). Federal law mandated the creation of the Citizens' Health Care Working Group. It is an example of a publicly financed, citizen-directed, one-time effort to consult the public through a series of open hearings, meetings and online polls. Fourteen citizens were appointed to the working group and, in 2005-06, served for a period of approximately one and a half years. The working group issued a report on the state of United States health care, and drafted interim and final recommendations to the President and the Congress. After completing its work, it disbanded. The working group's website contains extensive documentation of its activities and a record of the public's views as well as background information about health care in the United States.

  The statute required the Congress to hold hearings within 45 days following receipt of the final recommendations. The law did not specify any subsequent follow-up. It is too early to determine what impact, if any, the working group will have on health policy decisions.

- **Public consultation on tax reform (Hong Kong, China)** (*www.taxreform.gov.hk*). The government of Hong Kong, China asked the public to submit views on its proposal to broaden its revenue base by introducing a goods and services tax (GST). The government informed the public through a website dedicated to the consultation, appearances on television and radio, and printed information available through public information offices. The consultation period ran for nine months, during which time the government accepted written comments (e-mail, facsimile and mail) and hosted public meetings. The government promised to consider all views before deciding "whether, and if so, how" to pursue implementation of the GST and accompanying reforms to other taxes.

Half-way through the consultation period, the government reported that although the public agreed with the need to address tax reform, its attempts to respond to the public concerns about the GST proposal were unsuccessful. It concluded that public opposition was too strong to proceed. As a result, the government is reviewing its options, taking into account public concerns already aired, and asking the public to contribute further views on how to accomplish the agreed upon objective of broadening the tax base. The government plans to issue a final report on the consultation for consideration by future governments.

Although the government was unable to overcome popular resistance to the GST, the government reported that the population is better educated about problems related to the current tax structure and their implications for Hong Kong's economy. The consultation, while not endorsing the government's proposed approach, did reveal specific issues that worry the public and that officials can keep in mind when undertaking future policy development.

3.1.4. Direct democracy: participatory budgeting and policy making through referendum

In direct democracy, citizens are part of the final decision-making process. Forms of direct democracy include participatory budgeting, binding referenda, and citizen membership on public councils and commissions. Direct citizen involvement is no longer unusual at the municipal or regional levels of government, but there are few examples at the national level.

The strength of participatory processes lies in the citizens' ability to become directly involved – in other words, to participate. In addition, many of the direct participation initiatives rely on community-based organisations that conduct outreach, provide technical expertise and facilitate citizen involvement. It is impossible to replicate that sense of proximity at a national level. Few national civil society organisations have close ties to individual citizens in all regions. Geographic size and population numbers, which discourage participation in direct processes at the local level, become prohibitive at the national level. Even in local processes, direct participation is likely to be limited to the neighbourhood or community level. Representative structures replace direct citizen involvement as decision making moves from neighbourhoods and communities to municipalities. Those representative local citizen councils create parallel representative bodies, which typically supplement the traditional elected councils that retain responsibility for final decisions.

There are alternative means of achieving the good government benefits of local priority setting and resource allocation, for example, the block grant approach and other transfers of resources from the national budget to lower units of government. Those funds provide greater administrative discretion to local officials in the use of the funds than might be normally allowed in national programmes. Devolution or federalism goes further. It reassigns responsibility entirely away from the national government and gives lower units of government the responsibility of financing expenditures as well as deciding which to undertake.

It is instructive, however, to consider direct engagement efforts at sub-national levels of government because they provide insight into ways in which citizens can and are being involved in public decisions.

- **Participatory budgeting: Porto Alegre, Brazil.** Porto Alegre's successful experience with participatory budgeting has inspired followers among many other cities and regions across Brazil and around the globe.[12,13] Participatory budgeting was introduced in Porto Alegre in 1989 as an experiment after the Workers Party won the mayoral election. The approach became well integrated into the municipal budget process (although electoral losses by the Workers Party in 2004 appear to be having an impact on the system). The process is a combination of community-based, direct and representative democracy, organised by regions of the city. All citizens are entitled to participate in plenary assemblies and preparatory meetings. Those sessions set priorities by theme (transportation, education, economic development, etc.), elect members of the delegates' forum and the participatory budgeting council, and evaluate city performance. At subsequent stages of the process, elected citizen-representatives are responsible for preparing the investment plan. That plan contains detailed allocations by region and project. It is included in the executive budget and must be approved by the municipal legislature in order to be implemented.

  Although it is hard to separate the effects of a reformist-minded executive and fiscal reform laws from those resulting directly from Porto Alegre's participatory budget process, the participatory budgeting process has been credited with improvements in public service delivery (changes in the number of households connected to municipal sewage services, miles of roads paved, number of children enrolled in public school, etc.), more equitable distribution in public resources, greater willingness by the population to approve increases in municipal revenues, and, until recently, repeated electoral success for the Workers Party. Other benefits include greater inclusion and empowerment of formerly under-represented segments of the population (the poor and women), "trans-classist" municipal pride, and a more open, less paternalistic attitude on the part of government bureaucrats.

- **Colorado Taxpayers' Bill of Rights (TABOR), United States.** A series of provisions adopted through popular referendum provide a cautionary example of the potential downsides of direct public involvement in budget policy. In 1992, through ballot initiative (referendum), the citizens of Colorado amended the state constitution with a series of provisions, known as the Taxpayers' Bill of Rights (TABOR).[14] The TABOR amendment limits the amount of revenues that state and local governments can keep, the limit being the amount allowed in the previous year plus a percentage adjustment for changes in population and for inflation. Under the amendment, any amounts collected above the allowable levels must be rebated to taxpayers unless voters agree to allow the state to keep them. State legislators enacted a separate law that set limits on public spending.

  In the 1990s, population growth, a strong economy and a sustained period of rising incomes resulted in strong growth in public sector revenue collections and led to a series of taxpayer rebates. As a result of TABOR and spending restrictions, spending for public services – particularly education – failed to keep up with the growing economy and state population. In 2000, voters approved another constitutional provision to protect funding for elementary and secondary education from the spending restrictions. It mandated annual increases in spending per pupil equal to the rate of inflation plus one per cent.

  In 2000 and 2001, the economic contraction caused public revenues to decline. The situation was compounded by TABOR's inflexibility. Although immediate revenue shortfalls were projected, the state could not carry over "excess" collections from the previous year. Instead it had to issue tax rebates. Between 2000 and 2005, the continuing limitations on revenues combined with mandatory growth in education spending and rising health care costs created serious budgetary stress. In 2005, Colorado voters agreed to suspend the TABOR requirements for five years.

- **Citizen membership on the budget committee in Eugene, Oregon, United States.** In Eugene, Oregon, citizens are incorporated into the city's annual budget process.[15] The mayor and city council appoint citizens to three-year terms on the city's standing budget committee. Citizens fill half of the committee seats. Any citizen can apply to be on the committee. The budget committee reviews the mayor's capital and operating budget proposals and holds public hearings before forwarding its recommendations to the city council for amending the budget. In addition, city residents are encouraged to participate in public hearings on the budget held by the budget committee and the city council and to otherwise communicate their views.

3.2. Non-governmental initiatives to promote civic engagement in the budget

In addition to official efforts to engage citizens in national budgeting, non-governmental organisations and, on occasion, individuals can help to broaden the public debate about the budget and budget priorities. The presence of third-party intermediaries increases the opportunities for unorganised citizens to come into contact with policy questions and to join the debate. Their contributions can help foster government transparency and enhance overall accountability, while enriching the public's understanding of budget practices and policies.

Non-governmental organisations are supported financially through a variety of sources including government contracts and grants, private foundations, multilateral organisations, and private corporations and individuals. Ultimately their financial success signals that their work fulfils a need in the policy world that the market is willing to pay for.

Non-governmental efforts to engage citizens can be divided into two broad but overlapping categories:

- Policy research organisations ("think tanks") conduct independent analyses of public issues. Although their primary audience consists of lawmakers and the expert policy community rather than the general public, public policy organisations are not confined to the "ivory tower" of academia. They disseminate their work through websites, opinion pieces published by the mainstream press, blogs and podcasts, and to civil society and special interest groups. Public policy research organisations represent views from across the political spectrum and bring a range of perspectives to the public debate. Their work contributes to the public's understanding of the issues and thus indirectly promotes broader levels of engagement.
- Public advocacy, education and outreach organisations seek connections with the public to raise awareness, increase the level of understanding and motivate active participation in public affairs. They organise public events and meetings, promote communication with elected officials, publish issues briefs and generate "grassroots" (locally organised) activities to involve citizens. Some organisations advocate defined policy positions. Others are more neutral in terms of policies and politics. All seek to

influence decision makers by rousing public opinion and motivating voter behaviour.

A third type of effort is unorganised and informal. It originates with a single individual on line or a small virtual network of like-minded people. Over time, those Internet-based efforts can broaden and attract large audiences. Such activities are becoming increasingly common and, at some point, may become mainstream forms of public interaction, dialogue and discussion, particularly among younger populations.

3.2.1. Public policy research organisations

The Brookings Institution (*www.brookings.edu*) and **The Heritage Foundation** (*www.heritage.org*) are two examples of well-established public policy organisations ("think tanks") that are located in Washington, DC. They are designed to influence decision makers through their analytical work. Although neither is officially affiliated with an organised political party, the first is viewed as leaning towards the Democrats while the second is identified with Republicans. Scholars from both organisations conduct research on budget and fiscal policy, publish on topical issues, testify before the Congress, and serve on governmental commissions and boards. They are identified as experts and are often quoted in national press reports. The organisations sponsor forums in which staff from the Executive Office of the President and from the Congress, reporters, and academic and policy experts exchange views.

Despite their divergent political leanings, experts from Brookings, Heritage and other similar research institutions often co-operate with each other. Their goal is to raise the quality of the public debate and to increase the probability that decisions will be based on the merits of proposed policies, not ignorance or confusion about the underlying facts.

The **Women's Budget Group** in the United Kingdom (*www.wbg.org.uk/index.htm*) conducts activities designed to raise awareness of the gender and social implication of economic policy. Analyses and other work products are designed to answer the question: "Where do resources go, and what impact does resource allocation have on gender equality?"

The **International Budget Project** (IBP, *www.internationalbudget.org*) was formed almost 10 years ago by the Center on Budget and Policy Priorities, a United States civil society organisation, "to nurture the growth of civil society capacity to analyze and influence government budget processes, institutions and outcomes."[16] The role of the IBP is to support the development of budget expertise by civil society and public policy research organisations in countries with developing and transitional economies. Today, the IBP maintains a database of 77 active budget organisations in 36 countries. The work of those organisations improves public scrutiny of government budget policies and management and fosters a richer debate about programmes and priorities.

One of the theme areas of the IBP is transparency and participation in the budget process. The IBP directs major attention to addressing the absence of publicly available information and the existence of closed public processes because those conditions constitute serious obstacles to independent analyses, issue advocacy and civic engagement in budgeting. The IBP provides technical assistance to independent groups to further civil society efforts to participate in all phases of budgeting from formulation to legislation and execution.

3.2.2. Public education and outreach

The **Concord Coalition** in the United States is a nonpartisan national organisation (with local chapters of volunteers) that advocates fiscal responsibility. It organises public events and sponsors activities designed to educate the public about the impact of deficits and debt on the United States economy. The organisation is currently conducting a series of public meetings called "The Fiscal Wake Up Tour" (*http://concordcoalition.org/events/fiscal-wake-up/index.html*) to present discussions involving the Comptroller General of the United States, other government officials, current and former elected representatives and fiscal policy experts from research institutes like The Brookings Institution and The Heritage Foundation. The Comptroller General's tour-related activities were recently profiled by a primetime television broadcast by a major United States network (CBS, 2007). The comments about the segment that are posted to the website provide an indication of the unevenness of the public's knowledge of the United States budget.

Although personal contact by public officials can be more persuasive than other forms of communication, such activities are time-consuming and costly while reaching relatively small numbers of people. The Concord Coalition is seeking to develop online activities to extend its potential influence.

Also in the United States, **Next Ten** is an independent non-partisan organisation focused on budget and related issues facing the state of California over the next ten years. (Although it is a state, California's annual budget exceeds USD 100 billion, serving a population of nearly 37 million.) Next Ten created "California Budget Challenge", an online budget exercise that provides an excellent example of how technology can be used to educate the public about budget issues (*http://nextten.org/budget/challenge.php*). Next Ten is holding a contest for high school students to engage them in state budget issues. The student who develops the winning budget options will be awarded a USD 2 000 scholarship.

3.2.3. Informal public engagement: the future face of public engagement?

A web search for information implies a wealth of information on national budgets. A recent Google search of "United States budget" returned over 94 million hits. It listed web pages created by individuals or non-governmental sources before listings for official government sites like the Congressional Budget Office or the Budget Committee of the House of Representatives. A blog search using "United States budget" returned over 163 000 posts. The Wikipedia entry for "United States budget process" (*http://en.wikipedia.org/wiki/United_States_budget_process*) lists non-governmental sites as its first two external links. Similar results can be obtained for searches for other national budgets.

The political culture in the United States may cultivate greater individual interest in creating web pages and in blogging about budget policy than the current climate of other countries. The efforts indicate rapidly expanding online interaction and a virtual policy debate that extends beyond national borders. Although many individual efforts and postings can be brushed off as uninformed opinion, there are many examples of thoughtful and serious attempts to generate greater understanding and discussion of the budget.

- **thebudgetgraph.com, United States.** Jesse Bachman is a freelance graphics designer who created "Death and Taxes", a visual presentation of United States spending for discretionary programmes (*http://thebudgetgraph.com*). His efforts illustrate the potential provided by the Internet for single individuals to engage in public issues. The creator, a self-identified liberal, reports that he undertook the project after he saw a pie-chart presentation of the budget that assigned defence a 14% share of spending. He thought that the pie chart misrepresented the amount of defence spending. His visual presentation emphasises annually appropriated spending. By reclassifying spending into the defence category (*e.g.* spending for veterans' programmes and anti-terrorism activities) and excluding entitlements, the defence share rises to 64%.

  Bachman reports some 150 000 hits on the website. He has sold 1 000 posters since September 2006, many to federal government and military offices, schools and universities. Visitors to his website have encouraged him to create posters for budgets of other countries.

  Regarding the feedback he has received, Bachman said, "Mostly this project has [solidified] to me the **need** for a project like this to exist. It has really opened up a lot of eyes as to what is going on in that black hole called the federal budget. And not just to analysts and economists, but to everyday citizens, which is where it matters most. I really think knowing how your taxes are spent is essential to being a responsible citizen. Not only that, but this knowledge can serve as an equaliser when the media tends to push certain wasteful budget programmes and ignores others."

The budget graph site represents an emerging form of public engagement that allows individuals to take data, use them creatively, present a point of view to a global audience, and initiate a substantive online discussion. Other forms of engagement – such as "MeetUps"[17] or small group meetings organised and publicised electronically – are being used to bring people together for discussions, presentations and informative gatherings, fundraising, and other activities related to civic issues and politics. Enterprising individuals will surely find many creative new ways to use technology to exchange views and influence the views of others.

Governments play no role in such informal public engagement activities other than putting information into the public domain. The availability of that official information, however, is vital to the virtual public debate. The information provided on many informal websites and blogs is inaccurate. However, if Internet users can find and verify information through official sources, they are then able to make more informed judgments about the content of any non-governmental posting and participate more confidently in online discussions.

4. Conclusion

Successfully engaging the public in national budgeting will not solve complicated budget and fiscal policy dilemmas, but it is an important part of an overall strategy both to encourage good government practices and to adopt politically viable yet responsible fiscal policies. Engaged citizens are more knowledgeable about government, hold more thoughtful and sophisticated views of public policy, and are less cynical in their attitudes toward government.

Improving citizens' involvement in national budget policy is especially important. The budget represents the public's priorities and allocates the responsibility for paying for those activities. If citizens are not engaged in national budgeting, they cannot exercise meaningful oversight and hold officials accountable.

Budgeting, however, is a technically complex as well as a politically difficult exercise, made that much harder because it is a means – not an "end" – of governing. Most citizens quite sensibly do not view responsible budgeting as a higher priority than the major tasks that they assign to government, such as improving the welfare of citizens or providing the national defence. Citizens understand poorly how fiscal problems affect their well-being. Too often when they receive information about the budget, it is negative. Press reports tend to focus on waste, abuse and corruption, thereby reinforcing popular mistrust of government. When elected officials discuss the budget, it is often in highly partisan and simplistic terms that divide the population, rather than unify voters around common goals.

Efforts to engage the public are gaining the support of local officials and are becoming more common in municipalities and regional government. Those approaches, especially ones that involve direct participation by individual citizens in decision making, are not feasible at the national level. Other approaches to public engagement are required. National budget officials can help by providing citizens with the information they need to understand the budget and follow the public debate about fiscal policy. Technology has reduced the costs of sharing information (and has eliminated a major excuse for avoiding public disclosures). The potential reach of online information is vast.

A quick review of budget office websites indicates that many ignore the needs of the wide audiences that now have access to the sites. By designing more accessible websites and organising information in more attractive ways, government can encourage and support better public understanding of the budget. In addition, providing online access to comprehensive and timely information enables better quality research by academic and civil society organisations.

While not all citizens are interested in becoming more involved in the public debate over budgets and fiscal policies, those who want to learn more should be able to find the information they need. Work with public audiences shows that citizens are capable of understanding complex public issues and formulating rational opinions about how those problems should be addressed. What they need are more suitable materials. Public officials can support efforts to fill that void.

Individual members of the public need basic information in a non-technical, understandable form:

- They should be able to quickly find amounts reflecting total revenues and expenditures, budget deficits or surpluses, public debt levels, the composition of government receipts and spending, and recent budget trends. (Providing the information as a percentage of GDP in addition to currency amounts adds useful context, as does comparable information about other countries.)
- Information should avoid technical terms, if possible, or contain links to glossaries that explain them.
- Tables, charts, graphics and multimedia presentations help to put the information into clearer context.
- Background information, including discussion of major issues and an explanation of the budget process, promotes the public's education.

- Performance-related information helps to answer questions about whether public objectives are being met.

Legislators, civil society organisations, academic scholars and others require access to detailed accounting and financial data to perform oversight activities and conduct independent research. Those users demand comprehensive information and will be quick to identify gaps and misrepresentations. Governments that establish histories of full disclosure will develop reputations for honesty and trustworthiness that will extend beyond the immediate budget community. Their demonstration of openness will enhance their credibility.

Some budget officials are already using innovative methods to reach out to the general public. Online games, consultations and multimedia presentations provide non-expert visitors with enough basic information to understand the budget without intimidating technical terms and mind-numbing detail. Many of those initiatives are new. As experience accumulates, public officials will be able to determine which approaches are the most effective and attract the greatest public interest.

In addition, activities conducted by civil society organisations and individual citizens multiply the number of people who come into contact with the issues. Those non-governmental efforts depend on access to official information. Independent activities can improve the quality of the debate, increase transparency and inject new perspectives on the issues in ways that encourage greater popular interest and make positive contributions to policy development.

The rapid development of technology is changing the way people seek out and access information. Traditional forms of communication are being overtaken by new developments. Increasingly, more people – especially younger generations – are participating in unorganised, informal communications such as blogs and other Internet-based discussion forums. Governments, which once could contain debate by limiting access to information, are finding it difficult to resist popular demands for greater openness. In the new information environment where anyone can start a blog and communicate globally, government is likely to find that it is increasingly difficult to package information and control how it is used. The best strategy to counter misinformation and speculation is disclosure, thereby assuring that high-quality, accurate information is available. Credible, reliable and accessible information serves as a valuable reference against which other information sources can be compared. Individuals and civil society organisations can incorporate accurate publicly available information into their own outreach and public engagement activities, raising the quality of the overall public debate.

There is no single approach or initiative that is guaranteed to reach all citizens or to raise the public's overall level of knowledge of budget issues. Governments can demonstrate their receptivity to public input and discussion by being open and transparent and providing opportunities for citizens to express their views. Activities that support citizens' engagement provide valuable opportunities for mutual listening and learning. Public officials and lawmakers benefit from more informed constituencies. Citizens gain more accurate awareness of national issues and challenges. Actions that governments take to welcome citizens into the public discourse about national budget priorities promise to strengthen society's civic fabric and improve the quality of public interaction, thereby creating a more positive environment for addressing the difficult challenges that lie ahead.

ANNEX

Tips for Improving the Accessibility of Budget Office Websites

Budget office websites are often designed to meet the requirements of those directly involved in the government budget process. Those users are well acquainted with budget trends, terminology, concepts and accounting principles. But the website can also serve as a valuable reference for much wider audiences, including members of the general public, journalists, academics, students and foreign investors, who are unfamiliar with basic budgetary information.

The following suggestions are designed to provide an entry point into budget information for non-expert users. As users become more familiar with the budget, they should be able to conduct more in-depth research. (See OECD, 2001b, for a more comprehensive listing of information that should be publicly disclosed.)

- Consider creating a visible separate area for information designed for general public access. Create a link on the home page to that area using titles like "Citizens' Guide", "Quick Facts" or "About the Budget and the Budget Process" to signal introductory information.
- Content: When deciding what information to provide, ask what citizens should know or be able to learn about the budget. Information to include:

  1. Factual information:
     - Total revenues, total spending.
     - Revenues and spending by major category.
     - Deficit and debt amounts.
     - Amounts for current year and upcoming budget year.
     - Historical numbers to illustrate major trends.
     - Projections for future years without policy change.

2. Information about changes proposed in the most recent budget:
   - Total revenues, total spending.
   - Revenues and spending by major category.
   - Fiscal goals (projected deficit/surplus and debt levels).
   - Major policy proposals.
3. Economic indicators to disclose assumptions underlying the budget and to provide economic context (for example, size of budget relative to GDP).
4. Performance indicators, or links to such indicators, for major budget programmes that describe what the programme does, its objectives, and how well it is accomplishing its mission.
5. Explanation of the budget process and its timetable (in non-technical language).
6. A glossary to define terms and explain acronyms and abbreviations.
7. Feedback: If visitors are encouraged to submit views or comments, the site should report results of such consultations back to them.

- Presentation:
  - ❖ Keep the site up to date. Alert users to upcoming releases of major documents or upcoming milestones and mark that information, when posted, with release dates.
  - ❖ For proposed policy changes, provide pre- and post-policy amounts, in addition to indicating the amount of the change in percentages or in currency. For example: "The proposed policy would increase spending in 2008 by 100%, from USD 100 million to USD 200 million" and not "The proposed policy would double spending in 2008."
  - ❖ Use tables, pie charts, animation, other graphics, video and audio to highlight major points, enhance presentation, connect with the site visitor and keep his or her attention.
  - ❖ Provide alternative formats (PDF, html, flash, media formats, spreadsheets) to accommodate the needs and bandwidth capabilities of users.
  - ❖ Provide links to other relevant websites (*e.g.* legislature, treasury or finance ministries, comptroller, government agencies or ministries).
  - ❖ Provide site search capability and pay attention to site navigation features (drop-down menus, "back", "home", etc.) to help users move through the site and find information.

Notes

1. For example, see a description of OECD work on public engagement at: *www.oecd.org/gov/citizens*. World Bank activities can be found at: *http://lnweb18.worldbank.org/ESSD/sdvext.nsf/66ParentDoc/ParticipationandCivicEngagement?Opendocument*.
2. The author was limited to a search of websites and resources available in English and French. Thus the websites selected serve to illustrate, not to survey.
3. The most well-known and longest-running participatory budgeting initiative is Porto Alegre, Brazil. For more information about Porto Alegre's experience, a good place to start is the website of the Participatory Budgeting Project of the Center for Human Settlements at the University of British Columbia: *www.chs.ubc.ca/participatory/resources.htm*.
4. See Wampler (2000) for information about implementing participatory budgeting. See also the participatory budgeting Internet page of the International Budget Project: *www.internationalbudget.org/themes/PB/index.htm*.
5. It is beyond the scope of this article to discuss transparency efforts and practices. See OECD (2001b) for recommendations about information that should be disclosed. In addition, see the website of the International Budget Project for information on transparency and open budget initiatives in 36 nations with developing and transition economies: *www.internationalbudget.org/index.htm*.
6. See also Varonis *et al.*, 2004.
7. The author holds the title of Director of "The Exercise in Hard Choices^{SM}".
8. Participants do not represent a statistically valid sample of the United States population. They do tend to reflect the characteristics of individuals who actually vote.
9. See the PowerPoint presentation about Cyber-Budget at the symposium on e-democracy held at the Council of Europe in Strasbourg, 23-24 April 2007: *www.coe.int/t/e/integrated_projects/democracy/EDemocracy/Morali%20PPT%20-%20R%C3%A9union%20Symposium%20Cyber-budget.ppt*.
10. See the Japanese Ministry of Finance for another example of a government-sponsored budget game: *www.mof.go.jp/zaisei/game.html* (in Japanese).
11. See OECD (2003) for a discussion of effective practices for online consultation.
12. For a description of the Porto Alegre experience, see World Bank (2003b). See also UN-HABITAT (2004).
13. For resources about participatory budgeting in Porto Alegre, see "Porto Alegre Participatory Budgeting Virtual Library", *www.wier.ca/~%20daniel_schugurensky/lclp/poa_vl.html*.
14. See National Conference on State Legislatures, "Talking Points on TABOR", *www.ncsl.org/programs/fiscal/taborpts.htm*.
15. City of Eugene, Oregon, Budget Committee, *www.eugene-or.gov/portal/server.pt?space=CommunityPage&cached=true&parentname=CommunityPage&parentid=0&in_hi_userid=2&control=SetCommunity&CommunityID=324&PageID=0*.
16. More information about the Center on Budget and Policy Priorities, which conducts research on United States budget and fiscal policy, can be found at *www.cbpp.org*.

17. MeetUps were originated by the Howard Dean campaign for United States president in 2004 as a way to gather supporters and generate excitement and donations. MeetUps are simultaneous gatherings co-ordinated through a website. They rely on volunteers to make arrangements for meeting locations, including private residences, bars and restaurants. Interested individuals can sign up on the website to attend the meetings. The gatherings are a way of combining substantive engagement in an issue or cause with social interaction.

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