

Department of Economic and Social Affairs
Division for Public Economics
and Public Administration

Globalization and new challenges of public finance:

Financial management, transparency and accountability

In cooperation with the Ministry of Foreign Affairs
and the Italian Court of Auditors

Report of the Meeting of the Group of Experts
Rome, 28-30 November 2001



Notes

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The term “dollar” normally refers to the United States dollar (\$).

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FOREWORD

The benefits derived from globalization, namely, better allocation of resources, higher output and living standards, and greater access to foreign goods and services, are widely accepted today. Globalization is also perceived to increase inequality within and between nations, disempower the weak, threaten employment of unskilled and illiterate workers and their living standards, and thus increase poverty. In fact, the globalization process and its accompanying market forces must be properly designed to become inclusive forces for sustainable and human-oriented development. In this effort, governments, international financial organizations, the private sector, NGOs and the civil society will have to play a more meaningful role in a cooperative manner, to make globalization work for the benefit of the poor, in a spirit of partnership.

While the evidence of the quantitative impact of globalization on government revenues is still limited, there are indications that it may reduce such revenues due to increased tax competition among jurisdictions to attract foreign direct investment, portfolio investment, exponential growth of electronic commerce, increased mobility of factors of production, and growing threat of tax havens. The fall in government revenues might further aggravate the problem of fiscal deficits of developing countries and economies in transition. To the extent that globalization is perceived to be a factor in the worsening of income distribution, it appears that it increases the need for governmental regulation, while, at the same time, it reduces government's capacity to intervene due to reduced availability of financial resources.

Developing countries and economies in transition may need to undertake major public expenditure reforms to enhance competitiveness in the global market and reduce structural unemployment. Reforms in the budget management, which have been implemented in some countries during the past two decades, suggest that increasing budgetary transparency through strengthening budget mechanisms, measurement of outputs and performance in relation to objectives, government accounting and performance auditing, civil service reform, and some extent of discretion given to spending agencies or line managers, would encourage efficient resource allocation and improved budgetary credibility. The successful reform of financial management also requires enabling the environment outside the pure technical aspects of budget reform, namely, macroeconomic control of fiscal balance, prioritization of expenditures, consistent legal and regulatory frameworks, fiscal transparency, and public participation in the decision-making process. Particularly, public administration in the 21st century will be required to activate public interest and public feedback into policy-making. Availability, quality, and accessibility of information and fiscal data are important for the empowerment of citizens and their participation in the decision-making process, which may be realized through greater transparency and effective framework of accountability.

A Workshop on “Financial Management and Accountability” (28-30 November 2001) was organized by the Division for Public Economics and Public Administration of the United Nations Department of Economic and Social Affairs (UNDESA), in co-operation with the Ministry of Foreign Affairs and the Italian Court of Auditors. Approximately 35 people attended the workshop from at least 20 countries. The participants represented a broad range of views and experience, from academic, government, and international organizations. This report is intended both for those who attended the workshop and those who did not, as it highlights key issues discussed and presents an overview of the wide range of approaches suggested for enhancing transparency and accountability in public financial management. The workshop covered a wide range of the above-mentioned issues, and focused on the development of strategies to improve government financial management in developing countries and economies in transition.

This Meeting would not have been possible without the cooperation of the outstanding experts who joined us in Rome at the end of November 2001. We would like to use this opportunity to express to all of them our deep gratitude.

We would like also to invite you, the readers, to turn to the detailed presentations of all these important topics that you will find in this report.

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I. INTRODUCTION

This report presents papers that were submitted during the Rome Meeting of Experts on “Financial Management and Accountability” (28-30 November 2001). The Meeting was organized by the Division for Public Economics and Public Administration of the United Nations Department of Economic and Social Affairs (UNDESA), in cooperation with the Ministry of Foreign Affairs and the Italian Court of Auditors. It brought together approximately 35 experts from 20 countries who represented all parts of the world and practically all stages of economic and administrative development. The goal was to debate issues that are both very old and quite new: “How should governments be run? What should governments do?”

We believe that the moment for such a debate is most opportune, for many reasons. The tide of the New Public Management (NPM) revolution has risen and receded over the past 20 years. This has allowed a well-informed and somewhat less ideologically charged exchange of opinions and experiences. The heated debate about globalization, i.e., the polarized argument as to whether what we experience in terms of international movement of goods and capital is anything new, as compared with the turn of the last century, seems to have been settled. Due to the qualitative changes being introduced by information and communication technology (ICT), we live in unprecedented times; and the debate in this area is now focusing on the best ways of adjusting to these new times – as a society, as a market, and as a public administration. Finally, those who watch developments in the public sector domain are quick to point out that the wave of change has been moving beyond concern with the very machinery of the government or its efficiency and effectiveness; it now embraces transparency and accountability. This new revolution has many interesting implications for local and global politics. It relates to issues of the efficiency and effectiveness of public service. It impacts the way in which societies can adjust to the new world that is shaped by capacities put at the disposal of public institutions, businesses and citizens alike by the wonders of modern telecommunication.

Therefore, these two simple questions: “How should governments be run? What should governments do?” can be discussed today in a new intellectual environment. This is what transpired during the Meeting and why we believe this report is important. Though the Meeting has not provided all the answers to these questions, in our opinion, enough has been discussed to put a new signpost on the road to greater understanding of the complexities of today’s public financial management.

A number of important ideas emerged from the Meeting. The list starts with the major concern about the availability of financial resources to public administrations. Resentment has built up over the years towards excessive taxation and revenue collection by governments. There is proof that fiscal deficits can be harmful for macroeconomic stability. Adverse impact has been documented regarding the inefficient allocation of these resources by public administration and in general the many government failures in public financial management. Against this background, at least two thoughts deserve mentioning.

The first is that we may be heading towards the time when the sources of many local public revenues will be depleted. This is tied to the increased mobility of investment capital and skilled labour that has resulted from globalization. Both have the potential to relocate in search of low tax-rate jurisdictions. For years, international corporations have been known to practise this rather aggressively. Tax competition, tax evasion and tax havens have increasingly become part of our lives. If one takes this trend to its extreme, one can see a world in which too often only the immobile factors of production remain for the local tax collector. Also, these immobile factors of production will more than likely consist of the most vulnerable (and therefore immobile) groups of population: the poor, ill-educated, mainly rural population or the elderly pensioners. Quite naturally, such constituencies would prefer transfers; but in their case the sources of funding for social safety nets and subsidies would be the taxes on people who are more or less at the same, relatively low level of income. As a result, in these communities, no real, socially equalizing transfer of resources would occur: these redistributive programmes would be based on taking money from one poor pocket and putting it in a different, but equally poor pocket. Are international transfers between the rich north and the less affluent south the only way out? As you will discover, such is the conclusion of one of the papers in this report.

However, it is worth mentioning that parallel to this line of thinking, an interesting phenomenon seems to be evolving. One can see from statistics that the countries most engaged in globalization have the highest rates of revenue (including tax) collection in the world. Revenues in these countries are at the level of 40 – 50 per cent of GDP, while on average the tax rates in the developing world, both on corporate profits and on personal income, are at least 20 – 30 percentage points lower. Also, there is a substantive difference between the tax rates in the United States of America and Japan (lower) and Europe (higher). Nevertheless, one does not observe a massive exodus of investment capital and knowledge workers from the north to the south (quite the contrary); and even in the relatively homogeneous north, factors other than tax rates alone seem to be at work. While the Meeting has not formulated a definitive explanation of this situation, it seems obvious that corporate and personal decisions about location are not one-dimensional, but rather menu-driven. Rule of law that supports the contract and competition laws in the case of corporations, and human rights and freedoms in the case of the knowledge workers, is an important factor here. Countries offer a choice in terms of trade union rights, social protection, health care and sensitivity to preserving the natural environment. There is a competition for investors and for highly educated and skilled individuals that is occurring between societies, communities and tax jurisdictions. However, its result is not likely to be decided on the basis of the prevailing tax rate alone.

The second thought concerns the “unconventional” ways of broadening the resource base at the disposal of governments. However, as was stressed in the Meeting, “imaginative” new taxes generate political opposition and on occasion are declared unconstitutional. Also, privatization of public assets as a source of revenue comes with a term limit: this is a very finite source of revenue.

Therefore, public–private partnerships appear as a promising solution. They follow the still fashionable and “politically correct” trend towards downsizing the government. They also fall within a more recent thinking about the need for a public space within a society, “publicization”

(as different from pure privatization) of functions that serve the public, regardless whether the source for them is in public or private hands. A necessary condition for success would be making appropriate standards and values the foundation of such a space and then making the agents who serve the public (whether in public or in private institutions) live by them. This new thinking is important, especially for public–private partnerships. During the Meeting, the debate about their unquestionable usefulness came with a clear warning. They are justified only if they guarantee a more efficient allocation of resources than an allocation performed by the public institution alone. In many cases they do not. They are also prone to corrupt practices *inter alia* in valuing assets and in setting cost-recovery mechanisms. Pending the establishment and effective functioning of standards and values-based “public space”, a very strong external audit with clear benchmarks and indicators is needed to protect the public interest in this area.

Budgeting constitutes the opposite side of mobilization of resources. A case study of an economy in transition that was presented to the Meeting discussed this important and evolving issue, pointing out that at least in parts of the world a shift is occurring in this area. Again, providing a decisive conclusion here would require additional research, but a new area that needs public funding is the many public goods that are crucial from the point of view of securing future growth and development. This creates a demand for public resources in addition to two more traditional demands: the one for strengthening stabilization measures (to assure full employment at stable prices) and the one for sustaining redistributive measures (to manage mainly the equity–efficiency trade off). This occurs while the pressure of globalization to take care of the former (especially in terms of lowering and stabilizing the inflation rate) is relentless, and also while many local lobbies still regard the public budget as a customary and welcomed source of rent or social justice. Also, historically, those who are bound to lose from a change are known to organize faster and better than those who are bound to gain from it. This is why public budgets of many countries with economies in transition carry such substantial redistributive obligations.

This leads to an important observation. Speaking about finding a proper balance between stabilization, redistribution and securing conducive-to-growth externalities is in effect speaking about the political will and capacity to create a high-quality response to the challenge of globalization and the ICT revolution. The high ratio of public revenues to GDP in the developed countries of the north has been mentioned above. It would be interesting to examine how large a part of these revenues is budgeted for knowledge acquisition and for public goods that augment the market e.g., education, skill development, ICT infrastructure, and creation of new knowledge. Hypothetically, one can see a scenario in which a very specific profile of a tax jurisdiction appears: one in which the tax intake is relatively high, but the public funding for public goods is tied to knowledge acquisition and augmenting the market. It is more the profile of budgetary expenditures and not so much the profile of tax rates that is likely to define the difference between and future prospects of various tax jurisdictions. Difficult political choices in this regard lie ahead of the heavily indebted developing and heavily mortgaged transition economies. Also, it is a matter of debate what sources of external funding (if any) will be found to help them progress to the globalized, networked world. Will this be seen as a business opportunity? Or, as a political, strategic interest? Or, as a modern cause for charity? Or, will this be seen as a matter that is best dealt with internally, by internal reforms and local political

struggles and compromises? Globally, we are speaking of very different scenarios for future human development, depending on the answers given by the world to these questions.

Two other prominent groups of thoughts generated by the Meeting concern efficiency and effectiveness as well as transparency and accountability. However, before focusing on them, it would be worthwhile to reflect on change and its management. Moving from satisfaction with constructing the machinery of the government to caring about the efficiency and effectiveness with which it operates requires careful management of change. It also requires taking one more decisive step towards the realization that in the modern world, increasingly, it is not sufficient just to have properly constructed and effectively functioning branches of government; they have to measure up to high standards of transparency and accountability.

From the discussion about the management of change we are highlighting a few important concepts.

1. **Human capacities matter.** This concerns those who are responsible for introducing change, as change happens fastest if the change management teams can be trusted. It also concerns those who are at the receiving end of the change process and must cooperate with it.
2. **Proper sequencing of the reform also matters.** Whatever works seems to be the most frequently repeated prescription. However, we noted among the discussants a distinct belief in a gradualist rather than “big bang” approach. They seemed to favour managing with the available and the familiar, as opposed to introducing advanced technological innovations. Also, if such a choice has to be made, they seemed to believe more in incremental change than in an upfront effort to prescribe and describe every small detail of the change process.
3. **A shift in objectives, beliefs, standards and values seems most important.** They constitute a referral for everyday decisions; and if they do not correspond with the new reality that emerges, a dangerous conflict - that as a rule derails the change – emerges.
4. **Agents of change must be identified and equipped.** Who is going to recognize the need for reform? Who is going to design, implement and monitor the reform? Individuals, institutions and society at large all qualify as potential agents of change. They must have the confidence that a sudden policy shift or lack of material resources is not going to undermine them.
5. **Finally, incentives to undertake and sustain the reform must be established, maintained and protected.** As a rule, these have to cover the cost involved as well as address the benefits to the individuals, not to the system or to the society as a whole.

The readiness of the presenters and the discussants to devote time to the issue of change management confirms that the past 20 years of experience with public sector reform has taught humility and thoughtfulness. It is in this spirit that the topic of efficiency and effectiveness reform was approached in the Meeting.

This report contains *inter alia* three thought-provoking presentations of this subject matter: one written from the perspective of a country that praises itself to be among the pioneers and great

beneficiaries of the New Public Management (NPM) revolution; one from the perspective of a regional organization; and one from the perspective of a global multilateral organization. Yet, there is a surprising agreement among all three.

Public sector reform is needed perhaps more now than ever (globalization, the surge of public opinion and its “informed consent” as the source of legitimacy of governments). However, this reform is very difficult to achieve. It involves much more than the top-down introduction of a set of managerial gimmicks. To the extent that countries would like to follow NPM, they should look at it not as a set of generic managerial gimmicks, but rather as an important benchmark that allows identifying their own shortcomings. Also, as experience shows, the “soft side” of the reform, the environment that makes it possible, cannot be possibly overestimated in its importance.

It is also crucial to keep in mind the interactive relationship between management of the fiscal aggregates and introduction of efficiency and effectiveness measures. Macroeconomic stability assured by proper management of the fiscal aggregates gives the NPM reform the needed fiscal and political stability as well as financial resources that may be needed to equip the agents of change. In turn, efficiency and effectiveness in managing public finances act as an additional macroeconomic stabilizer. It often allows achieving the same macroeconomic results with less “pain” built into the fiscal stabilization package.

The technical core of the NPM, i.e., performance budgeting and accrual accounting, seems solid, though admittedly not without problems. Performance budgeting shifts attention from fiscal control to efficient resource allocation and effective performance. It requires breaking up governmental structures to convert departments into agencies. It thrives in environments in which customer orientation prevails. It invites considering budgets and expenditures from a medium-term rather than from a one-year perspective. It introduces managerial flexibility that must be subjected to control via strict external audit or by well-scrutinized adherence to prevailing standards and values (*vide* the above-mentioned “public space”). It requires the emergence of performance audit practices and benchmarks. It also requires transparency and strong public opinion with open access to the public sphere (a forum at which private persons can debate public matters). It is best supported by performance-related pay.

Accrual accounting shifts attention from the moment a payment occurs to the moment a commitment has been made. This way, it stresses the liability side of the balance sheet and shields a manager from disruptive surprises. However, as has been proven many times before, especially in a complex system like the NPM, if anything can go wrong, it usually does.

In the case of performance budgeting, it usually concerns the human factor: How to assure that independent managers still feel a sense of responsibility for the performance of the whole system? How to maintain their customer orientation and weed out rent-seeking behaviour? How to establish levels of performance-related pay and secure resources needed to support them?

In the case of accrual accounting, it concerns more the internal speed limits of the system: Where to draw the line for data entry? How to account for an unpaid political commitment? How to take

into consideration the fact that a child has been born and by the standards prevailing at the day of its birth, it can claim the right to a well-defined package of social services (which can change in time)?

The stress on the “soft side” of the NPM reform seems overwhelming. It can also cause concern. Does this mean that public sector reform is not for everybody? Does it require unique levels of social consciousness and responsibility? Is the experience with NPM disempowering? The conclusion that we would like to take from the Meeting is neither negative nor radical.

We would prefer to consider the following quote: “the growing understanding of the complexity of the efficiency revolution should never be treated as a general discouragement to act in this area”. Simply put, the lack of a perfect enabling environment for change cannot serve as an excuse to do nothing to improve efficiency and effectiveness of government operations.

True, managerial freedom can hardly be introduced without strict control in the environments where it will immediately be treated as a license. On the other hand, control cannot be suffocating, lest it derail managerial freedom.

True, skilled human resources, dedicated politicians and civil servants, advanced ICT connectivity, historically established culture of trust, accountability and risk-taking, as well as respect for citizens as recipients of public services and political decision makers, all help. However, nothing can replace the willingness and capacity to conduct serious policy analysis, political courage to face the consequences of the diagnosis of that analysis, and, a decision to engage in the reform process. Nothing can replace strong leadership of reform that comes from the top levels of the government or firmly placing the whole reform process in the broader framework of the government policy. Also, many incremental steps are crucial: putting expenditures within the budget law; stabilizing economy by management of fiscal aggregates; and noticing and rewarding greater productivity in the public sector. Most budget systems in the world have evolved by moving from one such activity to another, one step at a time.

Performance budgeting and accrual accounting are known to pose one more problem. Not only do they require high and difficult-to-match levels of skills within public administration, they also routinely produce information in a form that seems impenetrable to those outside the narrow circle of the public sector officials who deal directly with public budget and public accounting matters. This raises important concerns related to transparency and accountability.

As mentioned before, the drive towards greater transparency and accountability constitutes the most recent focus of public sector reform. It is noteworthy as until now, both have proved difficult to define and equally difficult to achieve, in developed democracies and in less democratic systems alike.

One of the papers contains a most interesting and comprehensive list of elements of a definition of transparency and accountability. However, a precise, easy to understand, universally accepted definition does not seem to exist; and, too often, the simple multiplication of publicly available government information and data is being marketed as increased transparency and

accountability. This poses a real problem as one cannot strive towards a goal and then measure the progress of the endeavour (or lack of it), if one cannot define the goal in unambiguous terms.

Ideally, continuously updated information about how a government operates should be provided in a timely and user-friendly form, and once this information is in the public domain, access to it should be free and easy (theoretically, ICT technology can help). Also, a public sphere that is free of government or business control should exist to allow private persons to debate public matters in a way that is meaningful. ‘Meaningful’ would mean the actual ability to participate in making decisions concerning public matters. It means also expressing satisfaction or dissatisfaction with the way the government operates, if need be, via revoking the government’s mandate (this is where accountability comes into play). Eventually, this means also freedom to establish, among private persons, networked domains of shared concern or interest that would deal with a selected public matter outside the government administrative machinery or in alliance with it and would have the freedom to assume executive powers, as desired or needed.

To summarize:

- User-friendliness and free access to quality information about how a government operates matter;
- Freedom to participate in the process that debates and decides public matters constitutes an integral part of any transparency system; and
- Existence of a body of oversight (legislature or the public at large) constitutes an integral part of any accountability system.

The world is far from this ideal. In quite a number of developing countries and in many countries with economies in transition, availability of fiscal information is limited. In some developed countries, decision-making and accountability are limited by the pre-existing spending legislation. The “agency structure” of some governments that have followed the NPM directives breeds “accountable to none” attitudes. Increased transfers from the central government to local governments and NGOs cause auditing problems. Also, in too many cases, the audit institutions are still focused on embezzlements and motivated awarding of contracts. Policy and performance review by audit is rare.

Yet, the pressure to go in this direction is growing. In East Asia, parliaments and the public at large did not like the fact that foreign investors had more information than they had about the status of economies and public finances in their respective countries. The knowledge workers, in exchange for paying taxes, want to know how their money is used, what public goods are being bought with it and how efficiently and effectively the government operates; and, they will not be pushed away from the decision-making process. No global investor is prepared to put money in an economy in which the government operations are shrouded in mystery. Fiscally transparent and accountable governments prove more predictable and sustainable in their policies – a priceless feature of an environment conducive to global financial flows.

With the end of the cold war, the basis for the state secrecy paranoia has become narrower. Also, ICT at least gives an impression that if only the will to open up the books and smoke-filled rooms existed, processing data and its real-time delivery to the public in an interactive way would not be a problem. However, transparency and accountability will not happen by themselves; they will happen only as a result of decreasing obstacles to their existence. As with other social phenomena, they need the establishment and effective operation of dedicated institutions in order to become part of everyday life. This is especially important as even advanced transparency and accountability standards, once achieved, have the tendency to be compromised in difficult economic times, to say nothing about an economic crisis.

Again, transparency is difficult to achieve. It requires advanced skills, well-established routines and – most difficult of all – shifting power. Also, the technical aspect is not too helpful. ICT is an excellent facilitator – no more, no less. Therefore, the challenge seems to be equally on the side of the political will to broaden the basis for government legitimacy as on the side of making the advanced budgetary and accounting instruments more accessible to the public at large: right now, even the well-staffed parliamentarians in advanced democracies complain.

A resounding message from the Meeting is that the above-mentioned difficulties should never constitute an excuse to do nothing to increase transparency and accountability of governments. Even small, incremental change has been encouraged, as especially in this area actions speak much louder than words. At the same time, a warning has been sounded against nominal, empty gestures, e.g., adoption of fiscal responsibility laws, fiscal codes, etc.

A most interesting debate begun in the first presentation lingered on throughout the Meeting. It concerned the relative value of fiscal rules as compared with fiscal transparency. A solid consensus emerged during this debate stating that in relative terms, fiscal transparency is much more important than fiscal rules.

The latter are introduced to impose legislative constraints on key fiscal variables, i.e. deficits, debt and expenditures --- all equally difficult to observe within a political or legal framework. The economic agents know that such rules are made to be broken and, as a matter of business routine, calculate into their business choices the expected deviation of the government from politically or legally self-imposed fiscal restrictions.

The former raises the level of confidence in government policy, insulates it from unexpected sharp changes and limits the amplitude of such changes. In other words, fiscal rules without fiscal transparency tend to be unreliable. Fiscal transparency without fiscal rules still plays an important stabilizing role in any economy.

Finally, the Meeting focused our attention on a number of useful future activities that may be undertaken:

- The Member States' government institutions are in need of training in performance budgeting, medium-term expenditure framework and accrual accounting techniques.

- More work is needed to simplify and make user-friendly the form in which information and data is being provided by the performance budgeting and accrual accounting systems.
- More work is needed to think through and formulate simple yet comprehensive and unambiguous definitions of transparency and accountability.
- Global networking of efforts to build up transparency and accountability institutions is useful for comparison of experiences and lessons learned.
- “Public space” and “public sphere”, as well as the set of standards, values, rights and freedoms that make them vibrant and relevant, and the whole idea of “publicizing” the provision of services to the public and of putting the citizenry in the centre of fiscal decision-making – all are a legitimate area of further debate and research; so is the possible polarization of tax jurisdictions according to the expenditure patterns.

There are also interesting trends to watch: Will fiscal rules, backed by fiscal transparency lead to a greater coordination of fiscal policy-setting across countries? If so, will the weight in macroeconomic policy-setting shift from fiscal to monetary policy? Will the application of fiscal rules at the macro level lead to greater harmonization of policies, including expenditure policies, at the micro level? Will the application of fiscal rules lead to greater harmonization of fiscal federalism arrangements, both within and across countries?

These are all interesting topics, and we in the United Nations are pleased to be part of the on-going global debate and effort to analyse these phenomena. This would not have been possible without the cooperation of the outstanding experts who joined us in Rome, nor without the generosity and hospitality extended to us by our Italian hosts.

Part I:

Public Finances and Financial Management in a Globalized World

FISCAL TRANSPARENCY, FISCAL RULES AND GLOBALIZATION: A WAY FORWARD FOR DEVELOPING AND TRANSITION ECONOMIES

by Barry Potter¹

This paper examines the influences of fiscal transparency, fiscal rules and globalization on the setting of fiscal policy and the conduct of fiscal management in industrialized, transition and developing countries; and then explores if there is a path, in the sense of an appropriate sequencing and timing of fiscal management reforms, that transition and developing countries might be best advised to pursue.

The paper first discusses fiscal transparency—the emerging interest in the topic during the 1990s: the incentives for governments to become more transparent, and the mechanisms now being used to assess fiscal transparency country by country. A review of progress to date in assessing fiscal transparency is also included. Second, the paper explores the adoption of fiscal rules by governments, as a means of ensuring an appropriate fiscal policy stance: the types and rationales for different kinds of fiscal rules are explored and some very tentative conclusions offered on their effects. A distinction is drawn between fiscal rules that put legal constraints on the fiscal policy stance in terms of certain fiscal aggregates, and fiscal transparency legislation that seeks both to set a policy framework and to stipulate certain fiscal management practices. Third, the paper considers how far globalization has affected both the drive toward greater fiscal transparency and the adoption of fiscal rules, and reviews some possible repercussions. Could globalization, in harness with greater transparency and fiscal rules, start to constrain the application of fiscal policy in an adverse way, leading to less overall economic policy flexibility in the future? Might these forces lead to a greater harmonization in individual tax or expenditure policies or perhaps in the practical administration of fiscal federalism arrangements within a country?

Finally, against that background, the paper examines what conclusions might be drawn that could be of benefit to developing and transition countries pursuing fiscal management reforms. Will the globalization of ideas on fiscal reforms oblige countries to reform their fiscal management practices; if so, will there be pressures to adopt certain specific means, such as fiscal rules; are some approaches more suitable to countries of one type or another; could going too quickly lead to adverse results; and, while recognizing that different countries face different circumstances, is there nonetheless some general guidance possible on the sequencing and timing of reform efforts?

¹ International Monetary Fund

A. Fiscal transparency

A useful starting point on transparency might be to recall why greater fiscal transparency was thought to be more important and politically attractive, especially in the second half of the 1990s. The economic history of the last three decades of the twentieth century helps to explain the evolution of interest in fiscal transparency. For many industrialized countries, the high deficits of the 1970s and 1980s, and the associated build up of large amounts of government debt (including in the host country for this workshop), provoked considerable concern and even bouts of alarm. In the 1970s and 1980s for developing countries, large fiscal deficits were often a source of macroeconomic instability: because of limited or unpredictable inflows of donor assistance and underdeveloped financial markets, any loosening of fiscal policy or loss of fiscal control through poor management tended to have an adverse impact on monetary aggregates and led to higher inflation and higher domestic debt through the familiar mechanisms. In the 1990s, many of the new transition economies had difficulty controlling fiscal deficits, faced with the collapse of output and sheer shock of the transition needed to transform from a socialist to a more market-oriented system; and in the 1990s the problems of developing countries and the mountain of overhanging external debt became increasingly of worldwide concern.

The literature defines a number of reasons why fiscal policy can be dysfunctional whether in terms of the setting of policies or the implementation of those policies through the tax and customs administration, public expenditure control and cash and debt management systems. In 1995, Alessina and Perrotti provided a useful overview of why political and institutional dimensions to the setting of fiscal policy could lead to sub-optimal solutions. They identified:

- i) fiscal illusion in the sense that voters take a short-sighted view: they do not penalize unsustainable fiscal policies, because they do not understand that governments face an intertemporal budget constraint;
- ii) the under-representation in the political process of future generations tempts governments to frontload the benefits of fiscal policy decisions and postpone their costs: this benefits current generations at the cost of their children;
- iii) the use of debt as a strategic variable that can be used by government to constrain the actions of successor governments;
- iv) the distributional conflict between different groups in fragmented political systems again tends to push needed fiscal adjustment into the future;
- v) there is a tendency for local groups to overestimate the benefits they receive from some higher public expenditure relative to the costs which are shared nationally: at the margin, any change that is specific to particular groups or areas will bring disproportional benefits relative to the costs that fall on the local community; and

- vi) inadequate and ineffective budget institutions, whether procedures for budget formulation or implementation.

With the exception of the last, the inherent problems identified above are all aspects of a mismatch between perceived costs and benefits—with the mismatch reflecting, intertemporal, spatial or “tragedy of the commons” factors. While the problems have been recognized for some time, none can be easily resolved: for example, most of the studies that have examined Ricardian equivalence—the idea that voters should be aware that incurring more debt today leads to higher taxes tomorrow—find that the equivalence does not seem to be satisfied, although that may apply for rational rather than illusory reasons. The basic point is that fiscal illusion, or mismatch between perceived costs and benefits, at least in the past, appears to have been widespread and deep-rooted.

It is possible to identify three main approaches to tackling dysfunctional fiscal policy setting that were initiated in the late 1980s, then pursued with greater vigor and by more countries in the 1990s:

- i) the first was to implement institutional reforms, whether increasing the power of ministries of finance over line ministries; the setting up of firm expenditure ceilings by a ministry; improved budgeting or accounting procedures, etc.—essentially the whole panoply of institutional budget reforms that will be discussed later at this conference;
- ii) the improvement of fiscal transparency; and
- iii) the adoption of fiscal rules.

It can be argued that institutional reforms (i) has been the traditional solution to the inherent problems of budget management not just since the 1970s but for centuries. Thus, it is ii) and iii) – the ideas that better fiscal transparency or the adoption of fiscal rules could serve as a more radical and effective approach to these problems – that the rest of this paper discusses.

A number of countries began in the 1990s to improve fiscal transparency. Pride of place has always gone to New Zealand with its Fiscal Responsibility Act of 1994—though Scott (1996), gives a very good and thorough account that traces the background stimulus to reform to an earlier conjunction of events and influences in the mid 1980s. He explains not only what was done but also the juxtaposition of political and economic events that first gave rise to the perceived need – amongst electors as much as politicians – for change. But several other countries, notably the United States of America, Australia, and the United Kingdom, were all moving by the 1990s to formulate clear fiscal policies, make them public and make their fiscal management stance more open.

Fiscal transparency can be defined as being open to the public about the structure and functions of government, fiscal policy intentions, public sector accounts and fiscal projections (Kopits and

Craig, 1996). Publication of the work by these two Fund economists was quickly followed by the adoption of an IMF Code of Good Practices on Fiscal Transparency in April 1998 (henceforward the Fiscal Code or the Code). The Code provides benchmarks and four general principles as set out in the box below. These were updated in May 2001, and the Code is now well established and widely referred to. It is necessary to keep in perspective what the Code sets out to do: it is not an attempt to codify New Zealand and Australian best practice; rather the deliberate aim is to select good practices, not the best. Indeed, there is now a separate OECD set of best practice guidelines issued in 2000 that the more advanced or industrialized countries should aspire to, if not attain, directly.

Main Principles of the Fiscal Transparency Code

1. Clarity of roles and responsibilities

- a) The government sector should be clearly distinguished from the rest of the public sector and from the rest of the economy, and policy and management roles within government should be well defined.
- b) There should be a clear legal and administrative framework for fiscal management.

2. Public availability of information

- a) The public should be provided with full information on the past, current, and projected fiscal activity of government.
- b) A commitment should be made to the timely publication of fiscal information.

3. Open budget preparation, execution, and reporting

- a) Budget documentation should specify fiscal policy objectives, the macroeconomic framework, the policy basis for the budget, and identifiable major fiscal risks.
- b) Budget data should be classified and presented in a way that facilitates policy analysis and promotes accountability.
- c) Procedures for the execution and monitoring of approved expenditures and for collecting revenue should be clearly specified.
- d) There should be regular fiscal reporting to the legislature and the public.

4. Independent assurances of integrity

- a) Fiscal data should meet accepted data quality standards.
- b) Fiscal information should be subject to independent scrutiny.

Unsurprisingly, given its Fund origin, the Code places much emphasis on the macroeconomic perspective: it focuses on general government and emphasizes fiscal risks. It does have a microelement, for example, on issues like employment standards and on the need to measure outputs and outcomes from individual public expenditure programmes, but the macro dimension is clearly the more important. It is that macro dimension which has the greatest relevance to any study of the interaction between fiscal transparency, fiscal rules and globalization.

The Fund is not alone in its advocacy or focus on fiscal transparency. Transparency International has long published material on individual countries' performance, though that centres on issues of corruption—a key indicator but not a comprehensive account of fiscal transparency in an individual country. The World Bank's Country Financial Accountability Assessments (CFAAs) are also an important tool: they give a much more detailed account of financial management practices, again principally in the public sector, that are essentially designed to ensure that countries have in place the systems to manage World Bank programme (as distinct from project) assistance. Nevertheless, in their own right, they are an important indicator of overall fiscal transparency and, to some extent, corporate transparency in an individual country.

The IMF's Fiscal Code is, however, the recognized benchmark. It forms part of a wider picture of 11 separate standards and codes which have been adopted by the Fund and the Bank, and with the active cooperation of a number of private sector institutions, that define benchmarks for key aspects of economic policy setting and implementation. The main tool adopted by the Fund for assessing performance against the benchmarks in the Fiscal Code is known as the fiscal module of the Report on the Observance of Standards and Codes, or fiscal ROSC for short. In form, these fiscal ROSC modules are usually carried out by a small team from the IMF that reviews country practice against each of the 35 separate items within the Code and prepares a report that is agreed upon with the country authorities.

Twenty-five of the fiscal ROSCs were completed by the end of September 2001 and a further 36 are under way. Of these, 7 are in the advanced countries, 22 in emerging market/transition economies and 15 in developing countries. A recent IMF paper (Allan, 2001) summarized the main lessons learned so far.

- i) The fiscal ROSCs do seem to be providing a potentially useful method for identifying core practices and disseminating them more widely—although the Fund could do even more to ensure the results are publicized and noticed. Completion of the fiscal ROSC modules is already beginning to have an impact on individual countries' fiscal management practices. Countries are encouraged but are not required to publish findings. Even though publication of a text means that it has to be negotiated, and the wording is perhaps gentler and more guarded than it might otherwise be, it has proven difficult either to disguise weaknesses or reveal them without promise of remedial action. So many countries, faced with the desirability (because it has become standard practice) to publish their findings, are simultaneously announcing new measures to address some of the weaknesses identified in the ROSC exercise.

- ii) There is some, admittedly still very limited, evidence that markets are paying attention to ROSCs. Development agencies are showing an interest in the ROSCs, in terms of deciding where to allocate available funds; and bond markets are aware of the fiscal ROSC, while the relevant agencies take them into account in setting their ratings. But this evidence is more anecdotal than concrete; and it is of course always difficult to identify the publication of an ROSC module (whether fiscal or monetary) as a proximate cause of an improved bond rating, rather than the underlying policy measures or other economic factors. Moreover, the sample size remains too small for a thorough analysis. A fair conclusion at this time would be that, at the very least, donors, bond markets and rating agencies are showing an interest in the fiscal ROSCs, as one of a number of assessment tools that identify the appropriateness of a country's fiscal policy stance and management practices.
- iii) In terms of what the fiscal ROSC modules are finding, the quality of fiscal data is proving to be a particular problem. One general message is that governments need to become more open about the reliability of their data and its status, i.e., whether it is audited or reconciled with the monetary accounts, for example. There are perhaps too many examples emerging of inadequate at best, and suspect at worst, fiscal data amongst developing and transition economies. Reliable, accurate and timely fiscal data are key to the credibility of any fiscal policy: good budget intentions must be translated, and be seen to be translated, into practice. Nothing seems more damaging to the credibility of any country's policy setting than that its effectiveness cannot be comprehensively and speedily measured ex post.
- iv) The poor coverage of underlying fiscal problems, and limited appreciation of fiscal vulnerability are another major concern. Persuasive evidence of fiscal sustainability requires more than just a long-term projection of revenues and expenditures on a current policy basis. The fiscal ROSCs to date indicate that contingent liabilities, quasi-fiscal expenditures and tax expenditures are not well documented, even amongst the OECD countries. The first two of these are a major source of fiscal vulnerability and greater pressure is to be expected—for example from bond markets—to publish full lists of contingent liabilities. The greater scope of quasi-fiscal activities, as well as the greater build up of contingent, but too often unrecognized liabilities, identified to date in transition and developing countries are the main reasons why some fiscal ROSCs are indicating a lack of fiscal sustainability on present policies.

Linking now to the main theme of this workshop, globalization interacts with fiscal transparency principally by widening and intensifying the pressure on all countries to be more transparent. The Fund, the World Bank, the OECD and the private sector are all playing a role in setting

codes, and norms, benchmarks, and standards². However, it still seems to be the case that the principles of fiscal transparency are perhaps better understood than reflected in the actual practices necessary to deliver on those principles. In many cases local electors or pressure groups are an important influence for betterment; but surely the main, indeed obvious, message that emerges is that globalization is either reinforcing that domestic pressure or just directly pushing countries to adhere or aspire to higher standards in the setting of fiscal policy and the conduct of fiscal management. Before examining what that might mean in terms of the pressures on developing and transition economies, it is first necessary to consider the separate but linked movement towards the adoption of fiscal rules.

B. Fiscal rules

At the heart of the concept of fiscal rules is a trade-off—the surrender of a certain amount of policy-setting freedom, in return for securing a greater degree of fiscal credibility, particularly in terms of fiscal sustainability. Correspondingly, governments that adopt fiscal rules take the view that the gain in fiscal credibility is worth the loss of some fiscal policy flexibility. Clearly, the form of those rules is important in determining just how constraining the fiscal rules are and what flexibility is allowed. One major problem in any discussion of fiscal rules is that different authors have placed different interpretations on what constitutes a fiscal rule. Kopits and Symansky (1998) describe them as a permanent constraint on fiscal policy; Hemming and Kell (2001) offer a broader definition which includes some time-limited budget targets, as well as some procedural rules used to ensure execution of either discretionary or rules-based fiscal policies.

In this paper, in an attempt to simplify and clarify, fiscal rules are considered to be legislative constraints on certain fiscal variables. Thus the consideration of fiscal rules here excludes fiscal responsibility acts or codes of fiscal stability that deal with procedures for setting fiscal policy and fiscal management, or with other more loosely defined codes of conduct. These can perhaps best be seen as a means of ensuring fiscal transparency that may also involve certain policy declarations but not legal limits on one or more fiscal aggregates. The concern here is thus those fiscal rules that operate to limit the freedom of policy action for governments on the three fiscal variables usually targeted or limited under such rules: deficits, debt and expenditures. Also excluded are policy statements on these variables of the kind that governments have so often made in the past—a fiscal rule requires legislation or other strong regulatory backing.

Even with this apparently tight definition, however, it should be recognized that in practice there is a range of instruments (currency boards) and arrangements (codes that are in the form of regulations derived from more general legislation) that can be seen as representing fiscal rules, with varying degrees of precision and status. However, from a globalization perspective, and in terms of their impact on transition and developing countries, this paper is interested in three

² Even then it should be noted that these codes and standards do not cover all aspects of fiscal policy-making: for example, fiscal transparency is not the same concept as efficiency or effectiveness in public policies.

aspects of fiscal rules: how widely are they applied; which rules are appropriate in which circumstances; and what impact have they had.

First, on coverage, fiscal rules are not, as is sometimes asserted, only a developed country tool. Clearly the best known example of tightly legislated deficit rules are those under the EU Maastricht Treaty. Switzerland, New Zealand, Sweden, Australia and the United States of America have also adopted strong fiscal rules, again based on reasonably explicit legislation. However, other countries, (as well as the United Kingdom) such as Costa Rica or Indonesia, have forms of the “golden rule”, while other developing countries, such as the CFA francs countries in Africa, have long placed legislative limits on borrowing from central banks. Moving to less precise fiscal rules, countries like Bulgaria and Estonia with currency boards can also be seen as having adopted a form of proxy fiscal rule—specifically practical restrictions on access to central bank borrowing. Moreover, there is clearly a shift toward the adoption of fiscal rules in Latin America with some countries moving from more general debt rules to tighter deficit rules: there is a long list now in all three categories with Argentina, Brazil, Peru, and Venezuela, likely to be joined by Colombia and Ecuador in the near future.

Second, which rules are appropriate in what circumstances? Hemming and Kell review the three main types. The fiscal deficit rules are perhaps the best known, and despite some problems discussed below, if they can be drawn up in such a way that they allow for the operation of the business cycle, they are the simplest, and perhaps the most familiar to commentators, electors and politicians; but they do require rigorous guard against creative accounting and a sophisticated capacity to report accurately and regularly on fiscal developments. The debt ceiling—probably best set as a limit on the net debt/GDP ratio—is a good indicator, but can probably serve best as a medium-term anchor for fiscal policy. It says relatively little about the annual fiscal stance—for example, when a country is well underneath its debt ceiling, such a ratio does not constrain the fiscal deficit. Also, in practical terms, getting information on a government’s financial assets so as to calculate net debt can be difficult. The expenditure ceiling is a more direct tool (in the sense that total expenditure ought to be more under government control than a deficit target) that, in association with normal good fiscal management, also implies limits on debt and the tax ratio. Although open to the creative accounting problem, it appears to have had some impact in those OECD countries to which it has been applied—though as with deficit rules, the scope for creative accounting, off-budget spending, use of tax expenditures and the difficulty of securing audited accounts quickly may mean it will be of most relevance to industrialized countries.

In terms of this workshop, one conclusion on types of fiscal rule from the work by Hemming and Kell is striking:

“Given that the biggest risk is that recent efforts to control expenditure will be reversed, the combination of expenditure ceilings to constrain short-term fiscal policy and the medium-term debt ceiling to ensure sustainability probably offers the best solution in most cases.”

If this conclusion turns out to be robust, then it could tend to become a norm for those countries which choose to adopt fiscal rules. That would inevitably focus even more pressure on issues such as medium-term expenditure frameworks, setting annual expenditure ceilings and public expenditure management—precisely the issues that this workshop is to address.

Third, what impact have fiscal rules had—have they worked? On a superficial level, it would certainly seem that fiscal rules have been associated with improved fiscal performance. An as yet unpublished IMF paper shows for most Maastricht Treaty countries deficits are falling, gross debt is decreasing and even expenditure itself is no longer rising at the rates experienced in the 1980s and early 1990s. However there is, of course, no real counterfactual: it might well have been that fiscal policies would have been adopted of the same broad size and nature without the additional pressure of fiscal rules. That said, this recent research by the Fund suggests that the following may be reasonable conclusions for industrialized country systems:

- Adopting carefully designed rules is a stimulus to improved fiscal performance; however, changing the type and mechanics of the rules can also be necessary before the benefits are enjoyed—for example, the United States experience with expenditure ceilings has been more successful than with deficit ceilings;
- For fiscal rules to work, care must be taken to ensure compliance ex post as well as ex ante; it is the ex-post evidence that rules are being applied that the markets find most convincing;
- Fiscal rules need to apply at a general government level: this often requires a pact or understanding with the lower-tiers of government: Ter-Minassian (1997) showed the importance of coordination of budgetary practices as well as the likely need to limit the ability of lower-tier governments to incur debt; this is already proving a problem within certain EU countries and is likely to prove an obstacle to large developing countries that might wish to adopt similar rules: Argentina is perhaps one example;
- The economic impact of discretionary fiscal policy may itself change: once economic agents perceive that fiscal rules are permanent and will be maintained, they may react differently to fiscal policy actions that are taken to alleviate a downturn. For example, they may be more widely understood to be discretionary and hence temporary rather than permanent.

However, what of developing country and transition economy experience of fiscal rules? As noted, that experience is more limited; but it also seems less positive. At least one interpretation of what happened in Indonesia is that the application of the golden fiscal rule may have contributed to the recent crisis by distorting the economy, disguising the indebtedness of the public sector and misleading commentators for a number of years. Thus, while no large amount of domestic government debt was incurred under the golden rule, directed lending and other means of placing public sector transactions, through private sector banks or off-budget accounts, contributed to the problems of an unhealthy banking structure and the inevitable demise of some banks, burdened with the non-performing assets. The golden rule was only one of the many

reasons for the near collapse of the banking sector; but the fiscal costs of the subsequent rescue have caused the domestic debt-to-GDP ratio in Indonesia rise from near zero toward the end of the 1990s to well over 50 per cent now.

In the case of the CFA francs countries, the rules prohibiting borrowing from the common central bank were either not observed or circumvented—with a rise in external borrowing and crowding out of lending to the private sector. In different forms, a number of other developing countries have found it difficult to adhere to rules on borrowing from the central banks—for example, when faced with a fiscal shock that cut revenues. Only in the case of the less rigorous rules of currency boards has experience been more promising, though again one must contrast the relatively good fiscal discipline record of Bulgaria and Estonia with the emergence of unresolved pressures in Argentina.

C. Globalization

Globalization is a somewhat loose term and has many dimensions. For the purposes of this paper, the focus is on three characteristics: the facilitation of the more rapid transmission of ideas; the greater integration of capital, goods and factor markets; and the apparent tendency towards increased harmonization of the business cycle. The essence of globalization is perhaps rooted in the faster communication of information brought about by the internet, satellite communications, or even international workshops. Economic policy-making is not immune from this: at the very least one can expect a faster response from industrialized countries, e.g., when one country produces a particular innovation. No one need now be ignorant of the latest advances in techniques for better budget management, or the more optimal setting of fiscal policy.

Therefore, globalization might be associated with greater pressure on all countries to modernize their fiscal management practices, simply because of the more rapid dissemination of ideas on fiscal transparency, and the adoption of fiscal rules. However, there is also the direct market effect to be taken into account: it is now only a little fanciful to talk about a global capital market emerging (for sovereign and commercial borrowing), and countries having an incentive to understand its rules and standards and to play by them, if they wish to attract capital.

In most economic studies globalization is seen as a “good thing”. However, just as the early support for the idea of freer capital markets in response to globalization waned as evidence grew that short-term capital influence could be highly disruptive to economic policy formulation in vulnerable countries, so might there be reasons for being a little cautious on the way ahead—for example, on the adoption of fiscal rules? Indeed, a crucial distinction might usefully be drawn. While it is by no means impossible to dispute the case for greater fiscal transparency, the reasons for secrecy (for example, to avoid market overreaction) are generally admitted to be limited: by being open, honest, and informative, all parties—workers, governments, and even bond traders—can expect to be gainers and all markets work more efficiently. The case for applying fiscal rules is much less unequivocal.

Fiscal rules too may often bring benefits as recent research has shown; but they also imply certain restrictions on economic policy-making—that is their whole point. Therefore, for a developing or transition economy seeking reform of its fiscal management, some questions need to be addressed in deciding on the trade off between loss of policy-making flexibility and greater fiscal credibility and self-imposed restraint. Are there potentially important drawbacks, and are some countries more in need of, or better able to benefit from, the application of fiscal rules than others? Even before examining that, one wider issue is worth considering: are there potential costs or at least consequences—for example, for the conduct of macroeconomic management—to fiscal rules as they mature (i.e., become “bedded in”) in those countries which have adopted them, which are only now beginning to emerge?

With more widespread (at least among developed countries) application of fiscal rules, there are some specific issues that need to be analysed further: in all cases there is simply not enough evidence to date to reach conclusions, but perhaps enough to pose some interesting questions:

- i) Will fiscal rules, backed by fiscal transparency, lead to a greater coordination of fiscal policy-setting across countries?
- ii) If so, will the weight in macroeconomic policy-setting shift from fiscal to monetary policy, e.g., in terms of stabilization activity?
- iii) Will the application of fiscal rules, allied to fiscal transparency, lead to harmonization of individual policies—e.g., on corporate taxation or on public services, or perhaps on the composition of total expenditure?
- iv) Will the application of fiscal rules lead to some greater harmonization of fiscal federalism arrangements, both within and across countries?
- v) Despite the pressures on globalization, does any of the preceding analysis suggest different approaches to fiscal rules for countries at different stages of development?

Assessing if fiscal rules might lead to a greater coordination of fiscal policy stance is a delicate, even dangerous, area on which to tread. Certainly at this stage it is very difficult to argue that fiscal rules have in themselves restricted fiscal policy decisions. Clearly, e.g., in the case of Maastricht treaty countries, the application of those rules, backed by vigorous inspection so that the rules are really being adhered to, would seem to suggest that they have indeed delivered greater fiscal discipline. Given the lack of a counterfactual, it could well be that even without the existence of fiscal rules, many member countries in the EU would have felt the need to narrow the fiscal deficits of the 80s and the early 90s—the United Kingdom is a prime example. However, an interesting analysis, from an as yet unpublished IMF report, suggests that even when the fiscal policy stance is pro-cyclical, within the EU countries are not very willing to change their stance. In short, countries seem less willing to undertake discretionary policy action, even when there is room to do so within the fiscal rules, in order to act in a counter-cyclical fashion.

Part of this may be a concern that any discretionary policy action might be regarded in a hostile way by the EU authorities or commentators. Part of the explanation may lie in uncertainty of economic response, because the consequences of discretionary fiscal policy action may have changed under fiscal rules, i.e., they may be less effective than in the past if it is perceived that any fiscal boost can only be temporary. (The counter-argument is that fiscal rules would actually make policy more effective—because the boost can be seen as temporary yet consistent with fiscal sustainability.) However, it is difficult to resist the conclusion that fiscal policy in most EU countries has been largely on auto-pilot in the last few years, driven more by the need to adhere to the fiscal rules on deficits, than on the application of discretionary action. This has been also a period of relative expansion and growth with little need perhaps to restrict the fiscal policy stance below that in line with the fiscal rules or to give a fiscal stimulus. Perhaps the test will come in the more trying times ahead for national authorities as the demands for discretionary policy action grow.

This leads to the question of with the wider adoption of fiscal rules the weight might now shift in stabilization policies from the fiscal to the monetary dimension. It is evident that we are now faced with a global slowdown though there are differences in view both about how severe this will be and how long it will last. Will countries rely largely on monetary policy as has certainly been the case within the EU (not necessarily to the full satisfaction of all interested parties) and, very recently, the United States of America, or will discretionary fiscal packages make a reappearance? Japan is already seen as an outlier in terms of fiscal policies amongst the G7 countries. It is tempting for all those with broadly Keynesian economic training to see evidence in the Japanese experience of a classic liquidity trap: that there is no interest rate low enough to generate the positive “animal spirits” necessary in the capital markets, so that a change in sentiment leads to recovery. On the other hand, those of a different persuasion might argue that successive fiscal stimulus packages have had little impact on activity in Japan. It will be particularly interesting to watch developments in the United States economy: at the time of writing there is already widespread anticipation of a further fiscal stimulus, with the balance between increases in expenditure and reductions in tax and taxation being debated along lines more of partisan politics and economics.

Thus, several questions have been posed by the recent experience and the greater reliance on monetary policy. Is there any danger that the globalization of economic problems, which seems to be associated with the greater harmonization of the business cycle combined with the greater globalization of fiscal rules and fiscal transparency amongst the OECD countries, could mean inadequate policy responses globally? How far will countries give a fiscal stimulus (and how much room will individual EU members have to do so consistent with the Growth and Stability Pact)? Even if they do, will the Japanese experience be mirrored elsewhere? The risks of stagnation from inadequate fiscal policy action, and even insubstantial economic response to any fiscal stimulus, are both relevant.

Will globalization and fiscal rules (with fiscal transparency) lead to harmonization of individual policies? There is at this stage not much evidence of this. Concerning taxation, such harmonization as has taken place indirectly is perhaps more led by a bureaucratic EU initiative than the collective demands of constituent governments. There has been some harmonization of

corporate tax rates, interestingly with some members under pressure to raise their corporate tax rates towards the EU pattern. However, there remain huge gaps between the corporate tax regime in the typical EU member country and that of the United States of America or Canada. However, while there are international trends amongst industrialized countries in taxation, e.g., the shift from direct to indirect or the shift to lower corporate taxation, it is difficult to attribute these in any way to fiscal rules.

Concerning expenditure, it is again quite difficult to see any great harmonization of individual expenditure policies. Indeed, perhaps most interesting is that the application of expenditure ceilings to a number of countries has not led to any consistent form of adjustment in expenditures. The only broadly detectable pattern is a sharp decline in transfer payments amongst Anglo-Saxon countries across the world, a reform that seems more associated with different visions of labour markets and the concept of the social wage vis-à-vis continental Europe, than any power of fiscal rules. If anything, the experience brings out a well-known lesson: in cutting back the growth of public expenditure there are no easy answers, only difficult policy choices.

One early message from the application of fiscal rules, as well as of fiscal transparency, is that it is no good focusing on central government alone. Clearly it is general government (or even the wider public sector) that matters for the fiscal policy stance, and that in turn implies the need for a greater harmonization at the stage of fiscal policy setting—between central- and lower-tier authorities. Countries such as Austria, Belgium and Italy have such internal stability pacts in place, while the Brazilian Fiscal Responsibility Act also requires transparency at all levels of government. This problem was explored several years ago in a book by Ter-Minassian (1997): various chapters pointed to the likely need to better harmonization of policy setting in the future, including on the budget, (Chapter 6, Potter) and on local government borrowing (Chapter 7, Ter-Minassian and Craig). A recent working paper by Pissauro (2000) also pointed to the likely dangers in future years for EU countries, especially in the case of federal governments; it will become increasingly necessary to harmonize not just the budget-setting arrangements, but also the expenditure and tax policies of each tier. Within the EU that is an argument that might eventually have to be taken a stage further.

D. Reforms for transitional and developing countries

How should the transitional or developing country go about responding to pressures (whether domestic or from globalization) for a more modern fiscal management approach? Schick (1998) pointed out that in public expenditure management there is a logical order of reforms that brings good results, while the premature adoption of more advanced techniques can lead to serious disruption and even regression. Are there some similar lessons that be learned from the pursuit of fiscal transparency and application of fiscal rules to date?

First, one obvious conclusion for this paper is surely that it would be wrong for transitional or developing countries to attempt the adoption of fiscal rules until they have sufficiently transparent mechanisms for policy-setting and budget management to monitor their effectiveness. Indeed, setting non-credible fiscal rules could prove to be counter-productive: it is

possible to have fiscal transparency without rules, it is less clear that meaningful fiscal rules can be applied without accompanying transparency.

Second, in terms of fiscal transparency, there are certain common weaknesses emerging in transition economies and in many developing countries that need to be addressed most urgently. Findings have differed and all weaknesses ought to be tackled. This is not a case of “one size fits all”; the solutions will depend on the country’s starting point, level of development, the existence of computerized information systems, etc. However, on the basis of the fiscal ROSC modules to date, the most notable and most worrying weakness is the absence of reliable fiscal data on a suitably wide fiscal aggregate. Without reconciled, comprehensive and regularly produced fiscal data, no country can put either transparency or fiscal rules-type reforms in place and expect them to have or gain credibility. Second in importance to the main fiscal data is reliable information on contingent liabilities and quasi-fiscal expenditures. Obtaining and then publishing this information should perhaps be seen as the priorities in terms of technical assistance needs.

Third, when a country has good fiscal data and a secure grasp on indicators of fiscal vulnerability, such as quasi-fiscal expenditures, contingent liabilities and the long-term trends of revenues and expenditures, then it would be appropriate to implement a fiscal responsibility law or other form of fiscal code. This should not be taken as discouraging countries from the early adoption of such transparency-related laws or codes as a means of self discipline to procure better fiscal information. Rather, the argument is that the right time to enact such legislation is after the data are in place, and are seen to be in place, thus building on a convincing and credible foundation. That is perhaps best attained after achieving a demonstrable track record—which can be a quite short period—of having in place the systems to give a comprehensive account of the fiscal position and prognosis.

Fourth, before any country proceeds beyond fiscal transparency to fiscal rules—whether a fiscal responsibility law is in place or not—it is worth questioning whether fiscal rules are really appropriate for that country. As noted, the trade off between greater credibility and self discipline and loss-of-policy flexibility may have different balances for different countries. It is probably more feasible for an industrialized country with a broad economic structure to adopt such rules, particularly where it has reasonable foreknowledge of the likely size and pattern (in terms of timing) of cyclical effects. It is much more difficult for a country that is heavily dependent on a single commodity, whether oil, tourism earnings or primary product, to design and stay within fiscal rules that can be both meaningful and accommodate large swings in activity. In such countries it may also be the case that a more interventionist fiscal policy is appropriate—for example, to obviate the immediate effects of a terms-of-trade loss (that may be unique to its product dependence rather than cyclical) through a carefully designed social safety net. There is a balance to be struck: is the gain from tighter fiscal rules in terms of enhanced credibility with donors or with markets greater or less than the gain that could be acquired by a more modest fiscal responsibility law, or even publication of a fiscal ROSC module with annual voluntary updating of that assessment?

Fifth, a transitional or developing country considering whether or not to adopt any of the various fiscal rules should take into account the sophistication of its financial markets. The more

comprehensive fiscal rules on debt require an ability to keep a very close record on debt (and for a net target financial assets) as well as an ability to refinance domestic or external debt issues with relative ease. Deficit targets are perhaps not so difficult; yet they too can be readily thrown off by the sudden premium necessary with high levels of domestic debt, where there is a high volume of refinancing necessary or where shocks lead to questions about the capacity to finance the deficit. Even the more modest fiscal rules such as restrictions associated with a currency board or quantitative legal limits on borrowing from the central bank need to be framed within a realistic assessment of technical capabilities, e.g., on the government's cash management and refinancing capabilities. Too often tough limits on such domestic borrowing have been adhered to—only at the cost of losing fiscal credibility because of off-budget transactions or in the case of the central bank's somewhat creative accounting. The general point is clear enough: well-functioning financial markets add to the credibility of fiscal rules.

Sixth, if there is an intention to adopt fiscal rules, these might be set more in general than in specific numerical terms—examples would include the application of some form of golden rule. Too precise or numerical constraints through debt limits, deficit rules and expenditure ceilings would seem to pose difficulties for countries without a broadly based economic structure and well-functioning financial markets. Again, assuming that credibility is the foundation of successful reforms both for transparency and for fiscal rules, it may be better to obtain good results under quite generous rules, rather than mixed or poor results under tighter limits.

In conclusion, generalizations in this field are perhaps dangerously premature, but nonetheless tempting. If the goal is to facilitate good economic policy-making, it does seem to depend on building a track record that constantly, ideally monotonically, enhances credibility—whether internally with electors or externally with donors and capital markets. There does seem to be a logical progression here which might be stated as follows:

- developing countries need to get fiscal transparency in place before they consider the adoption of fiscal rules;
- whatever ROSCs or other reviews of their fiscal transparency reveal, a particular priority should be on getting in place systems to present comprehensive, reconciled and regular fiscal data;
- their credibility will be further enhanced if they can go beyond this and build up a comprehensive picture of fiscal vulnerability in terms of contingent liabilities, information on—and ideally the elimination of—quasi-fiscal expenditures and longer-term projections of revenues and expenditures;
- correspondingly, these are the areas on which technical assistance should first focus;
- it would be better to have a comprehensive transparency framework in place before going to the further stage of enacting a fiscal responsibility law or adopting some kind of fiscal code; that should be regarded not as absolute, but advisory. To maintain the credibility of the new law, the data and information should be regularly and accurately available; and

- a fiscal rule approach requires a careful balance of the need for and risks of being pushed from some fixed rules on fiscal aggregates; countries vulnerable to large terms of trade swings, without a broad-based economic structure or with poorly developed financial markets might better avoid such rules; others may need convincing reasons to limit their own policy freedom; but any fiscal rules of this kind might be better—at least initially—announced in general terms.

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GLOBAL COMPETITION AND PUBLIC FINANCE

by Hirofumi Shibata³

A. Introduction

Intensified international mobility of capital, labour and goods are increasing disturbing the long cherished methods of taxation and income distribution of individual countries. The volume of international direct investments has increased more than 12 times worldwide in the past 15 years and that of commodity trade more than three times in the same period. In the period between 1983 and 1998, the annual flow of outbound foreign direct investment (FDI) has nominally risen from less than \$50 billion in 1983 to more than \$600 billion in 1998. During the same time period, the world commodity trade has increased from a total export volume of \$1,667 billion in 1983 to \$5,377 billion in 1998 (International Monetary Fund, 1990, 1999).

Globalization of the national markets is destroying the comprehensive income tax system based on the residence principle, and threatens progressive income tax and welfare systems of individual countries. The incidences of income tax avoidance with respect to incomes from capital, which can move internationally with more ease as compared with labour and natural resources, are becoming increasingly significant.

E-commerce of services whose delivery can be completed through electronic transmissions escapes indirect taxes completely and cross-border shopping threatens independence of indirect tax rates of individual countries.

In response to these developments, Scandinavian countries and Austria introduced the so-called “dual income tax system” in 1990s. It was an epoch-making departure from their long established comprehensive income tax regimes, which applies a progressive tax rate schedule on an individual’s entire income whatever the sources of his incomes may be.

The dual income tax, on the other hand, divides an individual’s entire income between the incomes from capital that can move easily across international borders and labour income that can not move so easily. It then applies to a progressive rate tax on the labour income and fixed rate tax on the capital income. The fixed tax rate applicable to the capital income is set equal to the lowest tax rate applicable to the labour income. The low tax rate on capital income is designed to prevent international outflows of capital that a higher tax rate would generate. Such a tax system reflects the modern thinking of optimal taxation, which recommends a tax rate inversely related to the elasticity of supply of the item to be taxed.

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Clearly, under the dual income tax system, the high-level welfare system supported by high-level taxation would become increasingly difficult. The opting to the dual tax system does not seem to reflect the willing choice of the traditionally egalitarian-minded citizens and the governments of those countries, but rather reflects the bitter choice forced on them under circumstances. It was a necessary decision for a small and open economy to survive under the intensified international competition for capital in the globally integrated economy.

The present unsettling world situation, symbolized by terrorism, regional conflicts and the Afghanistan situation, are results of, in large part, the state of utter poverty prevailing in many parts of the world and staggering income inequalities between the rich and the poor nations. Traditionally, the public finance system has shouldered the main burden of solving income inequalities in each country. The fact that the pressure of global competition is now forcing all countries to relinquish the income redistribution function of their public finance system presents a serious problem to stability of the world.

B. The advantages of the residence principle

Under the ability to pay principle of taxation, all incomes of an individual, wherever their sources may be, must be gathered together in one country and the progressive rate schedule of that country must apply to the sum of the gathered incomes. The system under which the country where a specific individual's incomes are gathered is the country where that individual resides is called the residence principle taxation.

Naturally, the country to which the revenue from a tax accrues and the country where the sources of that taxed income locate themselves are not necessarily the same. An alternative taxation system that attempts to match the revenue receiving country and the income source country exists. The system under which the country imposes a tax on the incomes whose sources are within that country is called the source principle taxation. Under the source principle taxation, when the sources of the taxpayer's entire income is distributed among different countries, his income of any one country does not reflect his ability to earn income. Unless the tax rates of all countries are the same and fixed, the sum of taxes paid in all countries changes as the country distribution pattern of income changes. Therefore, the source principle taxation cannot realize the ability to pay taxation. Clearly, it is essential to have a comprehensive income tax system based on the residence principle to realize the principle of the ability to pay taxation.

The source principle taxation is also defective in achieving an efficient use of the limited aggregate quantity of the world resources. For example, a capital investor, wishing to maximize his return to capital, would distribute his capital among different countries so that the rates of return to capital invested become the same in all countries. The rates of return that he uses for his maximization calculus are the returns after subtracting taxes that he has to pay in the source countries. When the tax rates of source countries are different, the returns to capital before subtracting source countries' taxes are also different. But an efficient allocation of the world's limited aggregate capital requires equalization of the tax inclusive returns to capital (returns before subtracting taxes). Thus the source principle taxation produces an undesirable outcome from the point of view of efficient resource allocation.

Under the residence principal, taxes that a capital investor subtracts from returns from different sources are the taxes of the country of his residence and are the same: They are unrelated to the taxes in the source countries. Hence when each investor maximizes the sum of returns of his capital, the returns of capital inclusive taxes of various sources are also equalized. Consequently, the aggregate capital of the world is automatically distributed efficiently among different sources.

Thus under the realistic situation where all countries' tax rates are different, the residence principle holds two theoretically desirable characteristics:

- Each country can use independently a progressive income tax system that it considers desirable and can pursue its own welfare programmes.
- When it is left to individual resource owners' free choice, the world resources are automatically distributed among different activities most efficiently.

However, the intense competition in the global economy is gradually demolishing the residence principle taxation.

C. Wrecking of the residence principle

Residence principle taxation is a desirable system because it realizes the ability to pay principle taxation and brings about an efficient use of the limited quantity of world resources. However, in the real world, the tax systems of all countries are moving to the source principle taxation, in which a country taxes incomes whose sources are located within its own territory.

Generally, a tax consists of two parts: one that finances transfer of income from the rich to the poor, namely the transfer tax; and the other, the part that finances the costs of providing governmental services and public goods, highways, harbours and the like, namely, the benefit tax. The availability of public services and public goods usually influences the productivity, and hence the rate of return, of the invested capital. Hence, it is justified that a source country that provides non-residents with public goods and services tax the returns to investments generated in that country's territory.

International taxation relationships are governed by networks of bilateral agreements designed to avoid double taxation of the same income, based on the OECD model of "International Convention of Avoidance of Double Taxation." This convention affords the source country the right to tax on the income generated in its own territory.

If the country where the owner of the income resides imposes a tax on the income generated in the source county, according to the residence principle, the owner of the income is taxed twice on the same income. It becomes necessary to refund a tax doubly imposed. The Convention recommends two alternative methods to avoid double taxation: (a) Exclude the non-domestic source income from the taxable income in the country where the owner resides; (b) Refund the

amount of the tax paid to the source country from the total tax that the owner paid to his residence country under the residence principle.

Under the first alternative, if the residence government excludes non-domestic source incomes from the taxable income base, that country's system effectively becomes the source principle taxation. Under the second alternative, two possible consequences arise if tax rates are different between the source and the residence country.

First, when the tax rate of the residence country is higher than that of the source country, the tax revenue is divided between the two countries. Because the amount of the tax refunded is limited to the amount that the taxpayer paid to the source country, the tax paid to the resident country that exceeds the amount of the tax refunded is left in the treasury of the resident country.

Second, when the tax rate of the source country exceeds that of the residence country, the amount paid to the residence country is fully refunded to the taxpayer, and it becomes the source principle taxation. Only if the residence country were to refund the full amount of the tax that the taxpayer paid to the source country, would it become the residence principle taxation. But the residence country normally limits the amount of the refund to the amount that corresponds to the resident country's tax on the non-domestic source, and therefore the amount of the refund is normally short of the full amount that the taxpayer paid to the source country.

In the first case, there is strong incentive for the source country to raise its tax rate to the resident country's level. Because the amount of the tax the source country imposes is to be refunded fully by the investor's residence country, a raise in the source country's tax will not cause the source country to lose foreign investments. If this situation prevailed, the residence country would lose the entire tax revenues from the non-domestic source incomes. The residence country has no means to counter against the source country in this case, except for reducing own tax rate to zero or abandoning the residence principle taxation.

Consider the case of investment through a subsidiary set up in the source country. Under the residence principle taxation, the resident country should tax the parent company in the year when the subsidiary has made profits. However, this practice is impossible under the present international law because the law sees the subsidiary as an independent company.

With respect to interest income from foreign investments, all countries employ the residence principle. But it is practically difficult to impose a tax on interests earned in foreign countries. Presently, a widespread use of the source principle is recognizable with respect to the interest income by the means of the withholding tax system.

On the whole, the existing international agreements for avoidance of double taxation, the established international law governing subsidiaries and practical tax administrative constraints are all antagonistic to upholding the residence principle taxation. They are forcing all countries to take a lukewarm attitude towards enforcement of the residence principle taxation.

D. Competitive tax rates reduction

As the source principle taxation in fact replaces the residence principle taxation in practice, international competition for tax rate reduction becomes a more intense reality.

Under the source principle taxation, the net rate of return to investment is the rate after subtracting the tax of the source country that an investor has to pay to the source country. Naturally, in the competition for attracting foreign capital, a country with a high tax rate suffers relative to a low tax rate country. The same applies to the competition for other internationally movable factors of production such as for skilled labour. But the degrees of mobility of factors of production are different due to the difference in the costs of the relocations. Monetary capital reacts to a slight change in the rate of return. The development of the IT technologies has made it possible for monetary capital to shift investment locations internationally, quickly and cheaply. Labour is less mobile as compared with monetary capital. Particularly, unskilled labour is less mobile because the difference in return that can be realized through shifting employment or locations is lower as compared with skilled labour and consequently difficult to absorb the cost of movements.

Countries attempting to attract productive factors of production to their own territories compete for lower effective tax rate on incomes to be earned by these factors of production. An example demonstrates the impact of a tax rate change on the international flow of capital. The German government decided to impose a 10 per cent withholding tax on interest income in 1989. The amount of long-term capital moved out of Germany in the prospect of the reduced net return amounted to DM85 billion. As the result, the German government was forced to abandon the introduction of the withholding tax. It reintroduced a 30 per cent withholding tax on interest incomes of residents by the order of the Supreme Court on the ground of equity. However, non-residents are exempt from this 30 per cent withholding tax. Many member countries of the EU also exempt investment incomes of non-residents from their withholding taxes.

Unification of national markets has induced active international movements of factors of production. But the degree of international shifting differs between tax bases such as labour and capital. It is now becoming a common practice in tax reform that a country sets different tax rates according to the degrees of international mobility of the tax bases. Accordingly, weights of the tax burden are shifting to relatively immovable factors of production, such as unskilled labour, from the easily movable factors of production, such as monetary capital. Such a trend naturally widens income differentials between the poor and the rich in many countries and creates serious disharmony in their society.

E. The dual income tax

Scandinavian countries and Austria abandoned their respective comprehensive income tax systems, and introduced the so-called “dual income tax” systems in 1990s. Under the dual income tax, the entire income from all sources of an individual is divided. One part is the capital income (monetary income and income from real estate) and the other part the labour income. A

progressive tax schedule applies to the labour income and a fixed rate, equal to the lowest tax rate applicable to the labour income, applies to the capital income.

Because the dual income tax applies a lower tax on the capital income, which can avoid a tax easily by moving out the country, theoretically, the tax revenue would decline. For a country like Sweden, which had employed a strict comprehensive income tax with a steeply progressive tax rate schedule, it appears a really great turnover from the high welfare, based on high tax, oriented to the efficiency-oriented national policy.

However, the decision is probably simply to adjust the country to the changed reality of the world. It is based on a judgement that it is desirable to keep foreign capital at home by a low tax rate rather than losing it by a high rate. If it is not possible to tax effectively the capital income under the present international capital flow situation, it is more efficient to tax labour, which is not as easily mobile as capital.

F. Indirect tax competition

We have discussed the importance of international competition in the area of direct taxation. Let us now turn to the same importance in the area of indirect taxation.

With respect to the methods of imposing indirect taxes under international taxation context, two major ways exist. One method is to impose on goods and services the taxes of the country in which they are consumed. This is called the destination principle taxation. Another method is to impose on goods and services the taxes of the country where they are produced. This is called the origin principle taxation.

Under the destination principle taxation, when goods and services are exported, all taxes imposed by the exporting countries up to the stage of exportation are refunded at the point of the exports. The importing country, in turn, imposes taxes equal to the amount that that country's comparable domestic products would have paid up to the same stage where imported goods and services had reached. Therefore the indirect taxes of the exporting countries are thus separated from those of the importing country. Consequently, each country can set its own tax rate independently.

On the other hand, under the origin principle taxation, no tax adjustments take place at the point of exportation and importation. In each country's domestic market, the domestically produced goods and services bearing domestic taxes compete directly with the foreign produced goods and services bearing the foreign taxes. The high tax rate country's products and services are placed at a disadvantage as compared with those of the low tax rate country. Each country loses independence in tax rates setting. It cannot determine its own tax rate without paying due consideration to the competing countries' tax rates. Thus, in order to maintain independence in income redistribution and welfare policies, the destination principle taxation is preferred to the origin principle taxation.

However, the maintenance of rigid international border control for the purposes of tax adjustments runs counter to the international free trade movement. The European Union is aiming at eventual complete abolition of border controls on intra-Union trade and moving to the origin principle taxation. At this moment, the EU has abolished border tax adjustments on goods and services related to the consumers' cross-border shopping except for automobiles and yachts.

With respect to E-commerce, imposition of indirect tax is particularly difficult. This is particularly so in the case of transactions which involve electronic delivery of the ordered products.

Because of competition between imported and domestically produced goods and services, the rates of indirect taxes on goods and services of all countries tend to gravitate at the rate of that of the lowest rate country, and the countries maintaining high tax rates tend to lose revenues. It was reported that 67 percent of cigarettes consumed in Quebec Province of Canada before the Province reduced its tobacco tax in 1994 were those purchased illegally in the United States.

G. Conclusions

Under the increasingly intensifying international competition, it is becoming extremely difficult to tax internationally mobile factors of production such as capital and skilled labour. Consequently, the burden of tax on relatively immobile factors of production such as unskilled labour, farmers and pensioners is increasing. But many of those whose burdens of taxation are increasing are receivers of income transfers until a few years back. Income transfers that depend on income tax revenues become simply transfers between low-income people. The existing transfer systems do not contribute to the improvement of the general welfare.

But we must aware of the effects of liberalization of trade and free movement of capital and labour. They must improve the efficiency of the world production as a whole. Therefore, as long as the rate of increase in the world population does not overtake the rate of increase in the world production, per capita income of the world population must increase. Indeed, it is the major or only justification for promoting worldwide efficiency improving policies.

However, in reality, the income gap between the rich and the poor in the world seems to be widening rather than shrinking. It implies that the increments in the world income brought out by the intensified competition and consequential efficiency improvement is held in the hands of the high-income people.

But we come to a standstill. As shown in this paper, under the globally integrated world markets, it is extremely difficult for a small and open country to pursue independently its own income redistribution policy and welfare programme. However, closing the income gap between the rich and the poor is at least theoretically possible if all countries jointly pursue common welfare programmes or if a large country leads a worldwide income redistribution programme.

It was the new capitalism led by Keynes and others that averted the international communists' revolutions. When we observe anti-WTO movements led by NGOs and regional conflicts, we

feel as if we are walking on the same wheel track to complete destruction of the world peace. It appears that it is time to institute a worldwide income redistribution programme and put excessive capital movements in harness.

PUBLIC EXPENDITURES IN POLAND, 1990-2001: MAJOR TRENDS, CHALLENGES AND POLICY CONCERNS

by Ryszard Rapacki⁴

A. Introductory remarks

In most general terms, public expenditures can be seen as one of the key means used by the government in an endeavour to achieve its policy objectives. Before embarking on a more detailed discussion, it seems advisable to first outline a more general analytical framework or broader context of the behaviour of public expenditure. The level, dynamic and allocation of the latter are best understood if looked upon from the angle of the role and goals pursued by the government in a market economy.

According to one of the most influential views, prevailing in the 1960s and 1970s, the government was perceived as having three economic roles or functions (Musgrave and Peacock, 1958). The first was the *stabilization* function; its responsibility was to ensure that the economy remained at full employment with stable prices. The second function was *allocation*. Here the government intervened with a view to influence the allocation of resources in the economy. It could do it either directly (government procurement of goods and services) or indirectly, through taxes and subsidies. The third function was *distribution*; while focusing on a more equitable distribution of goods produced among the society's members, it entailed the equity-efficiency trade-off. In the real world, these three areas of government activities are intertwined and cannot be that easily categorized. Still, the foregoing typology provides a convenient analytical tool that enables a better understanding of government policies.

Another line of argument, aimed to highlight the role and objectives of the contemporary government, hinges on possible rationales of government involvement in a market economy. In the view of Joseph Stiglitz, the 2001 Nobel Prize laureate, there are three such rationales of a fundamental nature: (1) market failures, (2) redistribution, and (3) merit goods (Stiglitz, 2000).

A *market failure* is present when the economy (a market) is unable to achieve Pareto efficiency. The sources of market failure comprise the following (Stiglitz, 2000; Gwartney, Stroup and Sobel, 2000):⁵

- Imperfect competition;

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⁵ They are not mutually exclusive. For example, externalities are frequently thought to arise from missing markets, and public goods are sometimes viewed as an extreme case of externalities.

- Public goods;
- Externalities (negative and positive);
- Incomplete or missing markets, due, *inter alia*, to information asymmetry, which may give rise to adverse selection (e.g., insurance, loans and risk);
- Imperfect information;
- Unemployment, inflation and disequilibrium.

The common thread in all of these sources of market failure is that - in the absence of government intervention - they result in economic inefficiency. However, even if the economy were Pareto efficient, there are two other arguments for government intervention; both are put forward on the equity or/and normative economics grounds.

The first is *income redistribution* geared to achieve a more equitable allocation of goods and services produced among the members of a society in the pursuit of broader-than-economic goals (such as fairness). The second non-economic rationale for government intervention in a Pareto efficient economy arises from concern that individuals may not act in their own best interest (*merit goods* or *merit bads*).

Government intervention, however, is not necessarily the best solution to market failures. Government action may in turn be conducive to even greater inefficiencies, if compared to private markets. There are four main reasons for the systematic failures of the government to achieve its stated objectives (Stiglitz, 2000):

- *Limited information.* The consequences of any government actions are complicated and difficult to foresee.
- *Limited control over private market response.* The government can only partly control these consequences.
- *Limited control over bureaucracy.* Those who design legislation have only limited control over the implementation of government programmes. This is of particular importance in view of the weak incentives for operational efficiency embedded in government bureaucracies.
- *Limitations imposed by political process.* Due to the very nature of the latter (e.g. the 'rational ignorance' effect) politicians tend to be subject to a 'short-sightedness' syndrome and biased to further special interests rather than the public interest. As a result, their decisions need not yield efficient outcomes (Buchanan and Tullock, 1962; Buchanan, 1987).

In ascertaining the appropriate role of government, an understanding of the limitations of both government and markets is essential. The recognition of government failures implies that government ought to take actions only in those areas in which market failures are most significant and/or where government intervention can make a real difference (e.g., alleviation of poverty). In particular, the government should not intervene if the relevant welfare loss, due to market failure, is small and the costs of intervention may exceed gains.

The present paper aims to survey – against this background – the behavior of government (or public) expenditures in Poland, one of the top-reformer transition economies in East-Central Europe. The ensuing discussion has been organized as follows. Section two provides an overview of major trends in public expenditures during systemic transformation, i.e., the period of 1990-2000. It also highlights the process of reprioritization of government objectives in channelling budgetary funds. Section three gives account of the most salient effects of the changing pattern of public expenditure (and more broadly, of the fiscal stance of the government) and discusses main policy concerns involved. In the last section, the most significant challenges ahead are outlined, with special emphasis on the implications of the public finance crunch in Poland that emerged in mid-2001. It is also argued that two ‘external’ factors, i.e., the process of globalization and the forthcoming EU accession, will be gaining importance in the future in shaping public expenditure in Poland.

B. Major trends in public expenditures in Poland

One of the key dimensions of institutional reforms Poland embarked on in its road from plan to market was the replacement of its fiscal system, inherited from the centrally-planned economy, with one designed for a market economy. Prior to 1990, fiscal policies were dominated by excessive enterprise taxation on the one hand, and by lack of discipline in government spending on the other. Firms not only were supposed to pay profits tax of 45 per cent to 60 per cent but also a large part of the depreciation fund was to be surrendered to the central budget. At the same time, a substantial redistribution of income through the tax system was taking place in the form of tax relief and direct subsidies. These implied the transfer of funds from efficient entities (mostly medium and small-size manufacturers) to inefficient ones (large heavy industry enterprises). Subsidies constituted the most important single item in the government budget and their share grew from some 25 per cent in 1983-84 to 36 per cent in 1988 (Rosati, 1991). Another salient feature of the fiscal system was that government expenditures were not directly dependent on budget revenues – they could always be financed through non-interest bearing credit from the National Bank of Poland (printing money). This mechanism of money creation was conducive to very low financial (and monetary) discipline. As a result, Poland entered its road from plan to market burdened with deep macroeconomic imbalances. To give but one example, the budget deficit in 1989 amounted to 10 per cent of country’s GDP (Blazycyca and Rapacki, 1991).

The early years of systemic transformation in Poland saw a comprehensive fiscal reform and overhaul of the entire financial system. They were implemented under adverse macro-economic conditions: the Polish economy initially responded to the Balcerowicz ‘shock therapy’ with a transformation recession, i.e., the burst of corrective inflation, deep fall of real incomes and

output contraction by a cumulative 18 per cent.⁶ The fiscal reform comprised both the revenue and expenditure side; in the first place direct subsidies were dramatically cut or eliminated and the tax system inherited from the command economy radically overhauled. As a result, by 1998 the central government budget was financed by taxes that, for the most part, did not exist during the era of central planning (Kemmer and Rapacki, 2000).

Below we embark on a more detailed analysis of major trends in public expenditures in Poland in the 1990s. The data presented in Tables 1-4 allow a number of observations.

First, as the most general remark, it should be noted that – in sharp contrast to an orthodox liberal phraseology of the first ‘Solidarity’-backed governments (1989-1993) – *the 1990s did not witness an unequivocal trend towards downsizing the general government sector*. The share of total public expenditures⁷ in Poland’s GDP amounted in 1999 to 44.0 per cent, compared to 45.1 per cent in 1990, 50.5 per cent in 1994 and 43.1 per cent in 1998 (OECD, 1997 and Table 4). This ratio was above the average for OECD countries and below the mean for the EU (46.4 per cent in 2000) (Wernik, 2001). Simultaneously, the share of Government spending on goods and services in aggregate demand increased slightly between 1996 and 1999 – from 15.6 per cent to 17.0 per cent (Table 4). By the same token, its contribution to overall economic growth – seen from the demand-side perspective – rose accordingly.

The size of the government can be also indirectly measured by means of such yardsticks as the share of budget spending on public administration in total expenditure and the level of employment in public administration. As can be seen from Table 2, the former ratio grew from 2.9 per cent in 1991 to 4.4 per cent in 2000. Simultaneously, overall employment in public administration rose from 380,000 in 1997 to 480,000 in 2000 and 485,900 in the first quarter of 2001, i.e., by 28 per cent (Kieżun, 2001).

Second, *it was expenditure of the state budget (central government) that underwent actual downsizing*. This process was particularly pronounced in the second half of the 1990s – while the share of state budget expenditures⁸ in GDP remained fairly stable in 1990-95 (34.6 per cent in 1990, 29.9 per cent in 1991, 33.2 per cent in 1992 and 29.9 per cent in 1995 (Table 1 and OECD, 1997), this ratio fell to 25.2 per cent in 1998 and 22.0 per cent in 2000. This downward trend reflects, for the most part, decentralization of public finance after 1995. In particular, local governments have gradually taken over the responsibility for primary and secondary education, and – since 1999 – for health care (regional health care funds or *kasy chorych*, see Table 3). As a result, the share of local

⁶ According to most recent estimates, the actual contraction was shallower than implied by official statistics. If ‘shadow economy’ or unreported activities are accounted for the cumulative fall (1990-91) of Poland’s GDP would total some 11 per cent. For details, see RCESS (1999).

⁷ Excluding transfers between the central budget, local budgets, extra-budgetary funds and extra-budgetary units.

⁸ Including transfers between the central budget, local budgets, extra-budgetary funds and extra-budgetary units.

Table 1. Government expenditures by type, 1991-2000
(in million zloty, shares of total revenue and annual rates of growth)

Year	Total Expenditures		Subsidies for Economic Entities		Housing and Community Services		Social Security Contributions*		Current Expenditures of Budgetary Units		Domestic Debt Service		Foreign Debt Service		Subsidies for Local Government		Investment Expenditures	
	Value	% GDP	Value	Share	Value	Share	Value	Share	Value	Share	Value	Share	Value	Share	Value	Share	Value	Share
1991	24 185.8	29.9	934.6	3.9	729.8	3.0	3 639.4	15.0	14 134.7	58.4	..	..	...	..	681.0	2.8	1 562.4	6.5
1992	38 189.0	33.2	529.4	1.4	921.1	2.4	7 345.3	19.2	20 758.6	54.4	..	..	..	..	757.9	2.0	1 945.1	5.1
<i>Annual ROG</i>	57.9		(43.4)		26.2		101.8		46.9						11.3		24.5	
1993	50 242.8	32.2	702.5	1.4	596.4	1.2	10 420.7	20.7	26 911.7	53.6	4 749.9	9.5	1 211.1	2.4	1 104.2	2.2	2 418.0	4.8
<i>Annual ROG</i>	31.6		32.7		(35.3)		41.9		29.6						45.7		24.3	
1994	68 865.0	32.7	1 947.3	2.8	514.5	0.7	14 270.0	20.7	23 581.7	34.2	7 400.9	10.7	1 832.1	2.7	2 219.2	3.2	3 083.4	4.5
<i>Annual ROG</i>	37.1		177.2		(13.7)		36.9		(12.4)		55.8		51.3		101.0		27.5	
1995	91 169.7	29.6	2 583.1	2.8	484.1	0.5	15 280.8	16.8	31 134.8	34.2	11 097.1	12.2	3 262.6	3.6	2 939.2	3.2	4 018.6	4.4
<i>Annual ROG</i>	32.4		32.7		(5.9)		7.1		32.0		49.9		78.1		32.4		30.3	
1996	108 841.7	28.1	2 420.2	2.2	492.3	0.5	17 389.0	16.0	36 767.7	33.8	11 032.3	10.1	3 369.5	3.1	8 053.9	7.4	5 980.0	5.5
<i>Annual ROG</i>	19.4		(6.3)		1.7		13.8		18.1		(0.6)		3.3		174.0		48.8	
1997	125 674.9	26.6	2 669.9	2.1	510.6	0.4	21 037.5	16.7	41 608.0	33.1	12 610.3	10.0	3 683.3	2.9	9 543.5	7.6	7 649.3	6.1
<i>Annual ROG</i>	15.5		10.3		3.7		21.0		13.2		14.3		9.3		18.5		27.9	
1998	139 755.8	25.2	2 394.6	1.7	194.8	0.1	25 218.7	18.0	46 214.3	33.1	14 141.2	10.1	3 769.9	2.7	11 737.2	8.4	9 348.1	6.7
<i>Annual ROG</i>	11.2		(10.3)		(61.8)		18.6		11.1		12.1		2.4		21.9		22.2	
1999	138 401.2	22.5	2 573.0	1.9	8.1	0	29 436.4	21.3	25 809.5	18.6	14 893.8	10.8	3 884.0	2.8	22 123.3	16.0	7 388.6	5.3
<i>Annual ROG</i>	(0.9)		7.4		(96.4)		16.7		(44.2)		5.3		3.0		88.5		(21.0)	
2000	151 054.9	22.0	2 832.2	1.9	-	-	36 698.6	24.3	26 928.5	17.8	13 727.9	9.1	4 296.6	2.8	25 860.2	17.1	7 427.7	4.9
<i>Annual ROG</i>	9.1		10.1		-		24.8		4.3		(7.8)		10.6		16.9		0.5	

Notes: Data for 1994 and later for expenditures of budgetary units are not exactly comparable to earlier periods due to changes in classification of units. Expenditures are on an accrual basis.

* Social security contributions are for both unemployed and pension fund subsidies.

Source: *Rocznik Statystyczny*, GUS, various issues

government expenditure in GDP increased from 4.3 per cent in 1991 to 5.4 per cent in 1995 and 10.7 per cent in 1999 (OECD, 1997; Rocznik Statystyczny, 2000). Simultaneously, the share of funds transferred from the state budget to local governments (both general subsidies and appropriated allocations) in total expenditures of the former augmented from 5.0 per cent in 1991 to 24.3 per cent in 1999 and 25.9 per cent in 2000 (Mały Rocznik Statystyczny, 2001).

Third, Table 1 shows the *changing pattern of expenditures of the central government*. During the 1990s the two largest expenditures were current expenditures of budgetary units and social insurance contributions. Current expenditures of budgetary units reflect the operations of government agencies and consist predominantly of wages and salaries. While this was – until 1998 – the largest single expenditure, its share of total government expenditures has fallen from 58.4 per cent in 1991 to 33.1 per cent in 1998 and 17.8 per cent in 2000, an indication of the shrinking central government.

Table 1 also indicates that social security contributions grew dramatically in the early transition period. Social contributions exploded due to the very low retirement age,⁹ incentives for early retirement, branch and occupational privileges, liberal definitions of entitlements, liberal rules for granting disabilities and preferences for setting pension terms in agriculture (Kemmer and Rapacki, 2000). Then, during 1995-98, social security spending declined in relative terms, as a function of shrinking unemployment. Since 1999 this budgetary item has accelerated again. By 2000 social insurance contributions (including Farmers' Social Security Fund, KRUS) had reached 24.3 per cent of budget expenditures. Apart from the rising burden of unemployment benefits, the major underlying cause of the skyrocketing growth of social security expenditure should be seen in the generosity of the pension system in force. In Poland, pensions as a percentage of GDP amount to 15 per cent, the highest of all of the Central European countries¹⁰ and above the average for both OECD (10 per cent) and EU (12 per cent). One of the possible explanations of the high share of pensions in Poland's GDP are lax eligibility rules for disability and family pensions and the resulting excessive proportion of this category of beneficiaries in the total number of pensioners. For example, of the total number of 7,524,000 persons outside agriculture eligible for pensions in 1999 only 3,532,000 were receiving employee retirement pay (or old-age pensions), while the number of those entitled to disability and family pensions amounted to 3,992,000. It is also worth stressing that the replacement ratio was quite high for a transition economy as well: for all pensions it amounted in 1999 to 57.4 per cent and for old-age pensions alone – to 65.7 per cent. It displayed, however a downward trend, declining from 63.5 per cent and 73.6 per cent in 1995, respectively (Rocznik Statystyczny, 2000).

Subsidies from the central government budget were a major portion of government expenditures during the era of central planning and were channeled directly to enterprises, for particular

⁹ As stipulated by law it is 60 years for women and 65 for men. However, the effective retirement age amounts to 55 and 59, respectively.

¹⁰ In Slovenia pensions amount to nearly 13 per cent of GDP, but in the Czech Republic, Slovakia, Hungary and Romania this proportion is substantially less than 10 per cent of GDP (Kemmer and Rapacki, 2000).

industrial activities or for specific products (food, children's clothing). For example, in 1988 food subsidies accounted for 17.1 per cent of budget expenditures. By 1990 food subsidies were completely eliminated. As indicated in Table 1, total explicit subsidies to enterprises in 1991 represented 3.9 per cent of budget expenditures, and by 2000 their share had fallen to 1.9 per cent. The remaining large budget categories, debt service and investment, grew in absolute amounts, but their shares remained approximately the same.

Table 2. Government expenditures by sectors, 1991-99 (per cent)

Item	1991	1995	1998	1999	2000
Agriculture	1.5	1.6	1.7	1.7	..
Transport	2.2	1.4	2.2	1.9	..
Municipal economy	1.9	1.0	1.3	0.6	..
R&D	2.5	1.6	1.7	2.0	1.9
Education	11.6	11.3	5.0	2.1	1.3
Higher education	2.7	2.4	3.0	3.7	3.5
Culture and art	1.0	0.7	0.8	0.4	0.4
Health care	16.1	14.4	15.0	4.6	2.8
Social welfare	5.5	9.3	6.6	7.3	7.9
Public administration	2.9	3.4	4.2	4.3	4.4
Administration of justice	1.4	1.9	2.2	2.8	2.7
Public safety	3.5	3.7	4.0	4.7	4.7
Finance	8.4	18.5	15.3	15.2	13.6
Social security	15.0	16.8	18.0	21.3	24.3
National defence	7.5	5.6	6.0	6.8	6.6

Source: *Rocznik Statystyczny 2000*, GUS, Warsaw 2000; *Mały Rocznik Statystyczny 2001*, GUS, Warsaw 2001, and author's calculations.

In order to properly address the problem of subsidies, a distinction should be made between explicit and implicit budget subsidies. While explicit subsidies consistently tended to shrink the implicit subsidies increased. Implicit subsidies took the form of growing tax payment arrears of state-owned enterprises (SOEs) in declining or inefficient sectors such as coal mining, metallurgy, rail transport, as well as public institutions – e.g. schools, hospitals, etc. The scale of uncollected taxes and social security contributions (including pension system contributions) from these debtors tended to sharply rise. For example, in 1999 tax arrears increased by 41.9 per cent, to 7,502 million zloty by the end of the year. Simultaneously, cumulative payment arrears of the coal-mining sector alone (including uncollected direct and indirect taxes, and social security contributions) amounted to 20,489 million zloty, i.e. some 16.3 per cent of total budget revenues in 1999. These trends adversely affected the level of potential budget revenues and led to budget

expenditures in excess of target levels.¹¹ As a result, the fiscal stance of the government proved much less restrictive than intended.

Fourth, the changing pattern of public expenditures can be also analyzed from the angle of government functions or objectives outlined earlier in the text, i.e. stabilization, allocation and redistribution.

The stabilization function of the government has been performed mostly via macroeconomic policy, i.e. the mix of fiscal and monetary policies. Nevertheless, some features of public expenditures alone may have contributed to dampen the adverse effects of external and domestic shocks on the macroeconomy and to diminish the volatility of aggregate demand in the 1990s. First, government expenditure – as the most autonomous component of aggregate demand – tended to display certain rigidity even in the most turbulent times. For instance, in 1991, when industrial output contracted by 17.1 per cent and GDP shrank by 7.0 per cent, state budget expenditure rose by 10.2 per cent (Blazyca and Rapacki, 2001) thus providing a cushion against an even deeper transformation recession. Second, government spending has had some automatic stabilizers built in, one example being unemployment benefits. As unemployment started to rise fast after 1998 (from 10.4 per cent to 15.0 per cent in 2000 and 16.5 per cent in 2001), so did budget disbursements for the jobless. This, again, may be seen as a factor providing for a stabilization of consumer demand and thus aggregate demand.¹²

As can be seen from Tables 2 and 3, public expenditures have also served as a device for *resource allocation*. This was done, on the one hand, through the public provision of public goods, such as national defence or public safety, or merit goods, such as primary and secondary education, which was predominantly funded from the state budget or local governments. On the other hand, via explicit budget subsidies or public procurement of goods and services on private markets, the government provided incentives affecting the behaviour of private suppliers and influenced the level and composition of output in the economy. This category of public expenditure represented 21.0 per cent¹³ of GDP and 47.7 per cent of the total public spending in 1999 and remained pretty stable in the second half of the 1990s.

¹¹ For example, as a result of arrears in social security contributions in 1999, the government had to increase the budget subsidy to ZUS (Social Insurance Institution) by some 6 billion zloty above the planned level. Moreover, to fully cover its deficit, ZUS also had to resort to commercial borrowing (2.8 billion zloty), which is also a part of the broad government sector deficit or public sector borrowing requirements (PSBR). The growing burden of the social safety net on the state budget was among the major underlying reasons for the reform of the old-age pension system implemented in 1999.

¹² The significance of this factor, however, is smaller than the data on incremental unemployment rate would suggest. This is due to the fact that over 60 per cent of registered unemployed in Poland nowadays are not eligible for transfer payments, as they have remained jobless for more than one year.

¹³ This ratio is the sum of three expenditure items: (i) spending on goods and services (17.0 per cent), (ii) capital expenditure (3.2), and (iii) subsidies to economic entities (0.8 per cent). The latter figure was derived indirectly from Tables 1 and 4, the former are explicitly shown in Table 4.

Table 3. Consolidated public expenditures, 1995-99, by sectors (per cent)

Item	1995			1998			1999		
	A	B	C	A	B	C	A	B	C
General public services	5.3	66.4	33.6	5.5	61.7	38.3	5.5	56.0	44.0
National defence	3.9	100.0	-	3.5	100.0	-	3.3	100.0	-
Public safety	3.8	97.2	2.8	4.1	96.2	3.8	4.3	67.4	32.8
Education	11.5	65.5	34.5	13.1	42.8	57.2	13.1	28.8	71.2
Health care	10.1	89.8	10.2	10.0	88.1	11.9	9.7	9.8	90.2
Social security and welfare	46.1	96.1	3.9	45.8	95.4	4.6	44.3	93.3	6.7
Housing and community services	8.5	25.7	74.3	8.2	17.9	82.1	7.1	11.5	88.5
Total expenditure	100.0	x	x	100.0	x	x	100.0	x	x

A – total, B – central government (per cent share in total expenditure for respective items),

C – local governments (per cent share in total expenditure for respective items).

Source: As in table 2.

An equally important proportion – in quantitative terms – of public expenditure (and GDP) in Poland was allocated to meet the *redistribution* objective of the government. In the second half of the last decade, some 20 per cent of GDP or 45 per cent to 50 per cent of total governments spending was disbursed for transfer payments (Tables 3 and 4). The overwhelming majority of transfers were channeled towards the social safety net, i.e. social security and welfare programmes. In 1999, they made up 44.3 per cent of the consolidated public expenditure, compared to 46.1 per cent in 1996. Bearing in mind the fact that in the early 1990s the weight of the state budget in Poland's public finance had been much greater than today and that a full-fledged decentralization of public expenditures began in 1998, it may be argued that the scale of redistribution significantly increased in Poland throughout the 1990s, both with regard to GDP and central government expenditure. While in 1991 transfer payments represented 20.5 per cent of the latter, in 1995 this proportion augmented to 26.1 per cent and in 2000 to 32.2 per cent (Table 2). Simultaneously, the share of transfer payments from the central budget in GDP amounted in 1991 to 6.1 per cent and in 1995 it grew to 7.7 per cent (own calculations based on Tables 1 and 2, and OECD, 1997).

The actual scale of income redistribution in Poland (other than through the tax system) tended to be larger than suggested by data on transfer payments. One of the underlying reasons for that was embedded in the provision of both public goods and merit goods, such as education and health care. As the share of certain social groups or regions in the consumption of such goods exceeded their tax contribution to finance those activities (e.g. children of poorer families and poor regions in case of education, and the elderly in case of health care) this entailed the transfer of wealth from the well-off to the poorer and from the young to the old generation, respectively.

Table 4. Composition of consolidated public expenditure, 1996-99 by type (billion zloty and per cent of GDP)

Item	1996		1997		1998		1999	
	Value	Share	Value	Share	Value	Share	Value	Share
Public revenues	163.8	42.2	197.4	41.8	225.2	40.7	251.7	40.9
Public expenditures	175.8	45.3	210.7	44.6	238.8	43.1	271.0	44.0
Current expenditure	161.0	41.5	192.4	40.7	216.3	39.1	249.2	40.5
Goods and services	60.6	15.6	71.9	15.2	82.3	14.9	104.3	17.0
Transfers and subsidies	86.1	22.2	104.4	22.1	115.9	20.9	125.9	20.4
Interest on public debt	14.3	3.7	16.2	3.4	18.0	3.3	19.0	3.1
Capital expenditure	11.9	3.1	16.7	3.5	20.4	3.7	19.4	3.2
Balance	- 12.1	-3.1	-13.3	-2.8	-13.6	-2.5	-19.2	-3.1

Source: Ministry of Finance; OECD (2001), p. 219.

Fifth, in the second half of the 1990s, some new unfavorable trends unfolded that increased the rigidity of public expenditure and restricted the scope of control of the central government over fiscal policy, while simultaneously adversely affecting the transparency of all public finance and accountability of fiscal authorities. As a consequence of institutional arrangements embedded in the central budget and aimed to ensure fulfillment of the redistribution priority (e.g. indexation mechanisms built in the transfer payments) the share of rigid items in total state budget expenditures has steadily grown to reach 63.2per cent in 2001, compared to 57.7per cent in 1999 (Ministry of Finance). This tendency left little room for manoeuvre in allocating public funds for 'pro-growth' purposes. Secondly, the late 1990s witnessed a sharp increase in the number of various extra-budgetary entities and in the associated volume of off-budget financial flows. This included, in particular, 'inflation' of different government agencies, auxiliary units of budgetary entities and their special funds. Such a policy facilitated, on the one hand, concealing the actual fiscal stance of the government (e.g. via moving some state budget expenditures to extra-budgetary funds), but on the other, it was conducive to declining transparency of fiscal policy and its lower effectiveness.

C. Most salient effects and policy concerns

While assessing the effects of public expenditure in Poland and the resulting policy concerns, we will occasionally refer back to the theoretical framework outlined in the first section. The following issues seem worth highlighting from this perspective.

- As the foregoing discussion demonstrated, the 1990s witnessed – in the broadest terms – a clear reprioritization of public expenditure towards redistributive objectives. Although this trend was less unambiguous in the second half of the last decade, the share of spending on social safety net (and in particular on pensions) seems to be excessive and ranks among the highest in all Central European countries. The gains from this pattern of reprioritization accrued predominantly to the beneficiaries of the pension system, and in particular those receiving disability pensions. Another

category of gainers encompasses a substantial part of coal-mining employees laid off within the restructuring programme of this sector being implemented since 1998, who received generous compensation from the budget. The costs that had to be borne by the Polish society at large boil down to constrained supply of most of the public (and merit) goods and their declining quality, as well as to the creation of perverse incentives which discourage a self-sustained, long-run economic growth. These problems are discussed in more detail later in the text.

- Based on available statistics, it may be claimed, however, that the ‘redistributive bias’ in Poland’s public expenditure policy may have produced one more general positive effect. Namely, the growing share of public funds devoted to strengthening the social safety net may be seen as an important explanatory variable for the relatively slow pace of growth of the ‘poverty zone’ and income disparities in Poland, compared to other transition economies. It should not be overlooked that Poland entered its road from plan to market as a country with one of the most inequitable patterns of income distribution in East-Central Europe. In 1988 the Gini coefficient amounted to 26, whereas in the Czech Republic and Slovakia it was 19, in Hungary 21, in Estonia 23 and in Russia 24. At the same time the percentage of population living below the poverty line totaled 6 in Poland, 1 in Estonia and Hungary, and 2 in Russia. By 1995 the Gini coefficient rose in Poland to 28; in Slovakia it remained unchanged, in the Czech Republic it stood at the level of 27, in Hungary 23, in Estonia 35 and in Russia 48. In the same year, the proportion of the population living in poverty increased in Poland to 10 per cent, while in Hungary to 7 per cent, in Estonia to 34 per cent and in Russia to 39 per cent (Milanovic, 1998).
- In designing and implementing the public expenditure policy (and more broadly – fiscal policy) Polish policy-makers had to face two important dilemmas: the equity-efficiency trade off and the choice between short and long-term objectives. If we assume that public goods are the extreme case of externalities (see footnote 1), then the provision of the former (in adequate quantity and quality) may be regarded as a means to enhance positive external effects for the private sector and, by the same token, as an efficiency driver. Seen from this perspective, the equity or redistribution ‘bias’, documented earlier in the text, tended to adversely affect both the available aggregate supply and quality of public and merit goods in Poland. This general conclusion is not inconsistent with diverging trends that can be traced in public expenditures with regard to particular categories of those goods. For example, as both Table 2 and Table 3 demonstrate, the 1990s saw a decline in relative spending on national defence and on research and development. At the same time, the proportion of public money allocated to such areas as public safety, education, health care, justice and public administration increased. However, the growth in financing the provision of public goods does not automatically safeguard their greater availability and adequate quality (the problem of weak incentives for operational efficiency in the public sector). Indeed, according to anecdotal evidence, the late 1990s saw deterioration in the availability and quality of a number of public goods. These

comprised declining yardsticks measuring the level of public safety, poor standard of health care services¹⁴, rising ineffectiveness of the judiciary power, low enforcement of the law and incompatibility of educational curricula at primary and secondary levels with the needs of a market economy (Blazyca and Rapacki, 2001).

- It is fair to say that successive Polish governments, while deciding on the priorities in public expenditures and faced with the trade off between short and long-term goals, tended to be biased towards the former. In particular, they appear to have neglected the importance of policies aimed at actively creating or enhancing positive externalities for the private sector, as key preconditions for long-term, sustainable (steady-state) economic growth. As an example, it suffices to mention unsatisfactory government support for the domestic R&D effort and low investment in physical infrastructure (especially roads). Although the government funding of R&D has steadily increased in the 1990s, in nominal terms, its share in both state budget expenditures (Table 2) and in Poland's GDP has consistently fallen. Its ratio to GDP reached in 1999 its lowest level after the war (0.4 per cent).¹⁵ If the private sector R&D outlays were included, this ratio would increase to 0.7 per cent, which is still well below the OECD (2.15 per cent) and EU averages (1.85 per cent) and also lower than the respective indices in the Czech Republic or Hungary (Blazyca and Rapacki, 2001). As a result, the 1990s brought a marked deterioration of key indicators illustrating the innovative capability of the Polish economy. They include data on inventive and patent activities, trade of licences and the share of new and improved products in industrial output (Blazyca and Rapacki, 2001). The government failure in encouraging the indigenous R&D effort, developing a domestic science and technology base and in generating new knowledge and technological innovations may impede the further growth of productive and allocative efficiency and, by the same token, adversely affect the competitive position of Polish firms in the global environment.
- The unequivocal assessment of public expenditures as a vehicle for enhancing the development of human capital in Poland is difficult. On the one hand, the share of government funding of higher education in state budget expenditures tended to grow in the 1990s (exception being year 2000 – see Table 2). On the other hand, the upward trend in government financing did not match an even faster increase in demand for college and university education – between 1990 and 2000 the number of students enrolled almost quadrupled. Some 50 per cent of this increase was absorbed by mushrooming private colleges and graduate schools. However, this quantitative

¹⁴ The health care system reform implemented in 1999, due to serious shortcomings in its very design, has not solved this problem.

¹⁵ A similar trend was recorded in Polish industry: the share of R&D expenditure in the value of output decreased from 0.43 per cent in 1991 to 0.42 per cent in 1999 (Rot, 2001).

expansion has not always come in par with appropriate content of curricula and quality of delivery. Simultaneously, the ambiguity of government policy about the status of higher education (merit good or private investment) and the perverse system of incentives prevailing in public universities adversely affected both instruction and research. Nonetheless, all in all, the new developments in the field of higher education have no doubt contributed to a considerable increase of the stock of human capital in Poland. Similarly, the rising inflow of public funds to the health care sphere has not helped much in solving its structural problems. It remained mostly inefficient and ‘patient-unfriendly’ even after the reform of 1999. On the other hand, most indicators of the health status of Polish population did improve during the 1990s, which apparently reflects positive changes in human capital as well.

- Public expenditure can also give rise to some important macroeconomic effects indirectly – through the balance of the state budget (and more broadly, the general government sector or PSBR). Polish fiscal authorities have run deficits in every year of the last decade, the exception being only 1990. These have not been excessively expansionary, however, as both the state budget deficit and that of the general government sector as a percentage of GDP have been falling. Moreover, until 1999 both measures of fiscal imbalance were kept below the ‘Maastricht ceiling’ (3 per cent GDP). This trend was reverted in 1999. Although the central budget deficit alone was still under control (2.3 per cent) the overall deficit of the government sector augmented to 3.2 per cent and in 2000 it grew further to 3.8 per cent of GDP (Rocznik Statystyczny, 2000; OECD, 2001). The major shock came from extra-budgetary funds – their expenditures in 1999-2000 increased much faster than revenues and the resulting deficit rose to 1 per cent of GDP. The single most important source of these developments was the endangered liquidity of the Social Insurance Fund (FUS) – its surplus from earlier years turned to deficit amounting to 0.8 per cent of Poland’s GDP. The fiscal stance of the government dramatically deteriorated in 2001. The unanticipated loosening of fiscal policy led to two unfavorable macroeconomic effects. First, it diminished the stock of domestic savings available for investment. One of the peculiarities of Poland’s economic growth path in the 1990s, compared to other Central European countries, was the combination of fastest GDP growth and the lowest savings rate (some 20 per cent of GDP in average) (Rapacki, 2001). Depressed domestic savings should be seen as a potential supply-side barrier to long-run economic growth. Second, growing fiscal deficit was eventually conducive to crowding out of private investment. Statistics seem to support this assertion. In 1999 the growth rate of gross fixed investment halved, compared to 1998 (6.9 per cent and 14.1 per cent, respectively). In 2000 it grew only by 3.1 per cent and in 2001 is expected to fall in absolute terms.
- A more expansionary fiscal policy has also put in motion a chain reaction in terms of adjustments in monetary policy that in turn gave birth to induced macroeconomic effects. Since 1999 the monetary policy has undergone a sharp tightening; as a result, real interest rates have been running at double-digit levels (14 per cent-15 per cent for business loans and 10 per cent for bank deposits). Although excessively restrictive

monetary policy was very effective in disinflating the Polish economy (CPI is expected to be 4.5 per cent in 2001, down from 8.5 per cent in 2000), it is simultaneously to be blamed (at least partly) for a dramatic slow down of economic growth in Poland (from 4.0 per cent in 2000 to a likely 1.5 per cent in 2001). Seen from a long-run economic growth perspective, the combination of the expansionary fiscal and restrictive monetary policies is the worst policy mix possible. If continued, it would entail: (1) fall in the average efficiency of resource allocation, (2) discouragement of private investment and (3) slower growth of potential output (Rapacki, 2001).

As a concluding remark, in this section we will attempt to briefly hypothesize on possible determinants of the major trends and effects of public expenditure, outlined earlier, applying the public choice framework. First, it should be noted that two previous Polish governments (1993-97 and 1997-2001) – due, *inter alia*, to their coalition nature – were particularly susceptible to the pressure of special interests. This holds true especially in the case of trade unions whose political influence by much exceeded their real significance at factory level (a sort of a ‘trade unionist capture’). One of the most detrimental effects of their political power, the outbreak of unemployment in end-1990s, stemmed in large part from their resistance to reforming the labour code with a view to make the labour market more flexible. Similar pressures were coming from other powerful special interest groups – regional, sectoral, professional, etc. Second, the past ruling coalitions appear to have embarked on a policy aimed at maximizing the volume of ‘political goods’ and at redistribution of the ‘economic pie’ rather than increasing the size of the latter. This gave birth to political favouritism and the development of ‘crony capitalism’ – Polish politicians tended to trade off efficiency goals for political perks. The widespread rent-seeking, as a symptom of government failure, was the obvious outcome. Third, the above developments entailed strengthening of the ‘short-sightedness’ effect. This would explain the strong bias of public expenditures towards short-term goals and negligence of positive externalities that might enhance the long-run growth potential of the Polish economy and its international competitiveness in the global marketplace.

D. Challenges ahead

As Poland’s accession to the European Union proceeds, the role of monetary (and exchange rate) policy will diminish and the role of fiscal policy by necessity will increase. This, combined with global developments and several vulnerabilities of the Polish economy, creates serious challenges for fiscal policy in general and public expenditure in particular. The following major challenges deserve highlighting here.

The first is connected with unanticipated liquidity problems that emerged in the state budget in mid-2001 and endangered stability of the entire general government sector. They were a derivative of three factors: (i) economic slow down, (ii) cumulative effects of past government failures in fiscal policy and (iii) imprudent decisions to excessively increase public expenditures taken by the outgoing parliament during 2001. As a result, the state budget deficit in 2001 is likely to overshoot the target figure by some two-percentage points (4.7 per cent of GDP compared to 2.7 per cent). Moreover, if no countervailing action were undertaken, the pertinent

deficit would rise in 2002 to 11 per cent of GDP. The new government, in office since mid-October, has pledged to keep the deficit within the 5 per cent-5.5 per cent band. It will have, however, to resort to unpopular measures, including spending cuts and higher or new taxes. Some of these measures (e.g. new tax on deposit interests and capital gains), may prove detrimental to domestic savings and future growth prospects.

The second challenge is closely related to the first one. Ad hoc measures proposed by the new ruling coalition are insufficient to solve structural problems and restore sustainable, long-run fiscal stability. What is really needed is an in-depth, comprehensive reform and overhaul of Poland's public finance system aimed to make it simpler, more transparent, effective and 'development-friendly'. A key precondition of such a reform is the redefinition of the new role and functions of the government in a maturing market economy.¹⁶ As far as fiscal reform is concerned, the following changes seem the most desirable:

- Consolidation of extra-budgetary agencies, special funds and entities into the state budget or local governments' budgets, which would allow a stronger control of fiscal authorities over public expenditures.
- Simplification of the tax code and the subsequent reduction of tax rates (stronger supply-side incentives for private entrepreneurship).
- Fine-tuning of the social safety net (means-tested approach) to reduce the burden of transfer payments on public expenditures.
- Reprioritization of public expenditure towards provision of public goods at the cost of redistributive objectives.
- While ranking public (merit) goods, top priority should be given to those expenditure items that create or enhance positive externalities for private markets, such as spending on R&D, human capital, new opportunities increasing access to information-communication technology, and investment in physical infrastructure.¹⁷

Third, delayed restructuring and privatization in a number of key sectors of the Polish economy and the political power of the labour force in those sectors (e.g., mining, railways, metallurgy, power generation and agriculture) may lead to excessive fiscal expenditures to appease these social groups. Bearing in mind the electoral programme of the present government coalition and the expectations of their constituency, one may wonder what is the political feasibility of a comprehensive fiscal reform outlined above. Additional political pressures may arise from skyrocketing unemployment and growing income and regional disparities.

¹⁶ More details can be found in (Rapacki, 2001a).

¹⁷ A potentially promising device for fostering infrastructure investment is the Public-Private Partnership (PPP).

Fourth, a special challenge of strategic significance stems from Poland's accession to the European Union. EU assistance funds to promote integration must be effectively absorbed, minimizing the potential of a real appreciation of the zloty and reduction in international competitiveness (the Dutch 'disease'). In this regard, Spain and Portugal may serve as examples of effective utilization of EU assistance funds to meet development goals, as opposed to Greece, where problems have been more prevalent.¹⁸

Finally, Poland, as a small open economy, will be increasingly exposed to global interdependencies and external shocks. The real challenge here boils down to the question: how to best appropriate potential benefits of globalization while minimizing the costs to be borne? In the case of public expenditures, Poland's growing global exposure may bring about both gains and losses. The former may consist in 'institutional convergence', that is, in sticking to global trends in public governance, which entail downsizing the government in general and contracting out some of its traditional functions to private agents. Simultaneously, this may call for a new ranking of public goods or government functions. The demand is likely to increase for those government actions in particular that are to alleviate such market failures as information imperfections, incomplete or missing markets and global pollution. The gains may also materialize in an improved access to the newest information technology, financial management techniques, proven fiscal procedures and best international practices that enhance effectiveness and transparency of public finance. On the other hand, globalization is likely to result in higher volatility of economic conditions (due, for instance, to rising divergence between the 'real' economy and financial markets) and more uncertainty in designing and executing fiscal plans. Simultaneously, it may entail swapping the domestic rigidity in public expenditure for external constraints. These may stem, for example, from EU-imposed norms and standards that would call for increased spending or excessive government regulation. Another possible source of rigidity may originate from Poland's new commitments as a NATO member after 11 September (e.g. higher spending on national defence or concerted anti-terrorist actions). As a concluding remark, it is worth noting that Poland's growing global exposure may be also seen as a factor that in some respects constrains the autonomy of national fiscal authorities and adds a new dimension to the problem of their accountability.

¹⁸ For an interesting discussion of the relevance of those countries' experience for Poland, see Orlowski (1996).

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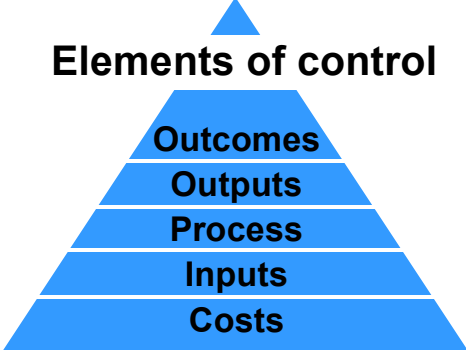

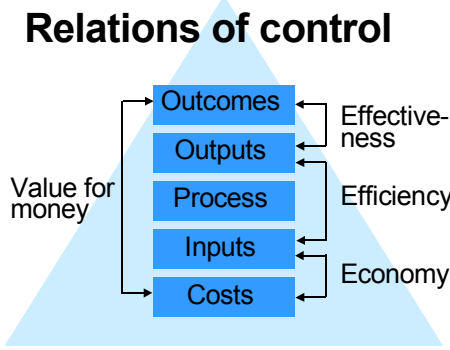
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Part II:

Measures to Increase Efficiency and Effectiveness

PERFORMANCE-ORIENTED BUDGETING AND MANAGEMENT

by Alex Matheson¹⁹

<p>OECD  OCDE</p> <p>Measures to increase efficiency and effectiveness</p> <p>28-30 November, 2001, Rome</p> <p>Alex Matheson, OECD, Public Management Service, OECD</p> <p>1</p>	<p>OECD  OCDE</p> <p>1. The Framework</p> <p>2</p>
<p>OECD  OCDE</p> <p>Elements of control</p>  <p>Outcomes Outputs Process Inputs Costs</p>	<p>OECD  OCDE</p> <p>Relations of control</p>  <p>Outcomes Outputs Process Inputs Costs</p> <p>Value for money</p> <p>Effectiveness Efficiency Economy</p> <p>4</p>

¹⁹ Organisation for Economic Co-operation and Development

Slide 3

- Inputs are a measure of what an organization or manager has available to achieve an output or outcome. Inputs can include employees, equipment or facilities, supplies on hands, goods or services received.
- Outputs are defined as the goods or services (usually the latter) which government agencies provide for citizens, business and other government agencies. An example from a Ministry of Finance could be a monthly delivery of reports of government financial performance and the annual financial statements.
- Output targets are defined as explicitly stated expectations in regard to the level of outputs. An example from a Ministry of Finance could be that 90 per cent of economic reports are delivered within the time frames agreed and are rated excellent or above average by prime stakeholders.
- Outcomes are defined as the impacts on, or the consequences for, the community from the outputs or activities of the government. Outcomes reflect the intended and unintended results from government actions and provide the rationale for government interventions. An example for a Ministry of Finance could be that government finances are sustainable.
- Outcome targets are defined as the effect government intends its outcomes to have on society. In this definition government intentions are conceived as the explicitly and publicly stated purposes of government activities. An example could be that road deaths should be reduced by 20 per cent within the following five years. One of the outputs contributing to this outcome could be an advertising campaign.

Slide 4

Corresponding to these elements of control are four relations. The point is that many management and budgeting regimes can be described in relations to where the emphasis is in this model and consequently which relations of control they facilitate:

- Costs
- Input focus
- Processes
- Output Focus
- Outcome focus




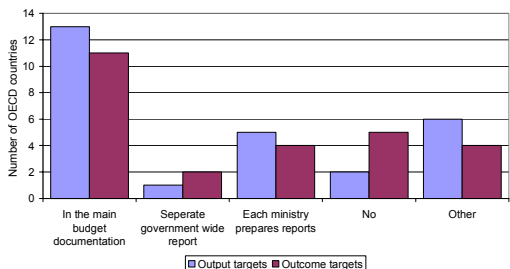



Typically many systems are commulative - meaning that elements of former regimes persist under new regimes - leading to frustration among managers at different levels







Strengths and weaknesses of control regimes

	Strengths	Weaknesses	Good for situations with...
Input	<ul style="list-style-type: none"> • Easy and affordable • Strengthens compliance • Facilitates control of aggregate expenditure 	<ul style="list-style-type: none"> • Does not support efficiency • Can be inflexible • Short-term 	...low confidence and variable competence
Output	<ul style="list-style-type: none"> • Facilitates efficiency • Accountability 	<ul style="list-style-type: none"> • Can distort focus • Measurement problems • Costs • Information overload 	...confidence, sound accounting and professionalism
Outcome	<ul style="list-style-type: none"> • Facilitates re-allocation • Supports policy formulation and co-ordination • Long-term 	<ul style="list-style-type: none"> • Measurement problems • Accountability problems • Costs • Information overload 	... the above and dedicated politicians

One of the main points of this slide is the cost side. It is costly to reform and to run more advanced systems - not always budgeted, risk managed and cost-benefit analysed.

2. Outcome-Focussed Management and Budgeting

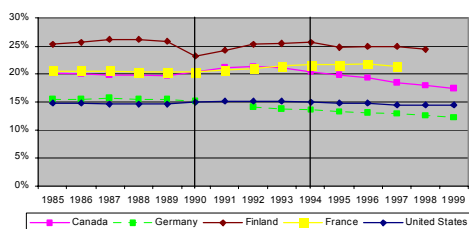
<div>OECD  OCDE</div> <div><div>An outcome focus to budgeting and management - Main motives</div><div><ul style="list-style-type: none">• Orientation of public sector production• Public awareness• Reallocation• Coherence</div></div> <div>7</div>	<div>OECD  OCDE</div> <div><div>An outcome focus to budgeting and management - Main implications</div><div><ul style="list-style-type: none">• Linking costs, inputs, outputs and outcomes• Increasing the use of policy evaluation• Restructuring budget processes</div></div> <div>8</div>																		
<div>OECD  OCDE</div> <div><div>International trends...</div><div>Are targets routinely displayed in the budget documentation</div><div><table><caption>Data for International trends... Are targets routinely displayed in the budget documentation</caption><thead><tr><th>Category</th><th>Output targets</th><th>Outcome targets</th></tr></thead><tbody><tr><td>In the main budget documentation</td><td>13</td><td>11</td></tr><tr><td>Separate government wide report</td><td>1</td><td>2</td></tr><tr><td>Each ministry prepares reports</td><td>5</td><td>4</td></tr><tr><td>No</td><td>2</td><td>5</td></tr><tr><td>Other</td><td>6</td><td>4</td></tr></tbody></table></div><div>9</div></div>	Category	Output targets	Outcome targets	In the main budget documentation	13	11	Separate government wide report	1	2	Each ministry prepares reports	5	4	No	2	5	Other	6	4	<div>OECD  OCDE</div> <div><div>Challenges</div><div><ul style="list-style-type: none">• Expectations• Resistance• Measurement• Information - a double edged sword• Costing• Coordination/coherence• Information overload• Incentives• Being of use to politicians• Limits on capacity</div></div> <div>10</div>
Category	Output targets	Outcome targets																	
In the main budget documentation	13	11																	
Separate government wide report	1	2																	
Each ministry prepares reports	5	4																	
No	2	5																	
Other	6	4																	
<div>OECD  OCDE</div> <div><div>3. Accrual Accounting</div><div>11</div></div>	<div>OECD  OCDE</div> <div><div>Accrual Accounting - Main Motives</div><div><ul style="list-style-type: none">• Part of larger modernization project• Move to results/output/outcome budgeting• Improved reporting of operating costs to managers, parliamentarians and the public• Better decision-making• Improved accountability for assets• Improved long-term planning</div></div>																		

<p style="text-align: center;">OECD  OCDE</p> <p>Accrual Accounting - Main Implications</p> <p>Cash</p> <ul style="list-style-type: none"> • Managers constrained by “input” of cash <p>Accruals</p> <ul style="list-style-type: none"> • Managers must maintain “assets” • Managers focus on liabilities -- know what the obligation is prior to the cash transaction • Long-term sustainability 	<p style="text-align: center;">OECD  OCDE</p> <p>International trends...</p> <p>Numbers...</p> <p style="text-align: right;">14</p>
<p style="text-align: center;">OECD  OCDE</p> <p>Challenges</p> <ul style="list-style-type: none"> • Operating balance fluctuations • Difficult for managers to deal with factors outside their control • Difficult for parliaments to understand and communicate to public • “Cooking the books” is an accrual term • Cash-based budgeting is cheap, reliable and straightforward • Power to tax not recognised in accrual • More difficult to use with fiscal policy 	<p style="text-align: center;">OECD  OCDE</p> <p>4. Enhanced Human Resource Management</p> <p style="text-align: right;">16</p>
<p style="text-align: center;">OECD  OCDE</p> <p>Enhanced Human Resource Management - Main motives</p> <ul style="list-style-type: none"> • Lack of confidence on the civil service • Economic recession • New Public Management (NPM) • Increased expectation from people <p>➤ Pressure to change “People Management”</p> <p style="text-align: right;">17</p>	<p style="text-align: center;">OECD  OCDE</p> <p>Enhanced Human Resource Management - Main implications</p> <ul style="list-style-type: none"> • Reducing the gap between public & private HRM • Providing greater flexibility and freedom • Securing accountability and performance • Maintaining a good employer model <p>➤ Enhanced efficiency and effectiveness</p> <p style="text-align: right;">18</p>

International trends...

1) Most governments reduced the size of public workforce ...

Share of Public Employment to Total Employment (1985 to 1999)



20

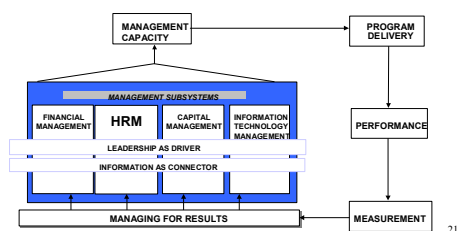
International trends...

2) Many governments linked "pay" with "performance" ...

- Performance - pay link
 - a salient feature in many countries (DK, UK, FI, AU)
 - for higher level officials than lower level officials
- Various types of PRP scheme - performance pay, productivity bonus, diligence bonus
- Many PRP schemes are not functioning effectively (OECD's previous survey)

International trends...

3) More emphasis was given to HRM and performance...

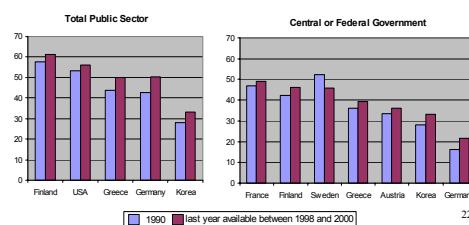


21

International trends...

4) Governments tried to maintain good employer model ...

Share of Female Employment in Public Sector (%)



22

Challenges

- Knowledge-intensive society
 - Need to effectively manage information and knowledge
 - How to manage knowledge?
- Lessened common *esprit de corps* of the civil service
 - Need to improve integrity of the public service
 - How to develop public sector leadership?
- Worsened image of the public sector
 - Problems of recruitment and retention
 - How to make government a competitive employer?
- Need to foster diversity in the civil service

5. Implementation

24

<p>OECD « OCDE</p> <p>Implementing public service controls</p> <p>25</p>	<p>OECD « OCDE</p> <p>Why governments can't do all the things all the time...</p> <ul style="list-style-type: none"> • Time • Limits on the amount of information that can be incorporated into decision-making • Only possible to pay attention to a few things at a time • Some incentives have much more influence on how officials direct their attention than others (e.g. the urgent driving out the important) <p>26</p>
<p>OECD « OCDE</p> <p>More information</p> <ul style="list-style-type: none"> • www.oecd.org/puma • www.oecd.org/puma/budget/ • www.oecd.org/puma/hrm/ <p>27</p>	<p>OECD « OCDE</p> <p>Measures to increase efficiency and effectiveness</p> <ul style="list-style-type: none"> • Managing money • Managing organisations • Managing people • Managing countries <p>Integrating management and budgeting to form a whole of government perspective</p> <p>28</p>

PERFORMANCE BUDGETING: MANAGING THE REFORM PROCESS

by Jack Diamond²⁰

A. Introduction

The fundamental changes in budget management that have been introduced in the OECD countries—characterized here under the rubric of performance budgeting—have caught the attention of many middle-income and emerging countries, who now seek to adopt similar reforms. The result has been that the Fiscal Affairs Department of the International Monetary Fund, as a provider of technical assistance in this area, has increasingly faced demands arising from this source. Our experience has been that while it is not too difficult to design budget reform measures, and specify detailed implementation plans, we generally face an important constraint. Namely, the management skills required by the reform process are often underestimated. This has two dimensions. First is the substantial management capacity required to operate the new type of budget management model. Second, and arguably more important, are the change management skills required to introduce new systems, to sustain efforts to follow through in implementation and to adapt to contingencies and changes in the external environment. This paper explores, from the perspective of recent country experiences, such problems when introducing performance-based budget management reforms.

B. The move to performance budgeting

In the past two decades, there has been a fundamental restructuring of the budget management systems in OECD countries. The previous view of budget management focused primarily on resource allocation and input control, and was usually highly centralized. This approach to budget management accepted a set of policy objectives—usually poorly articulated and unquantified—and allocated inputs to reach these objectives. At the same time, central budgeting agencies focused almost exclusively on control and compliance as the primary *modus operandi* in budget management. There was often little follow-up in examining the subsequent performance of spending departments. The new budget management model, indicated here (perhaps a little loosely) as “performance budgeting”, but with different titles in different countries, aimed at forging a more direct link between allocating resources through the budget and performance in reaching stated objectives.²¹

This reorientation necessitated a number of changes in traditional budget management:

²⁰ International Monetary Fund

²¹ See, for example, OECD 1994, 1995; Davis, Sullivan, and Yeatman, 1997.

Provision of increased *flexibility* to spending agencies in their access to budget funds and the uses to which funds can be applied

This concern with increased flexibility has focused mainly on the ability of spending agencies to reallocate funds within controls on budget line items. Changes are directed at giving organizations and managers greater freedom in operational decisions and removing unnecessary constraints in resource management. In return, organizations and managers are more directly accountable for results. Australia, New Zealand, and the Nordic countries have led reforms in this direction, and the United Kingdom and Canada reflect the same approach. However, there are still a number of OECD countries who resist giving increased powers to public servants and are suspicious that overspending will result if they do. Thus, the United States continues to exert firm congressional control over the executive branch, and France, while freeing controls on operating expenditures, still exerts central control over staffing.

Reduction of line item specificity has been a general feature of such reforms, although in different countries, increased flexibility has been provided in different ways. A first step is usually the consolidation of detailed appropriation items into wider-banded expenditure categories. The portfolio budgeting approach, giving ministries greater flexibility and incentive to reallocate resources within portfolio allocations to reflect changing priorities, is a more pronounced form of this approach. A minority of countries has also introduced greater end-of-year flexibility by allowing a carryover of unused appropriations; and the use of net appropriations to encourage the generation of non-tax revenues to finance specific types of spending. However, the latter approaches and resource agreements, as in the Australian and New Zealand systems, allowing the sale or acquisition of fixed assets, are still regarded as radical by most countries. It should be noted that such approaches are founded on two main preconditions: a tight budget constraint which agencies observe, and adequate capacity in the Budget Office to monitor developments and intervene if necessary.

Provision of greater *certainty* in the operating environment of spending agencies, particularly in regard to availability of funds

There is usually the need to take parallel steps to increase the certainty of budget funding. Forward medium-term expenditure frameworks (MTEFs) represent an important step in this regard. Medium-term budget planning has been a major development in OECD countries where fiscal targets have been set on a three- to five-year basis rather than on a traditional one-year basis. Different approaches are evident. Australia, as a pioneer in this area, has perhaps carried the approach further than most in developing a forward estimate system, where refined forward estimates become the estimates of future spending rather than simply forecasts of existing policies. In this way, there has been a transition to medium-term budgeting. However, in some countries, budget planning occurs only at the aggregate, rather than at the agency or ministerial

level where plans are just that—and are not used to give indicative allocations or limits to individual agencies and programmes.²²

Increased *pressure* on agencies to pursue improvement in programme results

Within the OECD, there has been an increasing reorientation of central Budget Offices from compliance issues, based on detailed control of inputs, to more performance-oriented managerial issues, concerned with outputs. In part, this reflects greater concern in improving resource allocation than meeting fiscal stabilization objectives, but also, in part, it reflects a recognition that improved programme performance is as important for macro control as detailed controls on inputs. Hence, in recent years, there have been increased attempts to: integrate budgeting with other management processes; require agencies to measure performance and evaluate the results of their operations; develop new guidelines and methods for holding managers accountable; and develop the information bases and reporting systems that can enforce this accountability.

Some Anglo-Saxon countries have attempted to employ formal contractual arrangements to ensure performance (for example, the New Zealand purchase agreements for outputs between ministers and agencies, or the UK's annual performance agreements between a minister and an executive agency). In this way, an attempt is made to connect budget provision directly to performance (see Box A).²³ Recognizing the many methodological and practical problems on performance measurement, other countries (Canada, Denmark, Finland, Sweden, and the United States) have introduced initiatives to promote performance without tying this directly to budgeting. This has taken the form of developing performance indicators, formalizing requirements for programme evaluation, and enhancing the role of external review agencies, such as supreme audit institutions (SAIs). It has been recognized that there are limitations to performance indicators capturing all relevant aspects dictating performance; it is easier to devise and identify outputs rather than outcomes, which are more relevant to performance. Nor is it always clear what should be the budget implications of poor performance—how to achieve the linkage between performance and budgeting remains unresolved.

Among the major challenges faced by emerging market economies has been the need to adjust institutions to function in an increasingly market-oriented and global environment. With this recognition, middle-income countries have increasingly looked to emulate OECD budget reforms. Can, or should, the above reform strategy be applied generally to non-OECD countries? How universal is this reform paradigm? Do all countries have the management capabilities within government to implement such reforms? These are questions that are increasingly faced by the IMF when providing technical assistance to middle-income countries.

²² On a somewhat parallel line, a few countries (Italy, Norway, and the United States) have published intergenerational accounts using the methodology developed by Auerbach, Gokhale, and Kotlikoff. This approach relies on a number of rather difficult assumptions and there appears to be considerable reservation about the clarity of the message that is conveyed.

²³ A useful discussion of OECD experience with performance contracts is contained in PUMA, PAC (99) 2.

C. What can be learned from the OECD experience?

Budget reform has been an evolutionary, not a discrete process

In advising countries on budget reform, it is always as well to recognize that this is an evolving process with budget systems moving through distinct stages. It is generally agreed that a modern budget system should be able to achieve three main objectives: first, to **ensure control over expenditures** so that they are consistent with the budget law; second, to **stabilize the economy** through timely and efficient adjustment in fiscal aggregates; and third, to promote **efficiency in service delivery** through procedures that provide incentives for greater productivity. Typically, budget systems have evolved by progressively assuming, and placing different emphasis on, these three objectives. However, the process has been an evolutionary one, rather than one characterized by discrete jumps.

One can characterize budget systems as moving through distinct stages. Traditionally, the most basic systems focus on the first objective—ensuring compliance with the annual budget law. This has been manifested in detailed line-item budgeting. While meeting basic compliance requirements, traditional budget systems usually then have been modified to accommodate the government's broad stabilization objectives and its need to control fiscal aggregates. This usually involved incorporating a top-down approach to ensure that fiscal policy can be harmonized with monetary policy, introducing procedures so that the government has the means to plan, control, and monitor spending effectively and to be able to adjust fiscal aggregates to meet fiscal targets which are increasingly set in a multi-year framework. After budget systems are capable of handling compliance and stabilization objectives, typically increasing emphasis has been placed on the third objective, to ensure efficiency and effectiveness in the use of government resources. It is this last objective, putting in place mechanisms to ensure performance-oriented budget management, that has progressively become the focus for OECD budget managers over the last two decades.

General recognition of the need for reform

In attempting to move to OECD levels of budget management, middle-income countries typically find themselves facing common problems. Their past attempts to ensure that budgetary processes would deliver a satisfactory aggregate fiscal outcome in support of macroeconomic stabilization, now have revealed certain limitations. Even when care was taken to incorporate some degree of budget flexibility, typically the budget systems were left with a complex set of restrictions. These were increasingly recognized as diminishing the allocative and operational efficiency of budget execution, typically with budget managers' operating with limited responsibility for results. Accordingly, there is growing acceptance that the next stage of reform is to provide greater inducement for managers to focus on possible improvements in allocative and operational efficiency at the programme delivery level. However, before this stage can be reached, there must be a strong enough consensus—a critical mass of reform impetus—to enable a shift in the budget management model.

Typically, this consensus has been derived at from two separate sources. First, the limitations of traditional compliance-oriented budget systems became more apparent. Second, with the increased use of more flexible budget management procedures, there was increased realization that stabilization and efficiency objectives were not necessarily competing, but could be complementary. Traditional budget systems, based on short-term and detailed control of inputs, have generally been discredited as a tool for promoting public sector performance, which by definition should focus on the outputs or the impacts resulting from these inputs. The increased suspicion that fiscal stabilization objectives were being achieved at the cost of performance, led to OECD countries modifying their budgets into performance management instruments and not just instruments of macro control.

When introducing a performance budget management model, with associated increased managerial freedom, it became evident that greater managerial flexibility could be viewed not only as a tool to improve efficiency but also to achieve the expenditure targets that had been set. Typically, managers of individual programmes are in the best position to decide on the most appropriate mix of inputs to be used for executing their programmes. By providing them greater managerial freedom, managers could be assisted in achieving tighter budgetary limits—that is, improved efficiency in resource use could support stabilization targets.²⁴

The reform strategy is a major part of government's overall policy

Once the need for reform was recognized and accepted, a common approach is that it became part of the government's fiscal strategy and a central element of government policy. The reform initiative was “owned” and supported by all ministers, not just the Ministry of Finance or the Budget Office. In this way, it formed a critical element of management strategy for all budget institutions. All public sector managers had to assume responsibility for its implementation, and this could not be left to those managing the agencies' budget or its accounting system. This high-level commitment facilitated the required changes in administrative procedures and the willingness of central agencies to devolve budget management.

Assurance that adequate levels of fiscal control exist

Before advancing down the road of a more flexible, more decentralized budget model, all countries ensured that they had reached some adequate levels of control to ensure compliance and stabilization objectives. It was recognized that each of the three tracks—providing flexibility to budget managers, greater certainty in budget funding, and increasing pressure to perform—is essential, and should be followed to ensure the overall success of the reform process. In particular, increasing flexibility for spending agencies without pressure for performance

²⁴ In a recent OECD study, it was found that greater managerial flexibility was associated with a positive aggregate fiscal outturn, that allowing managers greater freedom resulted in less emphasis placed on aggregate spending caps and increased the success of spending cutting exercises. See Strauch, R., *Managerial Flexibility and Fiscal Performance*, 2000 (Paris: OECD).

improvement could increase rather than reduce inefficient use of budget funds. Similarly, provision of a more certain operating environment without increased pressure on agencies to deliver results could reduce aggregate fiscal control without generating improved programme outcomes. It was, therefore, essential to proceed down these three tracks in a highly coordinated manner.

The need to “engineer” budget reforms

Even within OECD countries, reform programmes had to be engineered—a reform plan formulated, an implementation strategy agreed upon, and implementation managed to achieve the objectives and sustain the reform initiative. Additionally, the reform programme had to be sold to the main stakeholders in the budget system. But perhaps more important, a reform team had to be identified and empowered to carry out the reform. It is this aspect of the reform process—the exercise in change management—which is the focus of this paper. That is, it addresses the question of how to engineer the shift from one budget management model to the other—literally introducing a shift within government from a compliance to performance culture.

D. Elements of a reform strategy

With the recognition that the experience of OECD in making this change was evolutionary and not discrete in nature, and is a continuing effort, then the emphasis on this change process appears particularly relevant. In this way, attention is productively directed to an examination of the implementation strategy and the mechanics of implementation—i.e., managing the reform process as a whole rather than concentrating on individual reform elements.

Certainly, from the experience of government modernization programmes in emerging countries, we can conclude that getting agreement from top decision-makers that the budget system needs to be made more flexible may not be such a problem. Similarly, designing the organizational and procedural changes required are not so difficult. However, the real constraint is the human factor in institutional change. Generally, not enough attention is paid to the agents of change—identifying them, offering them incentives to undertake reforms, and removing the constraints they face in sustaining these reforms.

It can be argued that engineering successful budget system reform involves at least three elements:

Identifying agents of change

Who are the champions of reform? Who is going to recognize the need for reform, design the reform, monitor and implement the reform?

Assessing and assuring the adequacy of the means at their disposal

How, and by what means, is reform to be carried out? What is the capacity to carry forward reform—is this adequate or does it require administrative restructuring, changes in procedures, the skills available?

Restructuring the incentives to undertake and sustain reform

Why, and for what purpose, will reforms benefit the individual rather than the system as a whole, and compensate for the costs of the effort involved? Once reform incentives are established, how are they to be maintained and protected?

Some partial answers to these questions are provided in the remainder of the paper.

E. The agents of change

In a traditional, highly centralized budget system, there is a presumption that changes are derived top-down from the Budget Office. This is not necessarily the case when introducing the new devolved budget management model. Typically, any relaxation of centralized controls is likely to meet the resistance of the central Budget Office, which should be the key agent of change. This resistance arises from a number of sources.

First, there is the typical fear of the unknown. Why adopt different approaches when the present ones have not broken down and appear to be delivering at least the bottom line fiscal result? How to convince the Budget Office of the need for a new a budget management model which moves away from compliance and stabilization objectives and begins to emphasize efficiency, and effectiveness in resource use? Obviously, they will not be easily convinced unless they already have in place a management framework that assures basic compliance with the law, and sufficient certainty in the fiscal outcome to be able to minimize short-run disruptions to spending plans that may be needed to ensure fiscal stability.

Second, this conservatism is often reinforced by a genuine fear that relaxing central controls, and giving budget programme managers greater personal freedom, will result in more waste and corruption. How to assure the Budget Office that the programme managers will act responsibly? It is recognized that where line agency accounting and internal control systems are rudimentary and poor, corruption may increase. It follows that there should be a major programme to upgrade agency financial management skills to some basic level to offer the Budget Office assurances as to agency fiscal responsibility.

Third, there is often a natural reluctance to give up the power that goes with centralized control. Change is threatening. It may also mean a loss of pecuniary or other benefits that follow from the release of detailed line items to spending agencies. As a consequence, the central Budget Office, which should be the leader of reform, becomes its chief impediment. How to move the Budget Office toward a new role? Only by consistent pressure from government and by recognizing that budget reform is a reform of the whole system and not just the MOF. Indeed, perhaps in the new

decentralized budget management model, the leaders of reform are to be found in the programme agencies and not the MOF.

Fourth, it is not often recognized that the central Budget Office has limited capacity for change management. In private sector companies change management is an activity that receives much top-level attention, and tends to be heavily funded. In the public sector it typically has suffered from benign neglect. Often there is a need to inject or build up this capacity within the government.

The management constraint does not merely hinder the successful implementation of the reform process. The new budget model being introduced implies that public officials will cease being administrators and assume a management role akin to that in the private sector.²⁵ Unfortunately, a centralized compliance-oriented budget management system does not foster such management capacity. We have indicated that this capacity may be difficult to find in the MOF and is unlikely to exist in the line agencies either. These officials typically have spent most of their working lives in a compliance-oriented environment. Their reflex responses are to manipulate detailed external control systems to protect their programmes from the cash-rationing operations of the MOF. Often they see their role as administrators, distributing limited cash to keep basic services functioning. This role does not recognize the value of good agency financial management, nor does it foster the acceptance of increased managerial responsibility.

How to build management capacity in a compliance-oriented traditional budget system? There is no easy answer to this question. However, experience suggests that a “big bang” approach is not possible. An interesting case is that of the Government of Bolivia, which in 1988 recognized the lack of managerial talent in the public sector was surely hampering economic efficiency. It developed a programme which recruited and provided a limited number of middle-level managers in the belief that manning a few “key posts” in each agency would considerably enhance performance. A total of 653 key posts were originally planned but, by June 1993, only 69 had been filled. The strategy of sprinkling a small amount of managerial talent across a large number of agencies evidently had little impact. From 1992, the government adopted a broader civil service reform with a longer time frame, where around 2,500 targeted posts would be incorporated into a newly formed Civil Service Programme. The new strategy was to achieve a critical managerial mass within selected central administration agencies, and to progressively expand the number of agencies in the programme.

The case of Bolivia, and also the experience of other middle-income countries introducing such reforms, suggests that the answer to this management constraint is twofold. First, it must be recognized that building this capacity will take time, and needs to be developed in stages. Second, this phased approach should be an integral part of the reform’s design. The latter is evident in one strategy which has been used in some middle-income countries in adopting a

²⁵ For a discussion of the importance of the management capacity and ethic in this budget management model, see A. Schick, 1998, p. 130 ff.

contract or resource agreement. The approach used in Thailand is summarized in Box B. This approach, discussed more fully below, makes agency access to more managerial autonomy conditional on improved agency financial management. It is recognized that these systems, and the managerial capacity to operate them, if functioning properly, will be important assurances of the data quality and reliability of controls in the new devolved budget system. It is a way of minimizing the risk of misuse or abuse of managerial authority, while recognizing that agency capacity-building will take time.

F. The means to manage the reform process

When turning to the means required for reform to succeed, this is typically assumed adequate for the task, but experience suggests this is usually not the case. The experience of developing countries is one of efforts to improve systems being overtaken by changing external events. Are there lessons to be learned on the change management strategies that work?

Some generalizations (always subject to the qualification of exceptions) can be offered:

Emphasize objectives

The cultural shift from a compliance-oriented to a performance-oriented budget management model essentially involves the move from focusing on inputs and how they are employed to focusing on outputs and how they fulfill the original budget objectives. This is a move away from traditional administrative procedures to more modern management orientation focused on meeting clear objectives. Not surprisingly then, a key to a successful transition from one budget management model to the other is to focus on objectives. Those involved in the path-breaking public sector reform processes in New Zealand and Australia stressed this aspect of reform.²⁶

Keeping participants focused on objectives

Publicizing these objectives is one approach to create incentives and put pressure on participants to meet these objectives, and enforcing efforts to hold them accountable for achieving these objectives. The UK's "Citizen's Charter" represents such a device, which publicly commits public entities to meet specific performance standards and identifies the means of redress when they do not. In the United States of America, the National Performance Review during the Clinton Administration also placed heavy emphasis on measuring and publicizing results.

Evaluation of performance as a tool to enforce performance

To be effective in meeting objectives there must be a feedback mechanism to continuously improve the means to attain the objectives. At the same time, these mechanisms must be cost-

²⁶ For example, the 1989 New Zealand Public Finance Act, which introduced major reforms in fiscal management, developed a set of principles of financial management which began with the clarification of strategic and operational objectives.

effective, and excessive transactions costs, as well as the risks in their application, in deriving biased, inaccurate, or non-probative results, must be avoided.

Rewarding good performance and sanctioning poor performance

The reform leadership must ensure a clear link between performance and rewards. Establishing clear performance accountability involves first a threshold level of basic financial and personnel management systems to be in place to report on performance, and second a performance-oriented framework linking rewards to performance.

Middle-income countries are typically handicapped in following the above strategy. In a traditional type of budget system, there is little emphasis placed on performance. With the budget focused on inputs, with detailed line-item controls on expenditures, agencies focus on obtaining spending approvals and utilizing them within the year. There is little attention paid to non-financial performance, and few sanctions on agencies for poor performance (and little reward for good performance). Management in line agencies, therefore, have not been used to subjecting new policy proposals to critical analysis. Nor have they been used to managing expenditure to achieve a budgeted outcome because this function was tightly controlled by the center. Consequently, they have not felt the need to develop an information system for this purpose. There is a need, therefore, not only to develop such evaluation skills in agency management but to establish a supporting information system based on indicators of output and performance.

The need to upgrade basic management tools to provide adequate, relevant, and timely information

Three aspects are worth noting:

a) Restructure the accounting system

The typical government accounting system, even if conceptually well defined and internally consistent, is a cash-based one. The traditional emphasis on voted costs, the last stage of spending, may be adequate for the compliance and stabilization objectives of the MOF at the center, but less relevant for the management purposes of budget managers in government departments. A precondition for moving to the next stage of budget system development is a need to upgrade the accounting system.

b) Greater application of IT

Against the background of the ever-growing volume and complexity of government financial operations, the critical importance to the fiscal managers of timely management information reports in a usable form needs little emphasis. Improved classification systems to identify programmes, so that costs can be allocated to individual activities, to be compared with the outputs of these activities, has obvious management relevance. Tailoring such reports to management needs through a computerized financial information system has been a general

PEM reform undertaken in various parts of the world. However, often the effort required has been difficult to sustain.²⁷

c) Strengthening internal control systems

Before attempting to give agencies wider responsibilities in resource allocation, it is essential to ensure they are operating within an effective financial management framework. Good internal control is an important feature of this framework. Without satisfactory controls, management may not detect serious errors and irregularities, and the work of the central overseeing agencies, as well as external audit, becomes more difficult. Typically, control problems tend to cluster around control over the payroll and procurement procedures—which usually cover a large part of an agencies' expenditures. In strengthening and in ensuring quality control on internal financial management, internal audit has been seen as making a substantial contribution. The management effort required to upgrade these systems should not be underestimated. Similarly, the substantial information requirements to support internal control, and ways of ensuring its relevance, timeliness, and objectivity, cannot be ignored.

A top-down reform process may rapidly run into diminishing returns

In attempting to install a bottom-up system from the top down does involve a fundamental contradiction. The greater the success in decentralizing decision-making, the weaker will be the central Budget Office's leverage over agencies. With decentralization, and consequent greater managerial freedom, the previous approach of central control over detailed items of expenditure need not give the center effective control over the budget, and will most likely work against efficiency in resource allocation. The Budget Office must hence adapt its work practices and build up the information systems required for this new environment—and may encounter its own internal resistance to making such fundamental changes.

Therefore, in terms of engineering these reforms, there may be conflicts involved in a top-down approach in directing managerial improvement from the center. We have already remarked that, although it may be necessary, it may not be reasonable to expect the central Budget Office to take the lead, and increase its capacity to assist others in implementing the reforms. If it tries to do this too aggressively, will it smother managerial initiative and encourage the old compliance mentality? Will a greater devolution of decision-making be perceived in the central Budget Office's interest, both in the narrow view of attaining its compliance and stabilization objectives, or more generally in reducing its overall influence over the budget process? There are costs as well as benefits in moving away from traditional budgeting methods—will the principal agents of change see a net gain to them in advancing this process? It is this last aspect, that of

²⁷ Early efforts to introduce state of the art systems in Bolivia's Financial Administration and Control System (SAFCO), and Venezuela's integrated FMIS during the late 1980s and early 1990s stalled. On the other hand, Ecuador, in its Modernization of the State reforms, began with more modest "bridging systems" that were developed in a few months in consultation with the end users, and were found effective.

restructuring incentives to support reform, that comes out clearly as a crucial factor for success in countering the diminishing returns that may beset reform efforts.

G. Restructuring incentives to support reform

The reform programme cannot ignore the interests of stakeholders—particularly the key players, the central Budget Office, and the targeted agencies. If the Budget Office cannot see that the reform process will improve its control over the budgetary process, that Office will be unlikely to be a strong ally of the reform. If the systems being created by the reform process do not provide agency-specific management tools desired by targeted line agencies, those systems will be unlikely to yield desired impacts. Worker support may also need to be enlisted by involving them in the design and implementation, providing performance-linked institutional rewards, and introducing job transition assistance for retrenchment or retraining.

An approach that has been followed by some middle-income countries seems to have followed at least partly some of these lessons (see Box C). It is an approach that has been managed centrally, typically by the Budget Office, and it is described in a rather stylized fashion below. This can be characterized as a two-fold approach:

a) Applying pressure from above

The MOF would encourage agencies to undertake in-depth evaluations (possibly contracted out) of activities which it believes might warrant reconfiguration of resourcing. These evaluations could be an input to the preparation of a MTEF.

The MOF would institute an “efficiency dividend” policy, whereby agencies will be required to find savings in their baseline budgets of an agreed percentage each year.

Over time, as improved accounting for assets allows, a capital charge could be introduced to ensure better asset management.

However, performance information provided to central agencies is a fairly blunt weapon for ensuring that agencies actually use their new financial freedoms to enhance programme outcomes rather than bureaucratic or personal goals. The most effective pressure for good governance within an agency comes from within the agency itself, rather than from the central agencies. This is through effective leadership of the agency, clear frameworks of operation, effective management information systems, and proactive central coordinating divisions in the areas of agency accounting and budgeting. Hence the second approach:

(b) Increasing capacity from below

The central Budget Office, as the agency responsible for budget management, undertakes a proactive role in the development of good management in the spending agencies to which it provides budget funding. This is a key element in the budget reform model based on devolution of financial freedoms and a more certain operating environment. This takes the Budget Office

out of its usual control mode to adopt a more managerial approach. Typically, some of the main elements are:

- The Budget Office highlights improved management of spending agencies as a precondition of the budget reform process.
- The Budget Office would develop competencies in the evaluation of internal resource allocation processes and structures in spending agencies; these should focus particularly on the ability of a spending agency to identify cost-ineffective aspects of its activities and to reassign resources away from such areas.
- A checklist would be developed within the Budget Office of the attributes of management systems in spending agencies which are conducive to allocative flexibility.
- The Budget Office would work with spending agencies in the application of these competencies to agency operations; this is to cross-fertilize the spending agencies, with the ultimate goal of the agency both undertaking internal reallocation and identifying savings options in response to external budget management requirements.
- The Budget Office would initiate a review of performance indicators for each major department. This should begin with the enumeration of departmental activities and the objectives being pursued by each. Performance indicators already available in the department should then be matched to these objectives and gaps in the existing range of performance indicators identified. Assistance should then be sought from sectoral experts in the definition and collection of new performance indicators to fill these gaps.

H. Providing an enabling environment

Unlike a policy change, an institutional reform, such as that involved in budget system reform, has no political constituency. In the population no one is pressing for this reform because there is no perception on their part of the enhanced expenditure benefits or improved efficiency in service delivery. Part of the answer of sustaining reforms revolves around how to generate the pressure for reform in society as a whole. What are the elements of such an enabling environment?

An adequate level of fiscal stability

Crisis can trigger the perception of the need for reform; at the same time, it can deflect from it. While the debate continues, we note that OECD countries carried out a major fiscal consolidation concurrently with introducing major fiscal reforms. The pressure for budget reform largely arose from the rapid growth in the public sector in the 1970s and early 1980s, raising questions as to its affordability and whether it was providing value for money. The growth had been so sharp that there were doubts as to its sustainability and the need to find reductions in some sectors to satisfy new emerging demands, as well as general concerns that taxation levels

were too high and the public sector was crowding out the private sector. The consequence was a substantial fiscal consolidation, reducing budget deficits and stabilizing debt levels, alongside the introduction of fundamental budget system reforms.²⁸

While fiscal crisis may have been a barrier to reform, it could also be an opportunity to introduce fundamental reforms. It has been argued that in crisis conditions changes may be more easily accepted and more quickly implemented. Our experience in transition economies is that, when the degree of fiscal stress is severe, the initial reaction was to muddle through, adopting short-term crisis management solutions that often were hostile to longer-term reform. Undoubtedly, the degree of crisis is important—too much can be disruptive and counterproductive for reform.

Some qualifications are perhaps in order. Much depends not on the degree of fiscal stress but the capacity of the budget system to adapt to it. If reliable mechanisms are in place, then fiscal stress is probably a secondary factor. Second, if fiscal stress is not so destabilizing so as to allow some political and administrative stability, then its negative impact can be expected to be much diminished.

Third, much depends on the reform strategy adopted. An approach which lacks focus and priorities is most liable to fall prey to short-run crisis management. Also, an approach that is too ambitious and costly will also be doomed. As suggested, performance-oriented public sector modernization is costly and likely requires substantial infusion of scarce managerial talent to be effective. Recognizing this, reform should be designed in a way that phases in the cost increases over a long enough period of time so the government can meet the increase fiscal costs that does not jeopardize overall macro fiscal policy stance. A gradualist approach that incorporates agencies serially over a sustained period will be required because professional human resources required are in short supply. Also, such an approach enables learning from mistakes. Moreover, the serial approach, by allowing reform to start with the most promising agencies, thereby enhances the chances of demonstrating visible results early on, and provides momentum for reform.

To be sustainable, reform requires a consistent legal and regulatory framework

A broad regulatory framework is required that should establish the broad parameters for ensuring adequate budgetary controls and granting appropriate managerial autonomy. The latter should be conditional on the agency management providing adequate accountability for those public resources under its stewardship.

This usually involves a streamlining of existing budget procedures and associated financial regulations. In centralized compliance-oriented systems, there is usually an accumulation of layered controls that have arisen over the years. A set of controls is introduced to remedy some abuse; these are circumvented, leading to the institution of additional controls to plug the gaps.

²⁸ See OECD 1996.

The layers of controls encourage managers to try and circumvent them to get things done, leading to a vicious cycle. There is a need to rid the system of these redundant and counterproductive controls.

There may also be some advantage in setting the new regulatory framework in the wider context of a framework fiscal law. As is evident, a number of new fiscal frameworks are legally based, to force governments to commit credibly and assuage governance concerns. The basic idea is to create rules and procedures that impose costs on governments for deviating from fiscal responsibility.

The pioneer in this field was New Zealand, through the Fiscal Responsibility Act of 1994. The latter laid down principles of responsible fiscal management, as a framework for defining necessary fiscal procedures, fiscal targets, and fiscal reporting to ensure these principles were upheld. The need for greater transparency in fiscal management was an overarching objective of this legal framework. Not only are governments required to specify and adopt agreed fiscal targets, but they are required to explain the policies underlying their attainment and, when deviating from this policy commitment, they are required to explain not only its rationale but also planned future corrective action. The Australian Charter of Budget Honesty and the United Kingdom's Code for Fiscal Stability have adopted this approach, albeit in different forms. Notably, Brazil has recently adopted its own Fiscal Responsibility Law.

Increased emphasis on fiscal transparency

Transparency in government operations is increasingly regarded as an important precondition for good governance and sustainable economic growth—but, for the emerging economies, it is also an essential aspect of sustaining confidence in government and, through this, support for the democratic system and economic advancement. The latter has become particularly acute with the exposure of fiscal policies to international financial markets because of the increasing use of market financing of deficits. Such exposure has required many governments to modify past policies and so has assisted in achieving fiscal discipline and improved resource allocation.²⁹ It is also an essential ingredient in establishing the new budget management model.

Promoting greater transparency is a means to bolster reform. Restructuring incentives by concentrating on the stakeholders within the budget system is unlikely to be enough—there is also the need for measures to activate the interests of clients to support the reform. It has been

²⁹ “Global commercial liberalization and the free flow of capital are exerting new pressures on systems of public governance. Recent experience shows starkly that the quality of public institutions and the trust in which they are held by economic players can have very demonstrable effects on the behaviour of these markets. Public sector governance systems that induce loss of market trust impose costs not only directly on their domestic economies, but more generally as they reduce global growth rates below potential.” (J. Brumby, “Budgeting Reforms in OECD Member Countries,” in *Managing Government Expenditure*, ed. by S. Schiavo-Campo and D. Tommasi, Chapter 16, p. 343.)

recognized that clients need to be empowered, and client feedback strengthened and made more transparent. The latter is evidenced in two main trends: improving the type of performance information, and strengthening feedback channels.

Empowering clients

One technique to accomplish this is by widely publicizing performance standards they should expect from particular public agencies and spell out the specific steps they can take to force agencies to meet these standards. As indicated, the UK Citizen's Charter, attempted to do this at an aggregate level, but such initiatives are possible at a programme level.

Moving performance indicators from quantity to quality

The importance of performance indicators has long been recognized in reforms associated with performance budgeting, as evidenced by the ever-expanding literature on the subject. The requirement for performance data and improving performance measurement as a way to improve resource allocation for government cannot be doubted. However, one can detect a new trend to obtain different types of performance data. Typically, performance data has been directed to the following questions: first, how well are services delivered? (efficiency concerns); and secondly, are planned objectives being met? (effectiveness). However, increasingly important has been a third type of question: are customers satisfied with the results? (a quality dimension).

In the United States of America, the Government Performance and Results Act (GPRA) was enacted in August 1993 to improve the public's confidence in government by holding agencies accountable for programme results. Promoting a focus on results, improving the quality of services, and measuring customer/citizen satisfaction with government services were important elements of the Act. Improving the delivery of services by not only requiring that managers establish plans for meeting their goals/objectives but also providing feedback to managers regarding actual programme results and quality (see Box D).³⁰

Strengthening consumer feedback

Nowhere is this push to improve the efficiency and effectiveness of government service provision more noticeable than in the rapid adoption of IT in government, mirroring developments in the private sector. The spread of e-government has been increasingly documented. In the United States of America, there has been a rapid expansion in Constituent Relationship Management (CRM, also known as Customer Relationship Management)—a class of software designed to provide governments with the ability to manage their constituent relationships. The idea is that constituents can contact their government via a variety of channels. Recorded contact information can be logged, analyzed, and then effectively employed in various business processes. The widespread use of e-government means that the analysis of consumer

³⁰ See Clinton and Gore, 1994.

feedback data can be a powerful input to agency decision-making. In this way, government's performance can be monitored for the quality of different types of contacts, showing where the government is doing well and where improvements are required. Constituent data can be analyzed so managers can segment their client groups in order to deliver more specifically tailored programmes—and so improve the quality of service provision.

I. Lessons learned

Are there any lessons learned for successfully introducing and sustaining the move from one budget model to another?

First and foremost, the degree of required management skills should never be underestimated

Who is going to manage the reform process? Who is going to manage the new budget system being introduced? The successful answering of these questions can make a key difference in emerging countries where the depth of managerial expertise in government is lacking.

Proper sequencing of reforms

Management capacities must be strengthened as a prerequisite to devolving management autonomy. The new devolved budget management model must rest on solid management foundations, especially at the agency level.

Begin modestly and do not to be too ambitious

In design, rather than a “big bang”, a gradualist approach is advocated. In implementation, rather than attempting blanket coverage, a serial approach is preferred. Rather than advanced technologies, making do with what is available and familiar may pay dividends, at least initially. There has been some experience of public sector reforms that sought to install complex fully integrated FMIS. These have proved to be beyond immediate capacities and deflect from more fundamental managerial reform.

Identify the right management teams

The inevitability of allowing some discretion for the management teams, coupled with the impossibility of readily holding them fully accountable for all dimensions of their agency performance, implies some risk of misuse of this discretion. It is important that the change management team shares common objectives which are fully congruent with that of the government. The more fully the government can trust the management team, the more likely is the reform to achieve its objectives.

To find managerial leadership with common vision, technical competence, stature to spearhead the reform, and full commitment, seems daunting. But the fact is that such leadership has been

possible to find in many countries and offers living proof that, in budget reform, the human factor cannot be neglected.

Box A. The Contractual Approach in Performance Budgeting

A wide range of contractual arrangements has been developed in OECD member countries:

- Between the government and chief executive offices

An agreement that legislative appropriations are made on the basis of the agency producing an agreed level of outputs, e.g. New Zealand output agreements, where government is viewed as purchasing goods and services from a department, as well as owner of assets used by the department.

- Between minister and subordinate agency

An agreement between chief executive body and an agency on the services to be delivered and the level of performance to be achieved, e.g. UK annual performance agreements.

- Between the central budget office and spending ministries

An agreement that budget allocations are provided in return for agreed performance levels, e.g. Australian resource agreement where costs savings arising from new spending programmes will be deducted from an organization's indicative future funding levels.

- Between different levels of government

A partnership agreement between levels of government based on performance contracts, covering a variety of arrangements: joint production of a service; management of common resources; joint investment¹.

¹ For numerous examples, see PUMA, RD (99).

Box B. Thailand: Line Agencies Reform Contract

Main elements of the approach:

- Identify reform-oriented line agencies
- Offer them a “contract” or resource agreement
 - i. Reduced external control by Bureau of the Budget
 - ii. In exchange for demonstrated improvements in agency financial management
- The agency must demonstrate the achievement of “hurdle standards” in seven areas:
 - i. Budget planning
 - ii. Output costing
 - iii. Procurement management
 - iv. Budget/funds control
 - v. Financial and performance reporting
 - vi. Asset management
 - vii. Internal audit

Source: G. Dixon, “Budget Reform in Change Resistant Environments”, World Bank, PREM note.

Box C. Formal Performance Agreements between Central Authorities and Agencies in Latin America and the Caribbean¹

Benefits derived by agencies:

- Easier to hire key human resources;
- Enhanced managerial autonomy;
- Reliable cash flow relative to budget;
- Performance-linked institutional rewards;
- TA to improve management processes.

Accountability requirements:

- Minimum reporting standards in financial and personnel management systems;
- A financial restructuring plan or institutional strengthening agreement with detailed implementation plan and deliverables.
- Agreed performance targets and associated reporting requirements.

¹Based on programmes of Bolivia, Ecuador, Jamaica and Nicaragua.

Box D. The US Government Performance and Results Act, 1993

The Act is an amendment to the Budget and Accounting Act of 1921, covering all agencies of the federal government (only excluding legislative and judicial branches and the CIA).

Important elements of the Act

- To improve citizen confidence in government by holding agencies accountable for programme results.
- To encourage reform through a series of pilot projects focused on setting goals, measuring performance, and reporting progress against goals.
- To focus on results, improving the quality of services, and measuring customer/citizen satisfaction with government services.
- To enhance decision-making by disseminating information related to efficiency/effectiveness of federal programmes.

GPRA requirements

- Establish a system of interrelated plans and reports that were designed to provide the basis to link resources and results.
- Each agency has to produce a five-year strategic plan, which must be revised at least every three years.
- Agencies have to develop annual performance plans, establishing specific programme goals, identify the resources required to meet those goals, and link this with the strategic plan.
- Agencies have to provide an annual performance report reviewing its success in achieving the previous year's performance goals, and from this perspective explain any deviations.
- Pilot projects introduced to allow some agencies more flexibility, to waive certain administrative requirements for their annual performance plan, but managers would be held accountable for achieving higher performance.
- Introduction of a two-year pilot project of performance budgeting in a few agencies, providing Congress with information on the direct relationship between proposed programme spending and expected programme results.

Evaluation

Since its enactment, the GPRA has been continuously analyzed and reviewed by stakeholders and independent bodies. It has been found that some agencies have made substantial progress and others have found it difficult to meet basic requirements. Major problems encountered were the inability to generate reliable data, problems in developing measures for programmes/activities spanning more than one agency, and in making the transition to performance budgeting. Notwithstanding these difficulties, basic support for the implementation of the GPRA continues.

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MANAGING GOVERNMENTS FOR BETTER PERFORMANCE AND RESULTS: SOME LESSONS OF EXPERIENCE

by Graham Scott, C.B.³¹

A. Introduction

This section of the conference is intended to address “measures to improve efficiency and effectiveness”. This is a vast territory with a long and complex history over the last 40 years of the 20th century. I would like to spend a minute or so sketching the landscape of this territory, both to place my remarks in context but also to make the point that there are risks of getting our perspectives distorted if we focus on particular aspects of public management and lose sight of the total landscape.

In particular, it is important to note that both the theory and practice of performance management in government call on a wider range of influences than financial management and accountability – the headline issues for our conference. These influences do indeed have profound effects on the managerial performance of governments, but so too do many other influences. The list includes human resource management, information technology, clarification of roles and delegations of decision rights, the structure, form and function of public organizations, commitments to professional policy analysis, governance of the relationships between parliaments and the executive, organizational culture and capability and leadership.

There is a tendency among many financial management specialists to see everything else on this list as clipped on to the core systems for budgeting, financial reporting and holding managers accountable for financial results. This view has led to biases in reform programmes in some countries where elaborate financial management systems have been installed with disappointing results because they did not mesh with other aspects of the wider system of public management. The same is also true of reforms that have been biased towards structural reform, creating agencies and state enterprises, partnering with the private sector, civil service reforms, holding managers accountable for results, setting performance indicators etc. Reformers need to take a balanced and integrated view of all the factors that affect performance.

What is it that we mean when talking about measures to improve efficiency and effectiveness? In the developed world, the focus of attention on performance improvement from the 1960s onwards was on programme budgeting systems and evaluation methodologies. There was a brief and futile attempt in the United States of America in the 1970s to install zero-based budgeting in

³¹ Celtic Pacific Limited, Former Secretary to the Treasury, New Zealand

the federal government. Also in the United States, the Carter administration in the 1970s attempted a reform that featured performance incentives for public servants, but this also failed.

The two outstanding events of the 1980s were a highly imaginative attempt by the United Kingdom to shrink the government and make it more effective and a largely unimaginative attempt to achieve similar goals under the Reagan administration in the USA. The movement spawned in the United Kingdom, under a conservative government, was quickly adopted, transformed and expanded by socialist governments in Australia and New Zealand. The 1980s in that part of the world saw two governments introduce reforms which were aimed at the three dimensions of fiscal performance that define the subject matter of the first three sessions of our conference – that is, macroeconomic control of expenditure and the deficit, switching priorities and seeking greater efficiency and effectiveness. In Canada, an attempt at comprehensive reform was launched in the early nineties but did not take root. A major fiscal transformation did not take place there until the mid-1990s. These movements in the developed countries of the Commonwealth began to influence the thinking of the less developed member countries.

Meanwhile in the United States, Vice President Gore launched a public sector reform in the federal government in the 1990s, which was focused almost entirely on efficiency and effectiveness and scarcely mentioned the other two main dimensions of fiscal performance.

Movements to reform various aspects of the way governments work were taking place in other parts of the world, especially as the Soviet Union collapsed, European integration homogenized many of the practices of public administration and China's modernization accelerated. In other parts of Asia and with different timing, countries began to reform in various ways in response to the decline of the old oligarchic political systems, the growth of wealthy middle class political constituencies and the end of the cold war.

This is a complex tapestry, but there is one colour, albeit a vivid one, running through it that I want to draw your attention to. This is the collection of inter-related concepts and practices commonly known as the "New Public Management". This name was given to it by British political scientist Christopher Hood to capture the fact that in the UK, Australia and New Zealand a stream of reform to public management had arisen.

It is widely accepted that the generic features of new public management are:

- Clarification of roles of participants in government processes;
- Clear performance objectives;
- Professional non-partisan civil service that is motivated to perform;
- Delegated responsibilities for management;

- Extensive performance information;
- External scrutiny of performance;
- Focus on citizens as clients and customers;
- Market-type mechanisms, e.g. competitive sources of supply, cost recovery, private sector involvement, performance incentives;
- Rearrangement of organizational forms and functions to strengthen performance and accountability, separation of purchasing and provision functions etc.

From the perspective of an economist, these points are about the framework of incentives, capability and information around people who are required to meet specified performance goals and delegated the freedom necessary to do so.

The items on the list can be thought of as mostly being about the “hard” side of management. What is not shown there is the “soft” issues of management, which experienced practitioners will know are essential to high levels of performance in public organizations. These include issues of organizational values and culture, leadership, teamwork etc.

An important point I want to make is that it would only be in very favourable fiscal circumstances that this agenda of managerial issues could be addressed in isolation from the agendas that fiscal policy advisors typically have to address in developing and transition economies. The United States is the example where the entire programme of “reinventing government” bore little relationship to wider issues of aggregate fiscal policy and changing fiscal priorities. This is partly because the Clinton administration did not face much fiscal stress after its first two years in office, but more importantly because the US Congress has far greater independent control of fiscal policy than the legislatures in most countries. Vice President Gore was not in a position to reform the entire federal government fiscal system, but only to address problems that he saw in the quality and cost of services to the public provided by organizations under the control of the presidency.

The situations in the UK, Australia and New Zealand were very different. In addition to seeking greater efficiency and effectiveness, they were reforming their governments to restore aggregate fiscal control and to implement major shifts in spending priorities and, in the case of the UK and New Zealand, even change the role of government. The situations in these countries are closer, therefore to that in developing and transition economies than the USA. All three dimensions of fiscal performance had to be harmonized in some way, and it has been my experience in nine years of consulting that this is a common challenge.

The need for harmonization of initiatives to address the three dimensions of fiscal policy can be seen easily by considering a few examples of what happens where there is conflict between

them. In one African country where I was working, the Ministry of Finance was implementing a new public finance law that was designed to follow the principle of comprehensiveness by bringing into the budget and accounting system all the government's revenues. At the same time, the cabinet office was proposing to implement a policy of deep delegation of managerial control, with rights to dispose of many of the revenues that the finance act sought to bring within the budget.

In some transition economies where I have worked, the Ministry of Finance, often on the advice of the IMF, is seeking to impose highly detailed central controls of expenditures on inputs while other organs of government are seeking to promote efficiency and effectiveness by delegating more control to local managers with more focus on outputs and outcomes.

I have worked in countries both developed and developing where the principle of giving managers more certainty over the resources that will be available to them over at least one year has been given considerable attention. This is quite a critical condition for more effective service delivery. What I have seen, however, is that the Ministry of Finance, which is driven by concerns over aggregate spending, overrides such aims by making arbitrary cuts to expenditure in ways that demolish the management requirements of line ministries.

Ministries of Finance need to be very careful to design systems of fiscal planning and control which avoid, as far as possible, trading off their primary concerns for aggregate fiscal control against the requirements of a system of financial management that promotes effectiveness within operating units. This presents a challenge for most Ministries of Finance, as it requires them to employ staff who have a practical knowledge of what managing a line organization effectively requires. Most Ministries of Finance, in my experience, do not do this.

The consequence of this is that some Ministries of Finance can be very naive about the issue of accountability for performance in line organizations. They can be tempted to try to use a system of accountability for results to force expenditure cuts, which in fact make it impossible for managers to achieve the goals for which they are held to account. Until recently I was the chairman of the organization in New Zealand which provided the funds for the national health system, and I saw this problem in action. As part of an overall, programme of fiscal restraint, the government imposed spending limits on the health system, while at the same time making undertakings to the citizens of increased volumes of services for which funds were not provided. All hospitals began making large losses, and it was to common for the Treasury to advise that the boards and chief executives of these organizations should be dismissed for failing to keep within their budgets. The consequence was that over a period of three years, the turnover of board members and executives was so high as to cause chaos in these organizations.

These examples emphasize the point that our conference themes of financial management and accountability have great influences on efficiency and effectiveness, and also that reformers must think deeply about the design and operation of their systems if they are to avoid such mistakes. While there are always possibilities for introducing measures for greater effectiveness in any

government service at the micro level, any government-wide initiative aimed at comprehensive improvement will require an integrated approach in order to harmonize the three major dimensions of fiscal policy. It will also need to harmonize with policies in all other important dimensions of government management so as to ensure that the framework of hard and soft influences that make up the environment in which the organization for delivering services operates strongly promotes efficiency and effectiveness.

B. Case study of New Zealand

I would like now to summarize briefly the experiences of one country which has over the past fifteen years implemented many policies for reform of the systems of government management that drew on the principles of the new public management. This will provide more concrete illustrations of the approach. I will also provide some evaluative comments about that experience drawn from a book that I have recently published.³² This follows an earlier occasional paper published by the IMF, which contains my views on the New Zealand case study a few years earlier.³³

The components of New Zealand's public sector management reform were as follows:

- An independent central bank was created under the Reserve Bank Act in order to redefine the roles of the government and the board of the bank so that day-to-day management of monetary policy became independent from the government. I include the Reserve Bank Act in the reforms because of its key role in supporting fiscal policy in deregulated and globalized financial markets.
- Under the State Enterprises Act, the state enterprises, which were mostly run under the control of ministries and their ministers, were incorporated under private sector company law and required to focus on commercial success, while losing all their fiscal and regulatory privileges.
- Most of these enterprises were subsequently privatized.
- Many of the remaining functions of government were reorganized structurally with a view to improving their performance by removing the major conflicts between their functions and focusing their objectives so as to make their operations more manageable and transparent.

³² Graham Scott, "Public Management in New Zealand: Lessons and Challenges", Centre for Law and Economics, Australian National University, 2001.

³³ _____ "Government Reform in New Zealand", Occasional paper No. 140, International Monetary Fund, Washington DC, October 1996.

- A results-based management and financial framework was established by the Public Finance Act for all government organizations, which included charges for the use of capital and output-based budgeting.
- Under the State Sector Act, the roles of ministers, chief executive officers of public organizations and the central coordinating agencies of government were all redefined to support the new management framework. This was based on accountability for results that were recorded in a “performance agreement” and delegations of authority to managers which are very wide by international standards and perhaps succeeded only by Sweden.
- A framework of management and accountability was developed for what are known as “Crown entities”, which are similar to the British agencies, but report directly to ministers rather than permanent secretaries.
- The Fiscal Responsibility Act was passed that imposes the international generally accepted accounting principles on the whole of the government and a regime of fiscal transparency, which foreshadowed the transparency code promulgated later by the IMF.

There were, in addition to these laws, other laws which were specific to particular sectors but applied in various ways some, but often not all, the principles underlying the public sector reform. For example, the reform of the government science research organizations was a textbook application of the principles, whereas the reform of universities bore only a passing resemblance.

All of these laws were designed and implemented over a period of seven years, concluding in the early 1990s. Throughout most of that decade, New Zealand governments became preoccupied with other issues, returning only briefly to seek to consolidate and further improve and correct mistakes at the end of the decade. In 1999, the bipartisan support for the reforms that had existed for fifteen years ended with the election of a left-wing coalition, which is headed by the political party that had introduced the reforms in the mid-1980s. After two years in office, however, it has done almost nothing to change the system that it inherited, although there are signs that may be about to make some modest changes. In my view, however, an agenda of consolidation and redesign of some major components of the system is long overdue, although it is possibly a different agenda from that of the current government.

How has this management reform worked out in practice? The most obvious major improvements, which are almost beyond dispute, are that the processes of budgeting, financial management and financial reporting were vastly improved and took New Zealand to the frontiers of best practice internationally. The same can be said for fiscal transparency as the pioneering Fiscal Responsibility Act was implemented. New Zealand governments can no longer get away with the games that governments play when their financial systems are based only on cash

allocations for a 12-month planning period. Fiscal policies that have very long acting effects on the economy, such as pension programmes, are required to be reported to the parliament with the long-term implications of their effects numerically estimated. All contingent liabilities have to be reported to and there are even provisions for an independent fiscal report issued by the Treasury before an election campaign. Aggregate fiscal control was vastly improved, and the ministers of finance over the period of reform and subsequently have all said that the system provided them with tools that enable them to maintain fiscal discipline in the cabinet. The ratio of public debt to GDP fell from more than 50 percent to less than 20 percent over five years and the foreign public debt was all repatriated.

Whether the system improved the prioritization of public expenditure is more debatable. A study by the World Bank,³⁴ comparing five countries, concluded that Australia had been more successful in reprioritizing expenditure by observing the proportionate shifts in sector spending. This is, however, a controversial conclusion because it does not account for the fact that in New Zealand there was a vast shift in priorities caused by the removal of all the government's commercial activities from the fiscal system through the state enterprises policy and privatization.

Empirical studies of improvements in efficiency and effectiveness on a government-wide scale are almost impossible to conduct. Detailed information from particular areas of public service delivery is, however, much less elusive. The efficiency improvements in the state enterprise sector are well documented and very large. In the core state sector, a careful study³⁵ was conducted of the costs of a standard bundle of administrative services which showed that the average cost had declined by 25 per cent over the period of the reforms. The ministry of social welfare increased the volume of applications for welfare benefits that it processed by 60 percent over two years with only a two or three per cent increase in spending on administration. Managers in some areas of government made world-class efforts to apply information technology to service delivery. For example, the verification of the title to a piece of land, which once required a law firm to be paid and a time delay of a week or so, can now be done over the counter for a nominal sum. It is possible to register a company over the Internet in about half an hour of work.

These results were all achieved in the early years after the reforms and what is much more interesting today is to reflect upon the experience over the longer term and what should be learned from it. My views of what we have learned are as follows.

³⁴ Ed Campos and Sanjay Pradham, "Budgetary Institutions and Expenditure Outcomes: Binding Governments to Fiscal Performance", *World Bank Policy Research Working Paper* 1646, September 1996.

³⁵ Ian Duncan and Alan Bollard, *Corporatisation and Privatisation – Lessons from New Zealand*, Oxford University Press, Auckland, 1992.

New public management requires being very clear about roles, relationships, freedoms and accountabilities. There is much more discussion and negotiation in New Zealand than I am aware of anywhere else about these. The chairman of a Crown entity has a lot of authority over the organization, while at the same time, the minister is responsible to parliament for the effective conduct of the organization and for implementation of government policy. A wise chairman will spend some time in dialogue with the minister about what issues the government will retain control of and transparently issue instructions about, and what issues the chairman has discretion over. Critics of the New Zealand system complain that this is an expensive overhead. My own experience, and that of many Crown entity board members, is that it is a small cost with an enormous return in terms of organizational performance over time.

Similarly the chief executive of the ministry will seek to clarify with the government what are the matters that the minister will retain control of and what matters will be left to the discretion of the chief executive. The State Sector Act prohibits the minister from interfering in personnel decisions and the Public Finance Act makes the chief executive accountable for the finances in the ministry. But within these broad parameters there are still a lot of details about the respective roles of the parties that it is worthwhile to clarify.

A healthy public management system is always learning from its mistakes and grasping for new opportunities. There is a lot to be learned from the big things that go wrong that must become part of the rules and informal understandings about how people should behave in particular circumstances. The New Zealand Department of Conservation was responsible for a viewing platform which collapsed, killing 14 people. This tragedy has left behind clear messages for ministers and civil servants about how the system of accountability for performance should work in practice.

The performance of ministers is critical to any system of public management, but we have seen in New Zealand how much damage an incompetent minister can do and also how beneficial to the performance of public organizations are ministers who understand thoroughly how to conduct the role effectively. Together with every other government I know, New Zealand does not put enough effort into preparing ministers for the responsibilities they carry.

We learned in New Zealand that specifying performance requirements on public organizations can require sophistication, and this is as much art as science. As in the private sector, if you ask a manager to deliver something, you are likely to get it, so you should be careful to specify just what is the performance target you are concerned about. The same point applies to the way in which funds are delivered to public organizations in accordance with performance measures. For example, it is very common for hospitals to be paid for the number of beds that are occupied by patients overnight. It is no surprise that in countries that do this, the beds are always full even if the doctors have gone home for the weekend.

Some public services are extremely difficult or even impossible to capture in performance measures. Diplomatic services may be an example. For these it is important to be reminded that

a modern management system is not about corporals giving soldiers orders that are to be obeyed without question. Rather it is about an agreement between people at different points on a nexus of relationships in discussion about what will produce the most effective result from working together, while acknowledging their respective formal roles. It is a kind of informal contracting, and in some cases formal contracting, that is going on. If the parties can agree to what they both need to do in order that the service they produce be efficient and effective, without trying to inject concrete performance indicators with a risk of distorting behaviours, so be it. But transparency and accountability in the public sector does create an obligation to be clear about what services are being provided and at what cost, and there should be the presumption that the services will be described in a way that other stakeholders can understand.

The distinction between hard and soft aspects of management that I spoke of earlier has been shown to be important in the New Zealand case. Whereas central agencies have a natural bias towards the hard side of control and accountability, they cause damage when the way in which these necessary systems are imposed cuts across the values and culture of organizations. This can distort the behaviour of leaders towards compliance with central requirements at the expense of a clear focus on serving citizens. The central agencies in New Zealand are still trying to get this balance right and have not found it easy.

The skills, commitments and values of top management are always critical to organizational performance. New Zealand is a unique case in that a complete reform was put through the whole government in a short time period. The experiment showed that the variations in organizational performance subsequently could be attributed substantially to the skills and commitment of top management in taking advantage of their new freedoms. While the systemwide change put a floor under performance and made it somewhat easier to address performance failures, true excellence in management, where it emerged, was associated with particular gifted individuals.

Largely for this reason, it is observable that the impulse for excellence in public organizations must arise within them and cannot be forced on them from the outside. There are clear limits to how much central agencies of government can do to promote efficiency and effectiveness.

The New Zealand case also illustrates that it is a mistake to think that high capability in policy can be separated from management reform. In most important public policies, it is useless to draw a distinction between a policy and how it is going to be delivered. Governments can only have policies that they are capable of delivering and the way in which policy is delivered has major effects on results. Citizens do not care whether a bad outcome arose because the policy was flawed or because it was a good policy that was badly implemented. In my view, New Zealand has under-invested in high-quality policy analysis in some critical areas of government. Its health policies are one example, as are its defense policies.

A critical issue is how to counteract the centrifugal force that can be created by decentralization of the public management system. There has been a long debate in New Zealand about whether the reforms have undermined “the collective interests of the government”. This has been a rather

poorly defined concept, but has captured a couple issues. One concerns whether the performance incentives on managers make them less interested in acting collegially with other ministries. A related issue is how the government should develop a robust strategy to ensure that its wider policy programmes are implemented in addition to the day-to-day business of government. The first issue has a little substance, but I think it has been exaggerated. Like so many countries, New Zealand has found that the issues of the 1990s required a multifaceted response across the government that was not previously recognized. The control of the drug trade, addressing problems of families with multiple social disadvantages, thinking about economic development and social development as an integrated whole, are all examples of challenges that have arisen in many countries around the world, including those who have done no public sector reform in the manner of New Zealand. In fact there are examples in New Zealand of very successful multi-ministry responses to challenges that created what can be called a virtual ministry. In my view, the clarification and delegation of authority actually facilitates multi-ministry coordination.

There clearly is a problem, however, in ensuring that the more explicit requirements for performance placed on ministries do come together in a way that reflects a coherent policy programme overall (assuming that the government has one), and that it is integrated with budgeting and the management of performance. Another speaker on our programme, Alex Matheson, made a major contribution to this some years ago in thinking how the political and administrative officials could come together to decide on the key goals of the government in a way that promoted their successful implementation. In the late 1990s, in an attempt to bring together statements of key strategic goals for the government with a reorganization of the cabinet into subcommittees, they were to take responsibility for each one. This attempt was abandoned by the present government, which did not want to engage its officials in this way. But I am sure that something like it will re-emerge in time.

C. Developing and transitional economies

The language and concepts of the new public management and its American variant “reinventing government” have been picked up in different ways in many developing and transitional economies. Perhaps the most advanced applications are in Asia, where the dialogue and emerging practices on public management, particularly in Malaysia and Thailand, has been influenced by these developments. The metropolitan economies of Hong Kong and Singapore have been leaders rather than followers in significant respects.

More commonly in the developing world, particular techniques of new public management have been attempted, but without the wider overarching framework of performance management. The creation of British-style agencies, for example, has been quite common in Africa. Changes have been made in a large number of countries to improve the platform on which the techniques of new public management to improve efficiency and effectiveness necessarily must stand. A key one is civil service reform to create an administration based on non-political professionalism as regards both policy advice and management. Also needed is a budget and financial management system which gives local managers some degree of predictability about the resources they will

have available and the performance requirements expected of them, together with enough discretion to be able to make some improvements in service delivery. Such reforms offer the prospect of success and measures to improve efficiency and effectiveness in the longer term by creating a foundation for those measures.

The conditions for the success of new public management methods have become more clear as a wider range of countries have tried them out. Those of us undertaking these reforms in New Zealand fifteen years ago could take a lot of these as given. But developing economies typically have conditions that are not nearly so favourable to the adoption of these techniques. Hence it should not be surprising that there have been more failures than successes in the developing world. Also, the successes appear to have been particular to micro situations where conditions were more favourable, such as some city governments or isolated government programmes.

It is also important to know that new public management has not been an unqualified success in the countries where it arose. There have been some difficulties in all those jurisdictions, and I hope the case study of New Zealand that I have presented in my paper demonstrates that it can be demanding to implement and is always a work in progress.

The conditions in developing countries are typically not as favourable to this kind of public management as they were in the countries that pioneered it. All countries have informal cultural influences that partly shape public management, but the informal culture in many developing countries is particularly unfavourable to management systems based on high levels of trust in managers who have been delegated considerable discretionary authority. Patronage and corruption undermine management systems whose underlying principles are about clear accountability for results and public organizations motivated by a wider public interest.

The availability of skills can be a problem, but perhaps it is sometimes exaggerated. It is notable in the wealthier developing countries in Asia and in many transition countries, that there is no shortage of highly skilled people available to the government. But other influences in some cases cause this talent to be unable to flower into high quality advice and excellence in management. What is required is the creation over time of an enabling environment for technical skills to be applied to public management. But this can be a time-consuming challenge that may have to wait for wider political reform. From my perspective, the rush of interest in public management reform in Thailand in the 1990s had roots in the constitutional reform and the end of military government. Thailand and other countries in Asia are undergoing political transformation partly as a result of the decades of growth of a wealthy middle class, which is demanding reform away from the old oligarchic systems of government.

One of the papers at this conference raises the question of whether technical reform to public management can substitute for political reform. In my view, it can, but only in a very limited way. Public management reform creates winners and losers. The losers are those who benefit from the old system, and they are usually in very powerful positions. Measures to promote transparency can, however, be hard for the powerful to resist indefinitely, particularly when they

are being pressed on governments by lenders. Improvements in small parts of a government create demonstration effects, which hold the rest of the government to a higher standard. Major reform however must await a political mandate that is likely to be based on a political imperative in response to fiscal crisis or widespread public dissatisfaction with services. In the meantime reformers should grasp the opportunities that arise and risk making a few mistakes, as the cost of doing nothing in most developing and transitional economies is simply too high.

While the record of success in implementing measures for efficiency and effectiveness in so many developing and transitional economies is disappointing, this should be kept in perspective. Some of the attempts that have failed, as for example in Ecuador and Colombia, were highly ambitious even by the standards of the most advanced management systems. Some developing countries that I work in set expectations for the reforms that are obviously quite unrealistic even before the start. Any country should keep in mind the counterfactual of what will happen with no reform, and there is no country that can be so satisfied with its system of public management that it can afford to take no risks in trying initiatives that might not work out.

Also, one clear message from experience is that only the high-level principles of new public management shift easily between countries, because ultimately they are based on universal democratic principles about transparency and the accountability of executive government to the parliament and to the citizens as recipients of services. But how any country goes about implementing these principles is very largely determined by factors in the history, culture and current circumstances of that country.

Another conclusion that I would draw is that developing countries should not look for some universal best practice strategy for implementing performance improvement. There has been some debate internationally as to whether developing countries should attempt to implement measures for improvement in efficiency and effectiveness along lines of new public management, with a number of writers advising strongly against it. For these writers, the path of wisdom is to make the traditional system of bureaucratic centralism work properly before attempting decentralization and delegation of discretionary authority to managers. In fact, my own advice to various countries is along these lines as a general place to start a strategy from, for reasons which should be clear from my arguments in this paper. However, I am not a doctrinaire about this, as some of these writers appear to me, because in my experience, the circumstances of developing countries are so richly diverse that it is inconceivable that only one path of change lies on the path of wisdom. In some countries the central ministries are the most corrupt and the most determined opponents of reform. A strategy that involves strengthening them first before releasing power to lower levels of government would never work in such circumstances. Against this counterfactual, delegating some financial authority to service delivery organizations may be messy but still an improvement over what would otherwise occur. In many countries, local units of government and civil society organizations are more trusted than the central government and “hotwiring” around the centre to get resources directly into the field can bring improvements.

Also, while each country's path of reform will be unique to its circumstances, it seems probable that there will be a convergence in public management methods to improve efficiency and effectiveness over time. The list of problems that New Zealand was seeking to address when it began its reforms in 1985 is remarkably similar to the checklist of problems that I see in many of the countries in which I work today. It is probable that over time some of the solutions will look similar as well.

There are, however, problems in developing and transitional economies that I think can be alleviated. Too often I find solutions searching for problems and poor diagnosis of what is really causing the issues that governments need to address. I see unfocused and over-ambitious plans in some countries based on benchmarking some part of the public management system to what is thought to be international best practice. There is a fascination with gimmicks, such as the balanced scorecard model and other consultant methodologies.

In many countries, the bureaucratic leadership is deeply wedded to the status quo, and real change is simply not going to happen until those people leave office. I know countries where there are enormous cultural disincentives to promote change. In many countries it is not appropriate for junior officials to advocate reform to their superiors, and in some countries there is a strong cultural aversion to taking any personal career risk by advocating change.

While I generally think the international organizations are competent and well motivated to promote more effective government in their client countries, I have seen in some places some disastrous distortions imposed by these organizations. I have seen the game played where senior officials in a country will keep up the pretence that the government is intending to reform public management to meet a condition for the release of loan monies, when in fact there is no intention to do so.

I have never seen a reform proceed satisfactorily where there is not a strong partnership between local officials and politicians, on one hand, and their local and foreign advisers on the other. Too often I see advisers resorting to writing technical reports that no one will ever read, or even translate into the local language, out of frustration at not being able to make any substantial progress. On the other hand, I see local officials who are serious about reform but are unable to secure the kind of engagement with outside advisers that is truly going to help them achieve their goals.

D. Conclusions

In conclusion, let me reiterate three points.

First, measures to improve effectiveness and efficiency should be thought of in terms of the complete range of influences around the people delivering the services in question. This makes the design of measures that will work very specific to the situation in question. The measures for making an inoculation programme more effective will bear little resemblance to the measures to

make a primary education programme more effective. General financial management and accountability measures will not on their own ensure improved efficiency and effectiveness, although they are in most cases necessary to promote effectiveness. On the other hand, financial management and accountability systems can be devastating for effectiveness and quite commonly are.

Second, designers of government-wide systems of financial management and accountability should be aware that they could do as much harm as good and be careful to acknowledge the need to integrate the three dimensions of fiscal performance to avoid dysfunctional conflicts.

Third, while the attempts of a handful of the developed and some relatively better off developing countries to apply new public management techniques have produced some major improvements in efficiency and effectiveness, they have also created some unwanted side-effects. In all these countries major problems in substantial areas of the government persist – for example, in their health sectors. This is still work in progress, and there is a long way to go yet. With this as the benchmark, it is scarcely surprising that developing and transitional economies that have successfully applied these techniques are few and far between. The places where they have done it tend to be in specific subunits rather than government-wide. I think that advice that they should not try some variation of these reforms is doctrinaire, but provides a crucial warning to countries to be very careful about planning and implementing such reforms. In particular, there is no substitute for careful diagnosis and planning of reform and attention to the need for continuing political support for reform. Copying a best practice model from an advanced system out of context with the local circumstances is sure to fail. But doing nothing is not an option, given the dismal state of public management in so many countries.

THE ROLE AND ORGANIZATIONAL INTEGRATION OF INTERNAL AUDITING IN MINISTRIES, PUBLIC SECTOR ENTERPRISES, INSTITUTIONS AND MUNICIPAL ADMINISTRATIONS, TAKING THE AUSTRIAN EXAMPLE

by Gertrude Schlicker³⁶

A. Historical background

Internal auditing and internal control

Prompted by insufficiencies in major public sector construction projects (excessive and/or inexplicable expenses), a discussion arose in Austria in the seventies about the adequacy and effectiveness of the conventional review mechanisms employed in public administration and public sector undertakings (state-owned enterprises). The review arrangements in place, i.e. “internal audits” by public administration accounting staff as well as “external audits” by the Court of Audit, were no longer considered sufficient in view of the accounting personnels scope of duties and, where the Court of Audit was concerned, understaffing and the resulting need to confine reviews to mere test checking.

Based on the model of private sector corporate organization, internal audit functions were established at all territorial levels (federal government, provinces, municipalities) and for all types of public sector activities (public administration and public sector enterprises).

To ensure uniform structures and responsibilities, the Austrian Court of Audit examined internal auditing functions in two cross-sectional audits performed in the years 1981 and 1989. The Court of Audits recommendations were largely implemented. The newly created auditing bodies have meanwhile become an integral part of public administration.

Economic developments in recent years (budget deficits, high unemployment) have now resulted in an urgent need for public-sector budget cuts (compliance with Maastricht criteria) to restore the balance between public spending and revenues. The conventional instruments of budgetary control and staffing schedules have proven too inflexible and/or ineffective in achieving specific goals. As was done at the time when the internal auditing function was first established, efforts are being undertaken once again to adopt methods and techniques that are applied successfully in

³⁶ Austrian Court of Audit and International Organization of Supreme Audit Institutions

private sector corporate structures. Government agencies have therefore decided to introduce internal control to Austrian administrative practice as a fundamental management and control principle.

The Austrian Court of Audit welcomes the introduction of internal control (termed “controlling”) as a matter of principle, since it expects this step to result in an increased orientation of public administration towards the principles of efficiency and effectiveness. Due to the shortness of time, the Court of Audit has very little practical experience as yet regarding the actual impact of the new control mechanisms.

Differences between internal auditing and controlling

Within the context of Austrian administration, audits are understood as *a posteriori* examinations performed by bodies having no part in the procedures examined. The auditor or examiner must therefore not be involved in any way in the administrative processes to be reviewed by him. As long as an administrative process has not been completed, it cannot be audited. Audits therefore – even if following closely upon action taken – will always be post-audits and will therefore detect any inappropriate conduct only after it has been committed.

Special organizational and personnel-related measures must be taken to ensure the independence of the auditing bodies. This has a bearing, on the one hand, on their organizational integration into the administrative or corporate entity concerned and, on the other hand, on the legal status of the auditing bodies in the exercise of their duties (not subject to instructions in the pursuit of their auditing activities).

Internal auditors are typically part of the administrative or corporate organization in which they perform their reviews. Auditing bodies set up outside such administrative or corporate entities, including the Court of Audit, are called external auditors.

Regarding the term “controlling”, it must be noted that it stands neither for auditing nor checking activities. The aim of controlling is to continuously monitor and control activities in such a way that specified targets, expressed in numerical terms, are achieved or, if found to be unattainable, substituted in time by newly agreed targets. Setting targets, and monitoring and controlling their achievement, is an immediate executive or managerial task. To reduce excessive workloads, managers sometimes assign the task of monitoring and controlling target accomplishment to a special function, the controller. The controller is in a direct supporting relationship to the manager (staff function) and has no authority to engage in any management activities (issuing instructions) himself.

Both the auditor and the controller have special responsibilities in administrative or corporate organizations and therefore function outside the common organizational units. The auditor plays no part in day-to-day administrative activities, as he must examine on behalf of his employer (e.g. a minister) whether measures taken were carried out properly, efficiently and effectively.

The controller, on the other hand, is involved in day-to-day administrative processes, reports to his manager about the current status of target accomplishment, and makes proposals relating to the controlling of operations.

B. Internal auditing

Duties and tasks

In the Austrian administrative system, internal auditing is required to perform the following key tasks:

- Review of expenses and revenues for compliance with the principles of effectiveness, efficiency and economy;
- Development of proposals for rationalization;
- General monitoring of reports issued by the Court of Audit;
- Participation in issuing organizational regulations and in important organizational measures;
- Participation in awarding major contracts.

With regard to the above tasks and duties the following must be noted:

- Review of expenses and revenues for compliance with the principles of effectiveness, efficiency and economy

This task has always been the basic duty of any auditing function and by and large corresponds to the responsibilities of the Court of Audit. The Court of Audit holds the view that reviews should be based on annual plans drawn up by internal auditing, which should be harmonized with the “clients” (i.e. the minister’s, the department head’s, the company management’s) requirements and views.

- Development of proposals for rationalization

The development of rationalization schemes must be viewed in close connection with the auditing function. Basically, any criticism regarding non-compliance with the principles of effectiveness, efficiency and economy should be accompanied by proposed improvements. Based on a comparative assessment of administrative organizations, the internal auditor will be able to suggest rationalization measures. The presentation of such rationalization measures is a “complementary product” of his audit work.

- General monitoring of reports issued by the Court of Audit

The task of general monitoring of Court of Audit reports has been entrusted to internal auditing as it was assumed that this would facilitate implementation of recommendations issued by the Court of Audit. Internal auditing is to monitor “on site” the further “destiny” of Court of Audit recommendations and to contribute thereby to their prompt implementation.

According to observations by the Court of Audit, assignment of such a responsibility is problematical, however, as it forces internal auditors into a permanent solidarity conflict between their own department within the organization and the Court of Audit as an outside body. On the one hand, internal auditors do not wish to present to the Court of Audit “too bleak a picture” of their own organization, yet are committed on the other hand to their review function. The Court of Audit therefore feels that internal auditing should not be burdened with this responsibility. Nevertheless, internal auditors can and should examine from time to time if and in what manner Court of Audit recommendations are being implemented.

- Participation in issuing organizational regulations and in important organizational measures

The task of participating in issuing organizational regulations and in important organizational measures is likewise problematical, as this may compromise the status of internal auditing as a body independent of the administration. Measures in which internal auditing played a part cannot be reviewed by the same internal auditors at a later stage. The reason given for entrusting this task to internal auditing is the expected benefit to be gained from the wealth of experience gathered by the auditors in the course of their work.

The Court of Audit believes that internal auditing should be very careful in exercising this function, to avoid becoming involved in the “day-to-day” business of the entity. Also, precise parameters for participation would have to be specified to prevent internal auditing from being blamed unjustly for undesirable developments that may occur later in the process.

- Participation in awarding major contracts

The Court of Audit considers this participatory activity a major threat to the independence of internal auditing. It completes the transition from *a posteriori* audits to concurrent audits. Internal auditors are directly involved in a decision-making process that has not been completed or may not even have started yet. Court of Audit reviews have moreover shown that participatory activities by internal auditors are always performed under enormous time pressure and tie up considerable manpower, leaving very little time for the pursuit of auditing procedures proper (*a posteriori* auditing).

The reason why internal auditing was to participate in the awarding of major contracts was the

fact that inappropriate handling of contracts had been a major reason for establishing the internal auditing function. Apart from that, it had always been considered a major weakness of purely *a posteriori* audits that they were only “identifying” but not “preventing” irregularities.

The Court of Audit feels that the best solution would be to entrust the task of concurrent auditing to a function other than internal auditing. If it should still be assigned to internal auditing, the scope of such concurrent audits should be limited to a minimum, i.e. to mere test checks. Furthermore the procurement contracts to be inspected by internal auditing should be specified, along with the facts to be specifically examined. Internal auditing should furthermore have the right to perform in-depth *a posteriori* audits of complete contract-awarding procedures even in cases in which *a priori* test checks had been performed previously.

Organizational integration

The internal auditing function should be positioned as close to the management function as possible. There should be no intermediate management tier “interfering with” the direct reporting relationship to the “client” (minister, department head, company management). It would also appear important not to allow any areas to be exempt from audits, thereby ensuring that internal auditing is responsible for auditing the entire administrative or corporate organization.

The reality of Austrian administrative practice differs slightly from this rule, since for reasons of manpower utilization and creation of an undisturbed “zone” for department heads, particularly in ministries, internal auditing has been integrated into the so-called corporate policy division. The corporate policy division is responsible, as a rule, for the management of internal services including personnel, budgeting, EDP systems, facilities management, etc. These areas are of course key targets in any internal audit, as the general efficiency of any administrative or corporate organization is directly dependent on the proper management of its infrastructure. Internal auditors, being part of the corporate policy division, will therefore never be truly independent in their audits, as the leader of this organizational unit will of course try to have findings that are unfavourable to him presented in a better light. Since it is he who allocates resources (personnel and funds), he will usually succeed in having his wishes and views accepted.

It is therefore a key concern of the Court of Audit to ensure that internal auditing is indeed placed close to management and enjoys far-reaching independence in terms of both organization and personnel.

Human resources

When internal auditing was first introduced into public administration, no experience was available regarding the manpower and auditors’ qualifications required in this area. One had to rely therefore on private-sector experience, where staffing levels were found to vary substantially

with company size and type of industry. The highest staffing ratios found were about 7 auditors per one thousand employees. Auditors were moreover often recruited from within the company and had often studied business economics.

Austrian administration is always criticized for being overstaffed. The first thing that any new government therefore plans to do is to reduce the headcount and deploy staff more effectively. The chances of providing internal auditing with sufficient manpower were therefore slim from the very beginning. Occasionally, the problem kept being “postponed” by arguing that the important step had been to create the function and that the required staff would be found sometime in the future. Another solution used was part-time arrangements, under which responsibility for internal auditing was assigned to an individual in addition to other duties.

Another problem has been the lack of training facilities for systematic basic and in-service training. While Austria's Federal Academy of Public Administration is a high-quality training institution for civil servants, it had not been prepared in time for its new task when the internal auditing function was first introduced.

After several years of internal auditing activities, we now find that we are still unable to assign a reasonable number of auditors to each internal audit. The situation is exacerbated by a shortage of supporting services (typists and auxiliary personnel). The staff of auditors now comprises university graduates (lawyers, economists) and secondary school graduates holding the Austrian equivalent of “A-levels”. The principle that auditors should, as a rule, be recruited from within the organization and should be available full-time (with no additional duties) is now widely recognized. Nevertheless there is still some room for improvement.

Where training and uniform internal auditing standards are concerned, the approach of establishing, from the very beginning, an internal auditing coordinating office within the federal administration, at the Federal Chancellor's Office, has proved very effective. It addresses the subject of internal auditing methods and arranges meetings at regular intervals to promote exchanges of know-how and experience.

C. Controlling

As already set out at the beginning, the introduction of controlling into Austrian administration is still a relatively recent development. In order to identify suitable approaches, a steering group has been set up, consisting of representatives of various government departments and Court of Audit nominees. As a first project, the group decided to study benchmarking methods used in other countries' public sectors. Suitable models were found particularly in the OECD area. They are examples of how benchmarks can be defined as instruments of control for practically all public administration tasks.

As a next step it is planned to appoint an external consultant to investigate quantitative activity reporting methods already in operation in departments with a large number of subordinated

agencies, as e.g. Finance, Justice, Social Affairs, Agriculture and Forestry (e.g. data on the number of notifications issued and processing times in comparable organizational units). With a view to the development of a controlling function, these data will have to be studied to determine whether they can be used in the development of benchmark standards. Such an approach appears feasible, as these departments already have voluminous records. As a next step, the procedure should be extended to cover all departments in an effort to describe the services (products) provided by public administration by reference to uniform benchmark standards. Such a comprehensive catalogue of services would then be the basis on which targets might be set (e.g. quantitative increase in action completed) and monitored and controlled by an internal control system.

One thing, however, should finally be made clear once again: internal auditing and internal control are two entirely different functions serving different purposes. This should also be reflected clearly within the organization by segregating these two functions and refraining, for example, from entrusting internal auditors with internal control tasks. Within the scope of its responsibilities, however, internal auditing will of course also have to review, as part of its duties, the organization and effectiveness of the internal control function.

THE ROLE OF THE ITALIAN SUPREME AUDIT INSTITUTION IN COMBATING CORRUPTION AND MISMANAGEMENT, PERFORMANCE AUDITING, AND THE PRIVATIZATION PROCESS

by Giuseppe Cogliandro³⁷

A. Supreme Audit Institutions: differences and similarities

The “Supreme Audit Institutions” are the public institutions which carry out the external audit of the administrative and financial management of a State or an international organization, independently of the executive branch.

According to Intosai (*International Organization of Supreme Audit Institutions, the Lima Declaration of Guidelines on Auditing Precepts, Preamble, 17/26 October 1977*), the purpose of the external audit is to ascertain the proper and effective use of public funds, sound management, and the administrative propriety and public accountability of the authorities through the publication of objective reports.

There are two models of Supreme Audit Institutions: the “Court of Auditors” model (*Corte dei Conti* in Italy, *Cour des Comptes* in France and Belgium etc., *Chambre des comptes* in Luxembourg; *Tribunal de Cuentas* in Spain; *Tribunal de Contas* in Portugal, *Elenktiko Sinedrio* in Greece, *Bundesrechnungshof* in Germany; *Rekenkamer* in the Netherlands; etc.) and the “Audit Office” model, typical of the Anglo-American systems (*National Audit Office* in the United Kingdom, *Comptroller and Auditor General* in Ireland, the *General Accounting Office* in the United States of America, etc.).

The difference between the “Court of Auditors” and the “Audit Office” models is important, but should not be overemphasized. While it is true that the Supreme Audit Institutions configured as “Audit Offices” are not vested with judicial functions, the contrary does not apply. In other words, not all the external auditing institutions which are called “Courts” or “Tribunals” or “Chambers” exercise judicial functions either. Some do (for example Belgium, France and Italy), but not all. In particular, the European Union’s Supreme Audit Institution has no judicial powers at all. The distinction between these two models is not therefore based on their functions, but on their structure: a Court of Auditors delivers a collective or joint ruling, while a single auditor performs this task in the case of an Audit Office.

³⁷ Italian Court of Auditors

At all events, even a “Court of Auditors” that is vested with judicial powers and functions generally shares a number of the basic auditing powers of the “Audit Office” type bodies (accountability, auditing accounts, internal audits etc.), common general principles (independence, competence and due diligence), auditing procedures (programming, verifying the reliability of internal audits, etc.) and criteria for drafting reports (Intosai, *Normes de contrôle*, June 1992).

B. The relationship between the administration and auditing

A system for scrutinizing public finances comprises both variable and invariable components. The *variables*, namely, the changeable features of the audit, which differ from one State to another, stem from the fact that the external auditing system depends on the type of public administration department on which the audit is conducted. Administrative systems comprise a variety of different government departments or administrations, each of which comprises various component parts. If the administrative system is to function at its best, spending little, the combination of all these elements must be consistent within each individual department of the administration, and the administrative system as a whole must be consistent with the external auditing system.

From this point of view, it is the administrative system that conditions the external audit system. This is evidenced from the fact that every time the functions of an administrative department change, these changes affect its external auditing system.

The relationship between the administration and auditing is not, however, a one-way affair. Auditing is not merely a peripheral terminal on the “receiving end” of the work of the administration. It is also a “carrier”, which influences the administration itself.

But external auditing systems not only have variable components, depending on the type of administrations with which they are dealing, but a number of invariable features. These are general, commonly shared features, regardless of the economic situation, the political régime or even the structure of the audit institutions themselves. For, as we have already seen, the auditing systems, whether configured as a Court of Auditors or an Audit Office, also possess common features that they have acquired by osmosis at the international level, through the work of Intosai or the scientific community.

Hence the need to examine briefly the structure and the development of the Italian administrative system before moving on to address the issue of auditing.

C. The reform of the Italian administrative system

In the decade 1990-1999 the Italian administrative system (comprising the central government, the regional governments and the local authorities, schools, universities and non-economic public entities at the national, regional and local levels) was radically revamped.

The reform was very far-reaching in terms of its magnitude and method. As far as its scope was concerned, there was a transfer of central government powers to the lower tiers of government without precedent in the administrative history of Italy. The method adopted reflected the organic character of the reform. For it involved a systemic rethinking of every aspect of government (functions, organization, procedures, budgets, personnel management and auditing) in the pursuit of greater effectiveness and improved efficiency.

In particular, the reform involved the following:

- Central government shed a number of its public functions, some of which were abolished altogether (the abolition of licences and authorization to perform private activities, the abolition of environment programmes, etc.) while others were relegated to the private sector (e.g. the testing of vehicles or vehicular devices was henceforth to be carried out authorized private firms). Other areas in which central government intervention in the economy was reduced were connected with the privatization process, about which more will be said below;
- The devolution to the regional governments (the second-tier entities, which also have legislative powers) and the local authorities (provincial and municipal authorities possessing autonomous powers in respect of the central government and regional government tiers) of all functions and all administrative tasks relating to local matters of interest and of relevance to their respective communities, with the sole exclusion of any subject matter explicitly reserved to central government authority, such as foreign affairs, justice, defence, the armed forces, law and order and policing, currency, the protection of cultural property and environment, and immigration. These were devolved originally by Law No 59 of 1997 and more recently with the Constitutional Law (Law No 3 of 18 October 2001). Greater autonomy was also devolved on other branches of the public administration (in particular the universities and schools);
- The introduction into public administration departments of the principle of separating policy-making from administration. The policy-making authority (the minister, the president of the region, and so on) sets the objectives and the priorities, issues instructions, allocates resources and audits the results; the executive officers have been given the maximum independence over administrative and financial activities. They take all the decisions, including those committing the administration in its external relations, regarding the management and organization of the offices and personnel relations, the use of capital resources, and auditing. They are therefore exclusively liable for the result of their work;

- The reorganization of the central government departments and agencies and of national public corporations and entities, based on the principle of administrative federalism and the criteria of rational organization and the need for prompt and timely administrative action;
- The restructuring of the central government budget, consistently with the demands of financial management by objectives;
- The radical overhaul of human resource management, to encourage the pursuit of effective and efficient management;
- The reform of the assessment and auditing system, according to the guidelines that are discussed below.

D. The Italian Court of Auditors: origins, functions, organization, powers

The Italian Court of Auditors has very ancient roots, in that it was instituted under Law No 800 of 1862 immediately after the founding of the Italian State (1861). From the outset, the Court of Auditors was given an independent status, which was subsequently enshrined in the 1948 Constitution. The court was guaranteed its independence by giving its members the status of judges, vested with specific prerogatives. They could not be removed or transferred without the binding opinion of a commission made up of the Speakers and Deputy Speakers of the Senate and the Chamber of Deputies. The promotion of judges was also to be decided by the central government, acting on a proposal submitted by the Court of Auditors itself.

The purpose of this guarantee was to enable the Court of Auditors to audit government activities in complete independence. Its scrutiny must cover all the decrees issued by the government (except political decrees such as the convening of the Houses of Parliament, and the appointment of senators), and all other acts authorizing expenditure in excess of a given ceiling, as well as all orders of payment.

The Court of Auditors' auditing operations were designed to ensure that the acts examined were compliant with the law, and the audit was conducted *a priori*. This auditing model (which is still current today, albeit on a smaller scale) comprises two elements: the judgment ascertaining that an act is compliant with the law, and the "measure" in which the result of the judgment is expressed, which takes the form of a clearance stamp. If the judgment is favourable, in other words if the auditors declare that the act is in compliance with law, the measure is cleared (the clearance stamp is issued); if the judgment is negative, in other words, if the auditors declare the act to be noncompliant with the law, the measure is rejected (clearance is refused).

The audit concludes by physically placing a stamp on the document, indicating the grant or the

refusal of clearance. In the first case, the act has legal effects and can therefore be implemented and acted upon; in the second case, the acts has no legal effects, and cannot therefore be acted upon. The characteristic feature of this audit model is that it interferes with administrative activities, in the sense that the Court of Auditors can hold up the act subject to audit, preventing it from producing any effects.

To overcome the hurdle raised when the Court of Auditors refuses clearance, there is only one remedy: the government must decide to request the Court of Auditors to grant conditional clearance. However, in this case, the Court of Auditors is empowered to notify Parliament of the list of government requests for conditional clearance. The purpose of this report is to enable Parliament to scrutinize the work of government in relation to its acts which the Court of Auditors deems to be noncompliant with the law.

The powers to conduct an *a priori* audit to ensure statutory compliance of government acts are not only vested in the Court of Auditors over central government acts, but also in the other audit bodies which are responsible for scrutinizing the regional governments and local authorities. In the 1990s this audit model was, however, considerably downsized. It was in that period, too, that “performance auditing” was introduced, as we shall be seeing shortly.

Since its inception, the Court has always audited tax collection and the management of state assets. This is not done by appending a clearance stamp to the actual papers, but by monitoring.

Another power vested in the Court of Auditors by the 1862 Act is to scrutinise the Report on the central government accounts. The purpose of this audit is to see whether the data stated there on revenues and expenditures, and the data on State assets, tally with those stated in the accounting records. According to its performance audit programme, which was adopted in October 2001, the Court of Auditors must also carry out random sampling tests to ascertain the accuracy of the data in terms of the legality of the operations underlying them, using the same methodologies as those employed by the European Union’s Supreme Audit Institution.

The audit conducted by the Court of Auditors ends with the issue of a judgment certifying the regularity of the accounts. This decision is then forwarded by the Court to Parliament, together with its Annual Report on the central government report, containing critical comments on the way in which financial resources have been managed, together with any administrative or legislative proposals that might be adopted to improve performance.

These Annual Reports, which are drawn up by the Court of Auditors in joint session, also include assessments of public policies regarding the whole of the public administration, taking account of the remarks made by each individual audit division of the court.

In addition to its auditing work, the Court of Auditors also provides consultancy services and exercises judicial functions. Its advisory functions consist of powers to express opinions on draft legislation regarding public accounts or on the functions of the court itself. The court also gives

evidence to Parliament regarding the annual public finance measures set out in the budget. The judicial functions of the court are dealt with below.

The Court of Auditors performs its functions by handing down final decisions taken by a panel of judges. Its auditing work is carried out through the following Divisions (*Chambres...*):

- the Central Division for controlling the legitimacy of government acts and those of other central government administrations;
- the Central Division for controlling the performance of central government departments;
- the (central) Division for auditing local government (vetting the overall performance of the regional governments and local authorities);
- the Division controlling the performance of non-state-owned public corporations and entities;
- the (central) Division auditing financial relations between Italy and the European Union and other international organizations;
- Regional Audit Divisions. These divisions are set up in each region. Each one is responsible primarily for *a priori* scrutiny to ensure the legitimacy of the acts adopted by local branches of central government (but not of the regional government, for which a different body is responsible: the State Audit Commission). It also carries out *a posteriori* performance auditing of the regional governments, local authorities, universities and other public institutions in the region. When conducting performance auditing, the Regional Divisions must take account of the instructions issued by the Central Divisions and the Joint Session of Divisions;
- Joint Session of Divisions, composed of judges from the various Divisions. These are responsible for taking final decisions or more important decisions than those adopted by individual Divisions.

A bench of at least three judges sit on the Regional Divisions; generally speaking, the Central Divisions have a bench of 11 judges; but the Joint Session of Divisions has a bench of at least 15 judges.

A similar organizational setup also exists for the exercise of the judicial functions of the Court. The other important organs of the Court of Auditors are the President (who lays down the general policies for its administrative work) the General Secretary (who manages the administrative structure) and the President's Council (the Bureau, comprising the President, the judges elected by their colleagues and representatives of Parliament, with powers regarding

disciplinary measures and other measures relating to the functions of the judges). The Court of Auditors has its own budget, organizational autonomy and independent powers to manage the resources allocated to it out of the central government budget adopted by Parliament.

In performing its auditing functions, the Court of Auditors may request any document or information from any government department and their internal auditing bodies, and may carry out on-site inspections and checks. It can also delegate certain operations to civil servants, and call on outside technical consultants. It can also require government departments to review their acts (other than those subject to prior constitutionality control); after re-examining them, the departments concerned return the acts to the Court of Auditors which, if it deems them to be noncompliant with the law, may inform the senior authority of the department.

Lastly, it may request the Constitutional Court to rule on the constitutional legality of an Act of Parliament or on a conflict of powers between the Court of Auditors and another organ of the State. This is the most important power vested in the Court, and is therefore dealt with separately in the following section.

E. The power of the court of auditors to refer cases to the Constitutional Court for judgment

The Constitutional Court is responsible for ascertaining the constitutionality of Acts of Parliament. It is composed of 15 members, of whom one-third are appointed by the President of the Republic, one-third by Parliament and one-third by the Supreme Courts in the land (the Supreme Court of Cassation, the “Council of State” as the Supreme Administrative Court, and the Court of Auditors). When the Court declares an Act of Parliament unconstitutional, the Act loses its effects on the day following publication of the judgment.

The purpose behind a judgment of constitutionality is to safeguard the paramount public interest of ensuring the certainty of the law (which would be undermined by any doubts regarding constitutionality) and naturally on the principle that the Constitution must be observed. Hence the need to ensure that the courts are not obliged to enforce a law when grounds exist that cast doubt on its constitutionality; in such cases, they must stay proceedings and refer the matter to the Constitutional Court for a decision to be taken.

For a judge to raise an issue of constitutionality, two conditions must be met: there must be a hearing presided at by the head of a judicial body, and the court must be exercising its powers to objectively apply the law. In no instances may the Constitutional Court rule in the abstract, but only on specific factual situations.

As already mentioned, the Court of Auditors also has judicial functions. Like any other court it can therefore raise issues of constitutionality. However – and this is one very important aspect – this same power is also vested in the Court of Auditors when it is performing an audit. In judgment No 226 of 1977, the Constitutional Court ruled that the Court of Auditors is lawfully

empowered, when performing its auditing functions, to institute proceedings leading to a judgment of constitutionality.

Even though the proceedings before the Court of Auditors is not a “trial” in the true sense of the term, the *a priori* audit carried out by the Court of Auditors is similar to the performance of the court’s judicial functions because it consists of ascertaining that an act is statute-compliant by the rigorous application of juridical criteria, acting in wholly neutral capacity. For the Court of Auditors is considered to be one of the Supreme Courts in the land, vested with the widest degree of independence guaranteed by the Constitution. For this reason, none of the judgments handed down by the Court of Auditors when performing its auditing functions may be appealed before a court of law.

When the act examined by the Court of Auditors to ascertain its *a priori* legality is a central government regulation, any question of its constitutionality raised by the Court on the ground that it infringes article 81 of the Constitution guaranteeing the financial equilibrium of the State (according to this provision of the Constitution all acts of Parliament authorizing expenditure must also indicate the way in which that expenditure is to be covered) it stays the publication of the regulation, suspending it from coming into operation until the Constitutional Court has passed judgment on it (section 27 of Law No 340 of 2000).

When the Court is conducting an *a posteriori* audit, it can also refer a question of conflict to the Constitutional Court in relation to the act of another branch of government (central government, Parliament, regional authorities) in the defence of its prerogatives (Constitutional Court, Judgment 457 of 1999).

F. Scrutiny by the Court of Auditors of internal audits

It is now common practice for every organization, public or private, to have an internal auditing body when it exceeds a certain threshold of complexity, to provide reasonable certainty that the operations are conducted properly, effectively, economically and efficiently.

In particular, the task of an internal auditing body is to monitor the management of the administration’s financial resources; identify critical points in the management (errors, irregularities, fraud, violations of the law, failure to achieve objectives, waste, inefficiency, diseconomies, etc.); analyse the causes and the allied responsibilities and liabilities; and suggest corrective measures to the senior management bodies to improve the performance of the department in question.

This new perspective changes the purpose of the external audit. It is no longer (only) a matter of directly inspecting documents on the spot, at the premises of individual government departments, but (above all) a matter of examining the way in which the internal auditing system of the various government departments function, in order to ensure that they are reliable (in other words that they are able to identify the critical points in the management, in order to enable the

administration to correct any shortcomings) and in that case suggesting the adoption of any measures that are necessary to improve the functionality of the internal auditing system.

It follows from the rationale of the system that the Supreme Audit Institution must draw up the programme for its inspections based partly on its assessments of the internal audits, increasing the number of inspections carried out on the departments whose internal audit bodies are either nonexistent or weak, and omitting or reducing the inspections of the departments where the internal audit bodies are reliable.

Italian legislation has also adjusted to these principles. Section 3 of law No 20 of 1994 makes provision for the Court of Auditors to request documents and information from the internal audit bodies and to ascertain the way they function, notifying Parliament of the results of its inspections. The Regulation of the court, adopted on 16 June 2000, adds that the schedules drawn up by the Audit Divisions must contain methods for analysing the way in which the internal audits are performed in order to check their operations and draw up guidelines on this basis for scheduling its subsequent auditing and inspection activities.

Internal audit was introduced into Italy by a provision of Legislative Decree No 29 of 1993, which made it mandatory for all government departments to institute internal audit bodies with the task of ascertaining the attainment of objectives, the sound and cost-effective management of public resources, the impartiality and regularity of the administration, and to conduct comparative appraisals of costs and results.

This provision was subsequently amended by Legislative Decree No 286 of 1999, which created four different internal audit bodies, to perform the following tasks:

- To ascertain the legality, regularity and soundness of administrative action by auditing acts and carrying out inspections;
- To check the effectiveness, inefficiency and cost-effectiveness of the administration's work in order to optimize costs and results, also by promptly introducing corrective measures;
- Ascertaining consistency between the statutory missions of the administrations, the objectives set by the minister in the annual directives for the performance of administrative work, the operational decisions taken by the managers, and the distribution of human, material and financial resources;
- To assess the performance of the managers.

G. The role of the Court of Auditors in combating corruption and financial mismanagement

The Court of Auditors plays an important part in combating corruption and financial mismanagement in three ways: by monitoring the way in which internal audits are conducted, auditing Government acts, and exercising its judicial functions. The first of these has already been illustrated above. The rest of this section deals with the other two.

We have already said that, from the outset, the Court of Auditors was always responsible and still is, although to a more limited degree now, for the *a priori* monitoring of compliance with the law of virtually all the measures adopted by the central government and state public administration departments. This audit model has two drawbacks.

It is mostly performed before the act is implemented (because the purpose of the *a priori* audit is to see whether or not the act may be enforced or implemented). Firstly, this hampers the smooth running of the public administrations (particularly in the past when central government departments were subjected to two audits, one by the Ministry of the Treasury and then one by the Court of Auditors).

It also weakens responsibility: the civil servant loses the responsibility for solving the problem for which the act is designed, once it has been submitted to the audit body. This problem is addressed if and when the act is recognized as being compliant with the law by the auditors, and is subsequently returned bearing the clearance stamp.

The reform of the audit system has considerably reduced the number of acts subject to this type of audit. This cut-back has particularly affected the acts of the regional governments and local authorities. For now the audit is only required for a few regional and local regulations, and regional acts relating to Italy's membership of the European Union, and the accounts of the local authorities. But even this audit is bound to disappear eventually as a result of transferring functions from central to local government under the devolution of powers.

A priori audit to ascertain statutory compliance of government acts was (and still is) pyramidal and hierarchical in structure: there is one body provided by the Constitution for the Central Government departments (Court of Auditors), central government organs for the regional governments, one regional government organ to audit the local authorities.

This audit model was designed in the previous century, consistently with the idea of the traditional State based on a centralized system of public finances and a centralized civil service. But this is not very compatible with the present organization of the State, in which the public finance system is polycentric and above all with an administrative system that has now been redesigned along federal lines, as indicated earlier.

In other words, it is contradictory to vest the regional and local authorities with all the functions and administrative tasks relating to the territory within their jurisdiction and the interests of the local communities which were previously exercised by centralized public agencies, and then restrict their sphere of independence by imposing petty and highly detailed procedures to control them.

In terms of volume, too, the number audits carried out by the Court of Auditors of central government departments' acts has also been drastically reduced from over two million acts that were previously subject to audit before the reform to only a few hundred today. As far as the management of financial resources is concerned, under the aforementioned Law No 20 of 1994, the audit is required for contracts entered into by central government entities involving amounts exceeding a certain ceiling, measures relating to state-owned assets, changes made to the central government budget and, generally speaking, all the acts which the Prime Minister or the Court of Auditors consider to require prior auditing because they refer to sectors in which the ex-post audits tend to reveal widespread and repeated irregularities.

However, the 1994 Act extended the powers of the Court of Auditors over central government acts. For the Court is responsible for auditing measures issued as a result of resolutions adopted by the Council of Ministers (the Cabinet); government acts regarding directives for the performance of administrative activities, the appointment of executive officers to the civil service and setting personnel levels; normative acts of central government with external effects; programming acts involving expenditure; acts implementing rules of the European Union, and central government acts determining the distribution or allocation of financial resources.

A further instrument used by the Court of Auditors to defend the legality of the work of central government departments is the exercise of its judicial functions regarding the regularity of the accounts submitted by the treasurers, appeals regarding civil and military pensions partly or wholly paid by the central government and, above all, the administrative liability of civil servants or administrators who have caused financial/economic loss and damage to public administrations by violating their service obligations.

Generally speaking, for any such loss and damage, civil servants in other countries are liable for disciplinary action. But in Italy, civil servants and administrators are liable to make good any loss and damage, before a special Court set up by the Court of Auditors, and are sued by a special Public Attorney's Office called the "Procura", at the Court of Auditors.

Administrative liability consists of the following:

- The existence of loss or damage which is financially quantifiable, even if it is caused by a different government department to the one to which the civil servant belongs;
- Deliberate intention to cause the loss or damage;

- Civil servant status;
- A causal linkage between the civil servant's action and the loss or damage caused.

The other principles governing administrative liability are: liability is personal, even though it is possible to sue corporations; liability cannot be passed on to the heirs of the civil servant, save in the case of unlawful enrichment and the consequent unlawful advantage or benefit enjoyed by the heirs; the right of the Court to reduce the amount of damages to be paid; the obligation on the Court at all times to take account of the benefits to the administration or to the community of citizens affected; exclusion of any liability on the part of holders of political office who, in good faith, have approved or authorised acts falling within the sphere of competence of the administrative or technical officers concerned; the prohibition on the Court of Auditors to rule on any discretionary choices made by the civil servant; the fact that the right to damages is statute-barred after five years; the fact that the government departments to which a liable civil servant belongs is required to pay all costs and damages in the event that the defendant is cleared of any liability.

In every region there are Regional Divisions of the Court of Auditors which are responsible for judging the liability of public servants within the territory of the region (and in other cases regarding accounts and pensions). The Regional Courts have a Regional Procurator, acting as a "State Attorney" (Pubblico Ministero) who is responsible for instituting proceedings for financial loss and damage occasioned to public administrations. Appeals may be filed against judgments handed down by the Regional Divisions before the Central Divisions.

One specific initiative to combat public financial fraud was taken this year in May by the Court of Auditors in cooperation with the Supreme Audit Institutions of Germany, the United Kingdom, Spain, Portugal and the European Union, and with the other courts and institutions in those countries. It was carried out within the framework of the European Union's Grotius Programme, which is designed to encourage the exchange of information and methods between judicial officials within the framework of judicial cooperation provided by the 1992 European Union Treaty.

H. Performance auditing by the Court of Auditors

In addition to carrying out *a priori* audits of certain acts of central government departments, under Law No 20 of 1994, the Court of Auditors also carries out performance audits which consist of appraising the results of the performance of a given department using its financial resources and the assets, in terms of the principles of effectiveness, efficiency and cost-effectiveness.

This audit can also be carried out before the end of the financial year on the accounts and the

assets of all departments of the public administration and the funds paid to Italy by the European Union. For the Regional Governments, performance auditing is restricted to ascertaining whether they have achieved the objectives set out in the laws of principle and the programme laws.

The Court of Auditors appraises compliance with law of the operations performed and the internal audits. It also ascertains that the results meet the statutory objectives, and may draw on the results of other audits and inspections; it conducts a comparative appraisal of the costs, the procedures and the timing of the administrative operations; it draws up annual programmes and benchmark criteria for the audit; and at least once a year it reports to Parliament and to the Regional Councils on its findings; it can submit comments to the administrations which must notify the Court of what measures they have taken consequently.

The Reform Act did not change any of the previous rules regarding the need for the Court of Auditors to submit reports to Parliament. The Court therefore continues not only to report on the general performance of the public administration departments, but also on specific issues, such as university education, primary schooling, and pensions and cost of civil servants. The Court also provides four-monthly reports on the financial coverage of spending laws.

A comparison of the internal audit and the performance audit shows both similarities and differences. The similarities refer to the purposes of the audit (to improve the performance of the administrations) and the criteria for assessing the results (effectiveness, cost-effectiveness and efficiency). The differences are substantial and there are many of them. Here reference will only be made to the structure (multiple for the internal audit, unitary for the Court of Auditors' audit), the position of the office (internal and external to the government department, respectively), the rank of the audit body (the internal audit body is subordinate to the management body, while the Court of Auditors has total constitutionally guaranteed autonomy), the functions (the Court of Auditors' functions are wider, because they are also judicial), the subject matter (internal audit only refers to the one government department, while performance auditing covers all departments of the public administration), the recipients of the report (for the internal audit, the management body of the department concerned; but the report of the Court of Auditors is submitted to Parliament).

It is precisely because of the marked differences between these methods of appraisal that the reform was based upon the criteria of close synergy. For the system comprises the following: *a priori* and *a posteriori* audits (the fewer *a priori* audits are offset by increased *a posteriori* audits); ensuring statutory compliance and auditing the results; checking the acts and auditing the activities; internal audit and external audit.

Some regional governments have challenged the constitutionality of these audits, alleging a possible infringement of Law No 20 of 1994, which provided constitutional rules guaranteeing the autonomy of the Regional Governments. However, the Constitutional Court (in Judgment No 29 in 1995) ruled that Law No 20 was not unconstitutional, because the performance auditing conducted by the Court of Auditors was intended to meet fundamental constitutional interests,

and that being the organ of the State responsible for protecting the objective interests of the public administration, the Court of Auditors plays the role of an impartial guarantor of economic and financial equilibrium and, in particular, of the proper use of public funds in terms of effectiveness, efficiency and cost-effectiveness.

According to the audit programme, which was approved by the Joint Session of the Divisions of the Court of Auditors in October 2001, the performance audit is carried out in accordance with the following criteria:

- The financial audit, being the first phase which is necessary for all performance auditing operations, is conducted on the basis of the benchmark parameters laid down by the European Court of Auditors and the principles of corporate accounting;
- The government departments concerned are entitled to make representations to the Court of Auditors up to the phases preceding the rulings issued by the Court;
- The programmes approved by each individual Division of the Court of Auditors must lay down timescales within which all the various phases of the audit must be completed;
- Monitoring instruments must be used to ascertain how far the observations of the Court have been taken on board by the administrations concerned;
- Duplication, interference or overlapping in the period during which the programmes are draughted must be avoided;
- Comprehensive assessments of the performance of public finance using the indicators drawn up by the European Union must be used.

I. The appraisal by the Court of Auditors of the privatization process

During the last decade of the 20th century, in Italy a major privatization process was carried through, which changed the autonomous administrations into public economic entities, and changed state-owned corporations into joint stock companies, abolished a number of public agencies and vested their activities in joint stock companies, assigning the ownership of state-owned corporations to the private sector.

The Court of Auditors reported on this process to Parliament in the General Report on Central Government Accounts for 2000.

The privatization programme approved by the Treasury in 1998 was designed to pursue the following objectives:

- To contribute towards reducing the public deficit;
- To increase the dimensions of the Italian stock market;
- To attract direct foreign investment;
- To improve competition between companies.

According to the Court of Auditors, in the period 1996 – 2001 February, 82.5 billion euros had been raised by all the privatizations taken together. In addition to this, there were also the debts and liabilities that had been transferred from certain privatized public corporations to their purchasers, equivalent to over 1 billion euros, bringing the actual grand total to 94 billion euros.

Between 1993 and 2000, the privatizations carried out generated revenues which exceeded the gross domestic product by 1.15 per cent, which contributed to the ongoing process of reducing the public deficit. Italy's results were better than those of other European countries that had undergone a similar process.

One positive effect was also the widespread practice of equity investment among the general public. The overall percentage of Italian families' investment in shares and equity units rose from 21 percent in 1996 to 31 percent in 1999.

Another positive effect is the way in which the stock market has developed. The aggregate capitalization of Italian listed companies, according to the Treasury, rose from 89.4 billion to 818 billion euros.

J. Conclusions

The Italian Court of Auditors, until very recently, had always given pride of place in its work to ascertaining the administrative and financial legality of the work of government departments. To do this, it was vested with powers and responsibilities which other Supreme Auditing Institutions very rarely have.

When carrying out *a priori* audits of compliance with law, it has the power to block important acts of Government (regulations, programming acts involving expenditure, acts allocating or distributing financial resources, directives for the performance of certain administrative actions) and can prevent them from being implemented.

It also has the functions of a special Court to try cases of administrative liability (on the part of administrators or civil servants who have caused economic/financial loss or damage to the public administration) and in the other areas mentioned earlier.

As a Supreme Court, it elects one member of the Constitutional Court, to which it may refer cases when there are doubts regarding the constitutionality of the particular law or when it considers that an Act of Parliament or any act of central government or a regional authority infringes its prerogatives.

It gives evidence before the Parliamentary Committees regarding its assessments of central government budgetary measures. It must also submit its opinions regarding draft legislation affecting its functions or having to do with public accounts. Lastly, it submits four-monthly reports to Parliament on the financial coverage of expenditure laws.

The reform of the auditing system carried out in the 1990s as part of the broader reform of the public administration reorganized the auditing system in three directions: it reduced the number of acts subject to *a priori* audit, it introduced the general internal auditing system, vesting the Court of Auditors with the power to carry out performance auditing in all departments of the public administration.

In order to perform its new and complex functions, the Court of Auditors has decided to use the performance auditing methodologies drawn up by the European Union Supreme Auditing Institution. It also has its own specialized structure for training judges in the use of these new auditing instruments and tools. Lastly, in order to improve its own performance, it may also recruit as judges (in addition to lawyers, following a long-standing tradition) economists and statisticians, and call on the consultancy services of external experts who are particularly highly qualified.

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Part III:

Transparency and Accountability

FISCAL TRANSPARENCY AND ACCOUNTABILITY: IDEA AND REALITY

by Arigapundi Premchand

“The rule of the many, on the other hand, has, in the first place, the fairest of names, to wit *isonomy* (perfect equality of all civil and political rights – emphasis added) and further it is free from all those outrages which a king is wont to commit. There,..., the magistrate is answerable for what he does and measures rest with the commonality.... Again, in a democracy, it is impossible that but there will be malpractices.

Herodotus, *The Histories*

A. Introduction

Fiscal transparency, reflecting a system of well-organized windows on public policy-making and policy-implementation, is not an end in itself, but is a means contributing to effective and comprehensive accountability that aims at securing full answerability from governments and their officials. Both these aspects have had a long history and have evolved over the years. States and governments depend on authority needed to provide services, to regulate the economy and to finance both types of activities. Markets are dependent on securing utility, but both governments and markets depend for their smooth functioning on a large variety of information. The structure of information is heterogeneous, as are the users. The importance of information on the activities of the government to facilitate the twin roles of individual decision-makers, or economic agents – to ascertain what the government is doing and to evaluate how the financial resources of the community are being utilized – has all along been recognized. Similarly, there has been recognition, from the pre-Christian times, that “unaccountability meant lawlessness.” Although this lineage is kept in view, it is also important to recognize that there have been three major and interrelated factors that have been providing additional impetus to these subjects during recent years.

First, the growing recognition of the importance of strengthening the civic society to perform its designated role has been an important factor in shaping the debate on fiscal transparency. What is civic society is, itself, however, a controversial issue. To one school, it is one where the role of politics is reduced and that of individual liberty is expanded. To another school, however, the rule of private power over public goods, and the potential for malcontents, including anarchy, needs to be properly recognized if the civic society is to function smoothly. This, in turn, requires the development and strengthening of market-based institutions, and a regulatory framework that is not overstretched. The strengthening of the civic society requires greater transparency in governmental actions, and greater trust on government agencies, accompanied by

an effective framework of accountability. The determination of the content of transparency, and the processes contributing to effective accountability, however, remain to be delineated.

Second, the demand for a strengthened civic society comes in the context of a profound paradox in the working of the governments. On the one hand, there is a view that governments have grown enormously in size and in the range of tasks undertaken, and their performance has yet to match expectations. Notwithstanding this prevailing sense of disappointment, there is also greater demand for services that only a government can achieve. As Derek Bok says “over the past sixty years, Americans have come to ask *more and more* (emphasis added) of their governments as newer concerns for economic security, the environment, access to health care, racial and gender equality, and consumer protection have joined more traditional demands for national defense and essential services.”³⁸ A related issue is how this paradox may be addressed through greater fiscal transparency and improved accountability.

Third, the series of financial crises experienced during the last decade (i.e. 90s) has raised two issues about public policy-making, and the need to reduce high vulnerability. Public policy-making, in general, and the national fiscal system, in particular, has become a unit of analysis.³⁹ What is the role of fiscal institutions in economic transformation, whether during an expansionary phase, or during a structural adjustment phase through deregulation, liberalization and in partnership with private programmes? Given that the institutions involved in both phases are the same, how should they be evaluated and held accountable?⁴⁰ The other aspect is that to the extent market perceptions and associated belief systems, can contribute to sudden changes and destabilizing effects, how the crises may be forestalled, through an enhancement of fiscal transparency. These have an impact on the nature and content of information made available to the public. Associated with this institutional approach is the issue relating to the strengthening of governance, through participation and empowerment. If participation and empowerment are to be achieved, how should fiscal transparency and accountability framework be improved? These questions and several related ones have, indeed, lent a degree of added urgency for a detailed discussion of the subject.

B. Scope of the paper

This paper is devoted to a consideration of the above issues. To facilitate discussion, an essential perspective on the evolution of fiscal transparency and accountability is provided first. This is

³⁸ See Bok (2001), p. 10.

³⁹ The terms are not free from ambiguity: Essentially, however, they refer to a cycle of six stages – (i) identification of factors contributing to public actions; (ii) ensuring that policies are backed by actions and authority; (iii) evaluation of impact of proposed policies on finances and the observance of prudence and fiscal rectitude, (iv) identification of estimated benefits and their use by the different segments of population; (v) assignment of tasks to an agency, and the formulation of terms of accountability and (vi) imposition of penalties on deviations from proposed actions. This cycle is inherent in any sphere of public policy-making.

⁴⁰ For a recent case study of this approach, see Gao (2001).

followed by a delineation of the content of transparency and accountability. The reality, at the ground level, is often, however, different from the conceptual framework, and the issues arising from the reality, a sort of a worm's eye view, is provided, and the future directions are briefly indicated in the concluding part.

It is argued that the establishment of institutions aimed at providing transparency and accountability is only a first step, but the more important step is to ensure that they are effective in what they have been designed for. This, in turn, requires a specification of the framework of transparency and accountability and efforts, at several levels, aimed at making them fully operational.

C. Evolution

Both fiscal transparency and associated accountability (the form and content) have evolved over the years, and in order to gain a full understanding of their importance, coverage and contribution, it is essential to have a perspective of the saga of their development. The intent here is not to provide a detailed history but to selectively identify the important milestones that have had a significant impact on the content of fiscal transparency and accountability.

The contours of fiscal transparency and accountability were shaped during the last two millennia by two distinct trends – a desire to make public officials accountable for their actions, and the political arithmetic of the times reflecting the concerns of the financial class and their interest in investing money in instruments of indebtedness. The evolution can best be discussed in terms of six stylized stages.

During the first stage, the concern of financial accountability of the monarchs, on the one hand, and the concerns of an active society seeking a role in the utilization of public money (Aristotle was the first one to formulate the concept of public money) on the other, a feature associated with the Athenian state in pre-Christian era, dominated the fiscal scene. The concerns of the king were the preservation of wealth of his own domain and this required him, as may be gleaned from the histories of China and India, to devise ways and penalties that would prevent his numerous officials from stealing from the public treasury. The emphasis in a monarchy was on transparency that was intended for only one person, viz. the king, and his audit agency. The concerns were the same in the development of the Athenian State, where there was explicit recognition of the risks associated with handling of large sums of money by officials and the need for systematic accounts that would illumine the whole area. The common concern of accountability, although the channels were very different, was the estate management. In the monarchical system, all accountability was to the king; in the Athenian State, it was to the people's representatives.

The second stage reflects the emergence of double entry bookkeeping about five hundred years ago, and its relevance for governments. While available records do not throw much light upon

this, it would appear that the decision not to apply this system to the royal finances, but to develop the cameralist approaches that came to be extensively prevalent in the European monarchies, was a deliberate one. The finances of the royalty were not a matter of concern for the general public, and therefore there was no need to apply double entry bookkeeping to government finances. A distinct legacy of this approach is the fact that in a large number of countries, government accounting continues to be based on a single-entry system even today and to that extent, information of liabilities and assets remains outside its scope.

During the third stage, however, there was a minor reversal in the trend, in that the investing class in England forced the government during the seventeenth century to develop systems of government accounting, audit, and a legislative forum for overseeing the utilization of royal finances. This impetus, it is important to note, came not from the general public, but from the investing or financial class. A continuous engagement in wars depleted the British Treasury and made it dependent on private sources for financing. The investing class, as is its wont, pressed for details on the financial health of the government. As data were not available within the government, investors organized their own compilation of accounts, for a time, and later concentrated their efforts on the establishment of an accounting class in government. The overall development of a new nexus between governments and their investing public contributed to the colonization of the State by financial interests. (See Brewer (1983), Ferguson (2001) and Premchand (2001).

The fourth stage, representing a century from the mid-1700s, saw the consolidation of many efforts that were initiated in Britain during the previous period. Thus, in 1787, a consolidated fund “as one fund into which shall flow every stream of public revenue and from which shall come the supply for every service” was set up. Similarly, to ensure that the money was spent with “wisdom, faithfulness, and economy”, a legislative commission on accounts and a commission on audit were set up. These were later formalized in 1866 with the passage of the Exchequer and Audit Act, which led to the proper institutionalization of compilation of accounts, processes of audit, and oversight by the legislative committees.

The fifth stage witnessed, in the era stretching from the 1930s to the 1970s, an enlargement of the focus of transparency and accountability from finances, to performance, delivery of services, development and application of cost-accounting methods, and to the observance of economy, efficiency and effectiveness of expenditure. To a large extent, this enlargement, which had only a sporadic application in industrial and developing countries, was facilitated by variants of performance budgeting that also contributed to a paradigm shift in budgeting. (See Premchand, 2000)

The sixth stage, which represents, the period from the 1980s onwards, has contributed to a further enlargement of the scope of transparency and accountability. The focus expanded to include prudent economic management, and the overall quality of public finances that would facilitate an evaluation of fiscal sustainability of a government. This process also saw the active involvement of international financial institutions (See International Monetary Fund, 1998 and 2001), and growing emphasis, not merely on cash flows of government, but on liabilities and assets of government. Thus, emphasis was laid on accrual accounting and preparation of balance

sheets by each agency, strengthening of internal controls, and to the preparation of government-wide audit reports, as an integral part of the overall effort. The implicit faith in all these endeavours is that the overall enhanced transparency would reduce information asymmetries, and accountability would promote the cause of civic governance.

D. Content of transparency

The content of transparency has been determined, over the years, by the various user groups. These groups include policy-makers, legislators, investors, academics and the general public. Although, the traditional content of transparency largely revolved around budgets, audited annual accounts, intra-fiscal year indications of the fiscal accounts, the more recent emphasis on the quality of public finances has sought to shed light on institutions, approaches to policy-making, content of public expenditures, reform and adjustment efforts and their impact, etc. Together, the process of fiscal transparency seeks to provide a large amount of periodic information on the following aspects.

1. Structures and policy spheres

- Functions of central, regional, state and local governments;
- Financial arrangements among the various levels of governments;
- Autonomous bodies and their financing;
- State-owned enterprises and their performance;
- Relationships with the corporate private sector, including government equity holdings;
- Relationships with legislatures;
- Primary fund instruments;
- role of extra-budgetary activities, quasi-fiscal activities, guarantees, tax expenditures, contingent liabilities, etc.;
- Availability of a budget law;
- Taxation under authority of law including transparent methods of assessment and collections;
- Accounting basis to be explicit indicating cash position and liabilities;
- Classification of government transactions that shed light on the activities and their impact.

2. Fiscal management

- Statement of objectives and their legal status;
- Consolidated budget for all levels;
- Specification of macroeconomic framework governing annual budgets;
- Annual policy-making with particular reference to new policies, changes in revenue

- and lending policies, and efforts to contain budget deficits to utilize surpluses;
- Changes in debt position;
- Changes in delivery of services;
- Identification of high-risk areas;
- Detailed objectives of departments and agencies;
- Performance orientation;
- Pursuit of efficiency and economy;
- Changes in supporting administrative infrastructure.

3. Implementation of budgets

- Phased release of budget authority and related arrangements;
- Established cash management practices;
- Sound procedures for award of contracts;
- Procedures to ensure congruence between budgetary intent and outcome;
- Performance measures.

4. Accounting and reporting

- Basis of accounting;
- Procedures for payments;
- Compilation of intra-year and year-end accounts;
- Preparation of agency annual reports.

5. Evaluation

- Evaluation efforts within governments and their contribution.

6. Audit

- Arrangements for an independent audit agency;
- Arrangements for accountancy, financial and performance audit reports;
- Arrangements for investigative audit;
- Arrangements for the consideration of audit reports by legislative bodies.

7. Independent standards

- Standards for the accounting and auditing systems and for the rating of government financial management systems.

8. Legislative review

- Role in policy-making, review of budgets, monitoring of budgets, implementation and review of annual audited accounts.

The above approach follows the traditional financial management cycle, as well as the new contours on the role of institutions, and is larger in scope than the content of fiscal transparency indicated in the guidelines issued by international financial agencies.⁴¹

The ground level arrangements in regard to the above do not form a uniform pattern, given the historical legacies, orientation to law (such as common and civil law), the role of the legislature, the role of audit, and the transparency of the working of fiscal instruments. These differences, which range from being delicate nuances to structural features, do not tend to be obvious when governments adopt common formats of reporting on the status of government finances, in conformity with international standards. These reports tend to be brief and essentially cover revenues, expenditures, size of deficit/surplus, and the financing arrangements at the level of the central government, and are intended for the international financial community. The implication is that large fiscal deficits, contributing in turn to significant public debt, may undermine confidence in the medium-term solvency of governments. These data are therefore intended to facilitate judgements on the state of fiscal health. Needs of the domestic legislatures, policy-makers, and the public are more varied and substantial and therefore need to be addressed by the other arrangements for fiscal transparency.

E. Content of accountability⁴²

Accountability is generally interpreted to be of two kinds – vertical accountability and horizontal accountability. The former has relevance to the pyramidal structures of governments and essentially refers to the accountability of the lower levels to the higher levels. The latter refers to the patterns of relationships between governments and the legislatures as well as to the public. The discussion here addresses horizontal accountability. In discussing accountability, two features should be noted at the outset. First, fiscal transparency or the act of providing information on the fiscal activities of governments, either to a specified group such as the legislature, or to several groups, is a means, as noted previously, to accountability and is not a substitute for the latter. Accountability implies the existence of a body of oversight charged with the responsibility of reviewing the content of information provided and reporting on that to the general public.⁴³

⁴¹ See, for example, the guidelines issued by the International Monetary Fund, (1998 and 2001). The guidelines are broadly divided into four groups – (i) clarity of roles and responsibilities, (ii) public availability of information, (iii) open budget preparation, execution and reporting; and (iv) independent assurances of integrity. There is a good deal of common ground between what is covered by the guidelines and the framework indicated above.

⁴² A more detailed account is given in Premchand (i), 1999.

⁴³ During recent years, many international agencies have claimed that their accountability has been enhanced merely because the decisions made are posted on the web site. Web sites are a medium for transparency and do not necessarily contribute to improved accountability in the absence of oversight bodies.

The term “accountability”, notwithstanding the long lineage, remains a fuzzy concept, with each analyst tending to define it in his/her own way. For the sake of precision, the scope of accountability, as interpreted here, is given below:

1. General accountability

- Answerability for action;
- Sanctions where justification is not adequate;
- Ability to revoke a mandate;
- Public scrutiny of governmental actions;
- Citizen participation in the design of programmes.

2. Fiscal accountability

- Approval of policies and actions having financial implications by a representative body;
- Approval of an annual or medium-term budget;
- Framework to ensure that in the process of economic management, no actions are taken to impair the fiscal capacity of the community.

3. Managerial accountability

- Appropriate rules are observed and that the authority is not abused;
- Risks are taken within delegated powers to achieve objectives;
- Responsibility for service delivery within specified cost, quality and time schedules;
- Observance of economy and efficiency.

The concept of fiscal accountability reflects the concerns of those interested in the sustainability and quality of public finances. Managerial accountability is closer to what is called by some international financial institutions (e.g. World Bank) financial accountability or fiduciary responsibility (distinct from stewardship of public resources) by others, but is larger in scope than the others, in that service delivery and observance of economy and efficiency are integral parts of this form.

The instruments of fiscal transparency, including medium-term fiscal strategies, development plans, annual budgets, annual accounts, including balance sheets, and audit reports, are utilized, in conjunction with other means, to render accountability. More specifically, however, emphasis is laid on two aspects – (i) role of the representative body in the approval of policies, budgets, and annual audited accounts, and (ii) the role of the audit in aiding the representative bodies, or independently to carry out the verifactory exercises. The guidelines issued by the international financial agencies appear, if only implicitly, to support the type of institutional arrangements found in the British administration. In Britain, there is an independent, statutorily laid out, National Audit office, whose investigative and annual findings are grist to the mill of the public accounts committee of the House of Commons. The form of audit varies from one country to

another. Some carry out *a priori* audit, while a few others are endowed with judicial powers, and most are engaged in *a posteriori* audit. Some are engaged in performance in additional financial audits, while a few others carry out essentially a financial audit. The arrangements for the audit of state enterprises and public bodies vary considerably, as do the periods of accounts for which audit is conducted. In a few European countries, the accounts of previous years may also be taken up. In a few countries, audit may be called upon to provide an “opinion” on the accounts, while in other countries, audit may have a key role in the granting of the discharge of the annual budget. Similarly, the time tables for audit and actions thereon vary, as do the roles of legislative committees. In some countries, e.g. the U.S.A., the committee on government operations, has the freedom to determine whether the annual accounts are to be reviewed. Although practices vary, the real issue relates to the extent to which transparency and related accountability are effective in fulfilling the tasks for which they were designed in the first place.

F. Issues

If the framework of transparency and accountability described above is incorporated into laws and administrative practices, would that contribute to improved governance, and greater participation by the people in the management of their own affairs? The answer to this question is dependent on an evaluation, cursory in the circumstances, of the institutions that have been assigned major roles in the above process. Evaluation of institutional performance is a delicate and complex area where full empiricism may not always be available. For the purpose here, the framework formulated by Putnam⁴⁴ has been kept in view. The application of this framework, which is comprehensive, internally consistent, and reliable, reveals a reality that raises several fundamental issues on the effectiveness of transparency and accountability arrangements and their combined contribution to a stable environment of improved governance.

The current reality is such that while several newly formed republics (such as those that were formerly in the Soviet Union) have established laws regarding the budget, its contents, and the overall financial system, thus ensuring fiscal transparency, in other countries access of the public to the budget and full accounts continues to be scant. In some of the centrally planned economies, which are also based on mono-political cultures, and some of the middle eastern kingdoms, the public gets only bits of information, and the full documentation on budgets and annual performance continues to be absent from the public domain. It is likely that approximately one-third of the world’s population is in this area of darkness.

The role of the legislature has also undergone major change during recent years in the name of quick decision-making, that is so essential to macroeconomic management, much of the power relating to the control of the purse has shifted to the executive wing of the government. Even in such countries as the United States, where the legislature has been viewed as traditionally dominant, the role of the congress has been reduced by the permanent legislation governing budgetary outlays. Nearly seventy per cent of the outlays in the annual budget are predetermined

⁴⁴ See Putnam (1993), p. 64-66.

by the existing legislation. In a large number of developing countries, the annual flexibility is very limited. This, together with the shift of power to the executive, has made governments more vulnerable, and its capacity to avoid financial crises, has reduced, in the eyes of the public, the esteem that it would have otherwise had. Besides, insistence on routine unidimensional financial accountability by separating it from effective service delivery has not improved matters. The financial management cycle, it is perceived, has become a ritual that is often carried on like an innocent folk rite, more for its own sake, than for the public. Further, the emphasis on these aspects by the international financial institutions has changed the color of the issue. It is viewed more as an elite idea than as a home-grown approach, undertaken more to please the international institutions than to be effective in the service of the community.

In addition, where the machinery for full (as distinct from minimum) transparency and accountability exists, the institutions charged with these responsibilities, as will be indicated further on, have not been very effective. Their underachievement is, in part, due to the laws enacted a long time ago governing their administrative processes and, in part, to poor effort to adjust to the changing tasks. A combined result is growing apathy toward government at a time when its role is also expanding, the paradox referred to at the outset, and the capture of policy-making by small groups, with a negative impact on governance. If the reality is different from the idea, then it is appropriate that the issues affecting transparency and accountability are addressed in detail. The problem is not with the general notion but with the functioning of the arrangements for transparency and accountability of operations. The details, however, are many, and the following discussion covers only the more salient ones.

G. Corruption and financial management

One of the underlying objectives of improved transparency and accountability is to reduce the extent of corruption in the management of governmental affairs. The nature of corruption, however, is a complex one, and may not be fully addressed by the existing fiscal machinery. Conceptually, corruption arises, in so far as the tax collection machinery is concerned, when the transactions between the assessor and the assessee are not transparent. In several countries, e.g. India, tax assessment is in part negotiated between the assessor and assessee. Even in regard to indirect taxes, e.g. customs, the scope for negotiated settlement is quite substantial and may be inherent in the system. In one country, for instance, the customs law specifies forty-five varieties of imported steel, each with its own rate of tax. Given the subtle distinctions, the levy becomes a matter of negotiation, with the inevitable prospect of corruption. Similarly, the application of the law relating to tax expenditures, which in many countries, is extensive and covers a wide ground, also permits, in some cases by design, a good deal of discretionary action, contributing in turn to corruption. It could be argued that efforts aimed at reducing corruption should therefore address the task of revamping the tax system and related laws.

As for expenditures, financial management systems including effective internal and external audit control systems can only deal with embezzlements and motivated award of contracts. In both types, the proof of malafide intentions and practices is pursued, in most cases, as a part of criminal law, rather than as a part of the audit process. The introduction of electronic payment systems, particularly for payroll, pensions and public debt, was viewed, by some, as an approach

that would reduce the amount of corruption. Even here, the inadequate maintenance of manual record and the quick transition to electronic systems has contributed to the emergence of ‘ghost employees’ and ‘ghost pensioners.’⁴⁵ These aspects illustrate the need for a good deal of supplementary action aimed at improving the administrative infrastructure.

H. Fiscal policy and macroeconomic stability

Several measures taken during recent years by many governments reveal the pursuit of contradictory approaches. The enactment of fiscal responsibility legislation, the pursuit of hard budget constraint as an integral part of regional cooperation, have in some ways contributed to the picture of a strong determination to pursue fiscal rectitude. On the other hand, the passage of zero deficit approaches into law, or pursuit of cash-limited payment systems under which government payments are limited by available revenues, have posed serious problems to the pursuit of proper fiscal policy. A fiscal policy implies a balance between fiscal aspects and service delivery. In cash-limited approaches, budgeting becomes a back-door exercise in that the budget that is implemented may not be the one that is approved by the legislature but the one that is determined by cash inflows. In such a context, service delivery becomes incidental, and the very approach that is intended to shore up investor confidence ends up eroding the public trust of government, and more important, militates against the framework of legislative accountability. In some cases, the extremes of cash-limited back door budgets are sought to be mitigated through the specification of protected categories of expenditure. These categories, however, are limited to wages, pensions, public debt, defense, etc., which again reinforces the popular perception that in a crisis, the first activity that is protected is, not service delivery, but payment of wages to government employees.

I. Circumvention

The experience of both industrial and developing countries shows that governments are generally engaged in circumvention of their own laws. The practices include, generous window dressing of budget estimates of revenues and expenditures, avoidance of credit limits through an accumulation of unpaid bills, transfer of amounts toward the end of the year to personal accounts to avoid lapse of funds, manipulation of performance data and associated means. Window dressing involves assumption of rosy scenarios of economic growth, and policy measures yet to be formulated. Both these are sought to be done in such a way that a gullible public may not always know what the government is doing. While these practices are sought to be minimized in some countries through a review of the estimates by the audit agency, or through an assessment by credit rating agencies, it should be noted, that these efforts are, by and large, very limited. Meanwhile, the budget reflects, in several cases, the deployment of creative accounting approaches that effectively mask the reality in the short term. These practices, to say the least, work against the framework of financial accountability.

⁴⁵ The phenomenon of ghost employees is not entirely a new one. For a delightful spoof of the Russian situation at the end of the 19th century, see Ivan Turgenev’s novel “Ghost Souls.”

J. Implications of new management philosophy

During the last decade, advocacy for the introduction of new management philosophy in governments has become a major feature of public debate. Although there are several versions of this philosophy, in so far as financial management is concerned, it is expected to comprise the following – creation of small task-oriented agencies, indication of firm advance ceilings for the budget and the results expected during the fiscal year, and extensive delegation of financial, administrative powers to the managers of agencies, and a framework of accountability to the public. This approach, it was suggested, would shift the traditional emphasis in public authorities on the control of minutiae to results. There is much to be said in favor of the new philosophy. Experience, however, shows that the implementation of this approach has also contributed to the phenomenon of “accountable to none” in that the channels of accountability to the legislature tend to be very weak. The agencies are not subject, in most cases, to the discipline inherent in the legislative process, and placement of reports with the legislature or maintenance of web sites were deemed to be adequate for accountability. In most cases of administrative reorganization, the addition of financial accountability to the administrative design was more in the nature of an afterthought, rather than an integral part. The reduced accountability has in turn contributed to more issues about the design associated with the philosophy, including the inherent trade-off between managerial autonomy and accountability.

K. Rebuilding dilemma

The changes in the portfolio of expenditures of government have had serious implications for transparency and accountability. Increasingly, a greater share of government expenditures is devoted to transfers to local governments and, in the case of social services, to non-governmental organizations. This has inevitably contributed to a greater gap between funding of services and the actual provision of services. While government agencies concerned with funding engage in a good deal of conditionality aimed at ring fencing, in practice, the means of enforcement are limited. Local governments and non-governmental organizations have their own administrative systems and are generally not subject to end-use audit by the central audit agency. In several cases, non-governmental organizations may not have any self-enforcing standards governing their financial management systems. As a consequence, a whole layer of administration that is beyond the scope of accountability has emerged. In the view of some, this represents a serious leakage in the traditional system of financial control, without any redeeming advantages to service delivery.

L. Comprehension

The success of fiscal transparency is dependent on the way in which fiscal information is utilized by the public in guiding its own behavior. As noted earlier, the public is a generic concept that includes several homogeneous groups with conflicting interests. The overwhelming impression about the information released by governments on their financial transactions and associated transparency arrangements is that there are vital gaps in it, and it is far from adequate in serving the interests of the public. In several cases, neither the budgets nor the annual accounts provide

information on tax expenditures, outstanding guarantees, the nature and reliability of financial assets, and liabilities, including contingent ones. Moreover, a good deal of detailed information on small operations may be provided, while being generally opaque in large areas such as defense, and extremely brief on benefits of expenditure programmes or on the high-risk areas of operations. More important, most budgets tend to be very silent on risk management, that is, the changes in strategy in the event of changes in the underlying assumptions. Also, budgets and accounts in government speak a technical language that tends to be extremely difficult to comprehend for the public. In several cases, the classification of government activities may conceal more than they reveal. In turn, these built-in features have tended to reduce the beneficial impact of fiscal transparency, while contributing to greater reliance on interpreters of data.

M. Audit

The effective functioning of an independent audit system reinforces the trust that the public has on governments. During recent years, efforts have been made to establish audit systems in newly formed countries. While this is a major achievement, the overall performance of the audit systems leaves a good deal to be desired. In many cases, audit is not permitted to review government policies, and financial audit yields very limited results. In several cases, the audit cannot also follow the full trail of government expenditures. Transfers to local governments, non-governmental organizations and the books of contractors that perform tasks for and on behalf of governments are beyond the scope of a normal audit. Moreover, in most cases, audit continues to be of a conventional accountancy type and there is, as yet, little reliance on performance or investigative audit. In most cases, the purview of the audit is constrained by the laws, which are old, and which reflect the values prevalent then. In some countries, audit continues to be engaged in the maintenance of accounts too, and to that extent, is engaged in auditing its own books. Although, the international organization of supreme audit institutions has suggested more than a decade ago that each audit agency should undertake a peer review of its own activities, so far, only one country has done that. The result, in many cases, is an outdated audit agency that has to grow in several ways in order to be effective.

N. Legislatures

Legislatures are of several varieties, and their role in the approval and evaluation of public policies, both *a priori*, and *a posteriori*, reflects wide variations. For analytical purposes, however, they may be divided into three groups – (a) those that can transform public policies, including financial legislation, on their own initiative; (b) those that are limited to the approval/rejection of governmental policies; and (c) those that have a limited function of only debating government proposals without any powers either to approve or reject them. Excluding the third category, whose lack of effectiveness is too palpable, it would appear that even in the other cases, the role of party whip, and accumulated legislation with a decisive impact on the resources committed, their role in day-to-day management of fiscal affairs has been reduced

considerably. In several countries, the year-end review of accounts has become a ritual, and in some countries, non-existent. Due to schedule differences between the audit agencies and the legislators, the reports produced by the former may not even reach the legislative table, while the fact that the reports are available in the public domain should by itself be contributing to improved accountability, the absence of a channel to exercise effective oversight has, in combination with other weaknesses, contributed to a state of helplessness. Meanwhile, the very source that is expected to convert the idea of public accountability into a reality is also the one, mostly by accident and, paradoxically, in some cases by design, that is standing in the way.

O. Towards improvement

The preceding analysis shows some of the many factors impeding the effectiveness of fiscal machinery in many countries. It reveals the mismatch between the expectations of the public and the responses of the administrative machinery both within and outside government. Meanwhile, the changing portfolios of government expenditures and the dynamic compulsions of new management philosophies are making further assiduous efforts at improvement an imperative. The pursuit of this imperative through umbrella themes, such as fiscal transparency and accountability, is by itself not adequate. These terms have to be converted into operational frameworks, and this task implies continuing efforts dedicated to details and a constant process of adaptation – a task that remains to be undertaken.

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BUDGETARY TRANSPARENCY FOR PUBLIC EXPENDITURE CONTROL

by Franco Reviglio⁴⁶

A. Introduction

This paper focuses on whether political systems of euro area countries⁴⁷ have the capacity to enforce the major public expenditure reforms that are needed to enhance competitiveness in the global market and reduce structural unemployment. These governments need to reduce expenditure in order to reduce their relatively high tax rates on labour and profits, but also to change the composition of expenditure, by increasing the amount of productive expenditure. Some of these countries also need to increase the expenditure aimed at helping the poor escape from their marginalization.

In the 1992-97 transition to the EMU, euro area countries complied with the Maastricht Treaty budgetary constraints mostly by increasing taxes, cutting public investment, and using various budgetary gimmicks. Moreover, mainly in highly indebted countries such as Italy, Maastricht Treaty compliance was helped by lowering interest costs. As inflation was coming down and the introduction of the euro became a more and more credible target, nominal interest rates and spreads on the debt gradually declined. Structural reductions and realignments of current public expenditure other than interest payment played a relatively minor role. Historically, this failure to implement major public sector reforms has been blamed on overwhelming political difficulties.

In democratic societies, it is politically difficult to cut expenditure. Major expenditure reforms, such as the reforms needed in pension programmes and, more generally, in the social policy area, are not politically feasible. One way to interpret this difficulty is market failure – elected officials do not have sufficient incentives to internalize the externalities from the impact of wrong policies that are likely to materialize after their term expires.

⁴⁶ This paper was written when the author was a visiting scholar at the Fiscal Affairs Department of the International Monetary Fund, September-November 1999. The paper benefited greatly from the comments of Marco Annunziata, Giorgio Brosio, Adrienne Cheasty, Jorg Decressin, Riccardo Faini, Robert Gillingham, George Kopits, Joseph LaPalombara, Joergen Lotz, Taryn Parry, Giuseppe Pisauro, Barry H. Potter, Massimo Russo, Istvkn Szekely, and Howell H. Zee. The opinions expressed in this paper are solely those of the author.

⁴⁷ In this paper euro area countries include 10 of the 11 members countries of the European Union (Luxembourg is excluded). They are Austria, Belgium, Finland, France, Germany, Italy, Ireland, the Netherlands, Portugal, and Spain.

The political systems of the continental EU countries need to be reformed if they are to function efficiently. Even if some countries, such as Ireland and the Netherlands (IMF, 1999) and, more recently, Finland, were able to carry out major structural reforms, including the reform of the welfare state, the political systems of most euro countries were unable to pursue stressful structural reforms of the expenditure. These systems should be more responsive to long-term financial consequences than to short-term desires. This would mean facing up to the expenditure reductions required in the new global macroeconomic framework. But properly designing the correct incentive system would be as difficult as reforming the political systems themselves and the political systems appear unable or unwilling to reform from within.

How can these obstacles be overcome so that public expenditure reforms can be made? What can be done to push political systems to implement major public expenditure reforms? And how can public expenditure then be controlled? This paper seeks some answers to these questions.

Section B attempts to explain why continental EU countries are unable or unwilling to undertake the structural reforms of public expenditure needed to reduce tax rates on labour and profit, as a means to increasing their competitiveness in global markets and combating structural unemployment. This section concludes that reforms are likely to be introduced only as the result of external pressures.

Section C suggests that increasing budgetary transparency, by strengthening budget procedures, integrating accrual and cash accounting, and removing budgetary gimmicks that bypass fiscal constraints, may be a partial substitute for public expenditure reforms. Although procedural changes may have only a one-time impact on public expenditure, they may unmask gimmicks for what they are and help prevent the emergence of new creative accounting techniques. Though other EMU countries have as well practiced budgetary gimmicks to bypass difficult fiscal constraints, the paper uses the case of Italy as a reference to clarify the problem. Budgetary transparency may help discourage the use of gimmicks.

B. Why present political systems do not control public expenditure

1. In EMU countries, public expenditure has not been reformed as needed

In EMU countries, the size of general government expenditure should be constrained by two policies: compliance with the European Growth and Stability Pact (GSP) and, in the medium to long term, the need for a substantial reduction in taxes on both labour and profit, to increase competitiveness in global markets and combat unemployment. More generally, structural reforms are required to prevent public expenditure from growing faster than GDP at a time when the aging population is increasing and requiring more social security and health care expenditure. Reducing taxes by making large cuts in public expenditure, however, seems to be problematic: the present political systems of these countries seem unable to make the needed structural reforms.

The 1992-97 convergence to EMU requirements showed how difficult it is for these countries to lower budget deficits by reducing public expenditure. In 1997, these countries complied with the

Maastricht Treaty budgetary constraints mostly by increasing taxes, lowering interest rates, cutting public investment, and using various budgetary gimmicks (Reviglio, 1998; Caselli and Rinaldi, 1999). Italy achieved a large reduction (6.9 per cent of GDP) in the general government deficit during 1992-97 through an increase in receipts (1.7 per cent of GDP) and several expenditure cuts (2.0 per cent of GDP for interest payment, 1.5 per cent of GDP for other current expenditures, and 1.1 per cent of GDP for public investment).

Even if the comparison made for the 1993-97 period shows a somewhat larger current expenditure cut other than interest reduction, the contribution of this realignment to the total budgetary adjustment was relatively minor. It was not sizeable enough to allow the substantial reduction in taxes on both labour and profit required to increase competitiveness in global markets and combat unemployment.

Since 1997, these countries' political systems have further shown their unwillingness to make structural reforms in public expenditure, for example, in their failed attempts to enforce needed pension reforms. Although the governments of France and Germany proposed pension reforms, the proposals were withdrawn when they met with widespread popular opposition, including general strikes. Some reductions in government deficits were achieved by increasing social security contributions (and, thus, the cost of labour). In Germany, to fight unemployment, a reduction of the pensionable age has been suggested, a decision that would increase the expenditure for pensions. Both events suggest how difficult it is to make much-needed reforms of the pension system.

Italy undertook three pension reforms during the 1990s. The first two reforms made major changes to the rule of the system. The latest reform increased the speed of the implementation of the preceding interventions. Although these reforms smoothed the profile of the pension expenditure to GDP, they did not fully stabilize its trend. Moreover, the expenditure level was not brought toward the EU average. Suggestions to reform pensions more deeply were strongly opposed.

The inability to make major structural reforms in public expenditure may not prevent countries from complying with the GSP, which requires only minimal adjustments to public expenditure levels. Balancing the government budget in EMU member countries requires reducing the deficit by about 1-1.5 percent of GDP. This outcome may be reached by minor reductions in expenditure and, in Italy, by improving tax compliance and reducing the cost of debt servicing.

2. Political systems were designed to distribute, not reduce, benefits

As stated, under their present political systems, these countries seem incapable of making structural reforms in public expenditure. This can perhaps be explained by looking at the history of the European political systems. For decades, these systems were based on increases in public expenditure and on benefits to constituents larger than the taxes raised to cover benefit costs. In the period 1970-93, public expenditure in EMU countries increased by 17 percentage points from 36.1 percent to 53.1 percent of GDP; this was almost 7 percentage points of GDP more than the increase in the tax ratio in the same period (10.4 percentage points of GDP, from 33.3 per cent of

GDP in 1970 to 43.7 per cent of GDP in 1993). A large share of the increase in public expenditure was covered by increased net borrowing (an average of about 2.9 per cent of GDP in the period).

In the political scenario that prevailed in EMU countries before 1993, politicians were more electable if they promised to provide more public goods without asking to raise taxes to cover their cost. This was possible because a large share of the expenditure was financed by government borrowing; in EU countries, such as Italy, characterized by a persistent high inflation, a sizeable amount of the additional revenue came automatically through the fiscal drag, thanks to the two-digit inflation in the period 1974-83. The public did not perceive the costs of wide structural deficits.

However, in some other countries, such as the United States of America, public expenditure and taxes are lower (in 1999, 34.4 percent and 30.4 percent of GDP, respectively, against 48.6 percent and 42.9 percent in EMU countries), and in the period 1970-99, tax increases were very limited (Table 1; Figure 1). In the United States, politicians are more electable if they promise to cut taxes, so they continue to offer attractive tax cuts in combination with expenditure cuts that the public would support.

In EMU countries, however, in the 1970s and 1980s, this political framework did not work because the public preferred high expenditure, partially covered by large deficits, as a way of financing the expenditure without apparent costs in the short run (Figure 2). The public did not want to see expenditure reduced, and their reluctance to pay led to the large structural deficits.

Benefits provided by increases in public expenditure and debt built large public institutions. And the benefits fed the political systems. All major industrial countries exhibited a trend of increasing public expenditure and debt until the beginning of 1990s, but the increase was larger in EMU countries. From 1970 to 1990, in what are now OECD member countries, public expenditure as a proportion of GDP increased from 8.3 percent to 44.8 percent (Tanzi and Schuknecht, 1997). In the same period, in the EMU countries, the increase was larger: to 49.3 percent of GDP, as compared to 31.1 percent of GDP in the other European countries. Over the last century, in industrial countries, thanks to increasing public expenditure, the benefits distributed to citizens by the political systems were substantial; the increase, however, was almost 50 percent larger in EMU countries.

The increase in public expenditure was larger than that of taxes (Table 1; Figure 1). In the period 1970-93, in EMU countries, this increase in public expenditure was almost one-third larger. Both increases were substantially larger than in the United States. In the 1970s and 1980s, as taxable capacity became more constrained, increasing public expenditure meant increasing government borrowing and debt. In EMU countries, government debt rose from 33 percent of GDP in 1977 to 67 percent of GDP in 1993.

In 1992, this situation began to change dramatically. The institutional and financial events of 1992-93 (the Maastricht Treaty and the financial crisis in Italy) challenged political systems to reduce budget deficits and stop increasing government debt. The political systems, born and

developed under a different framework, however, were unable to produce sizable cuts in current expenditure.

As a mechanism that produces collective choices, a political system is similar to a car engine: born to produce motion. When cheap petrol was no longer available, new engines had to be designed and produced; the old engines were no longer economical. But the two situations are not completely analogous. Markets encourage the modernization of car designs and production, but not the reform of political systems. These reforms need political impetus. Institutions may, however, prefer the old systems if they allow society's special interest groups to prevail by blocking decisions that penalize such groups. For example, an aging population and the resulting increase in the median voter age moved preferences against the required social reforms, such as those of pensions and health care, because reforms in these areas could penalize mainly the elderly.

In EMU countries, the reverse budgetary scenario after 1993 forced governments to reduce net borrowing. To reach this goal, public expenditure had to be reduced. Increases in benefits, which in the past made politicians more popular, were no longer available. Political systems were, however, unable to produce sizable cuts in public expenditure because they make politicians less popular and, therefore, taxes could be cut only marginally. This explains why the proposed pension reforms failed in France and Germany and why more ambitious pension reforms were deferred in Italy. It is easier to share benefits than to share the costs of public expenditure cuts.

In the budgetary scenario realized in EMU countries since 1993, politicians can no longer benefit from increasing expenditure that is only partially financed by new tax revenues. According to the GSP, in normal economic situations, government budgets should be balanced, or should be slightly positive on average over the cycle, and there are special rules applying to severe recessions. The automatic stabilizers are allowed to work during the typical business cycle. Under this new framework, the political scenario is moving toward those in other industrial countries such as the United States, where politicians are more electable if they propose cutting taxes. But this cannot be achieved unless public expenditure is reduced, a condition requiring major reforms of public expenditure that EMU countries' political systems seem unable to meet.

3. Low economic growth and high and increasing unemployment makes expenditure cutting difficult

In the 1990s, differences in the growth and employment performances in the United States and Europe were large (IMF, 1999a). The US economy expanded at an average annual rate of 3 percent, generating a rise in private sector employment sufficient to reduce the unemployment rate to about 4 per cent. In the EMU, average growth reached only 2 per cent for the decade; unemployment increased to slightly more than 12 per cent in 1997, and has declined only modestly since then.

Table 1. EMU Countries and the United States of America: Public Expenditure, Taxes, and Government Borrowing, 1970-99: An Overview
(As per cent of GDP)

	1970	1980	1990	1993	1997	1999	Average		
							1970s ³	1980s ⁴	1990s ⁵
Public expenditure									
Continental EU countries 1/ United States	36.1 32.2	46.2 34.5	49.2 36.7	53.1 37.5	49.8 34.4	48.6 34.4	41.3 33.0	49.4 36.6	50.7 36.4
Taxes									
Continental EU countries 1/ United States	33.3 27.6	39.8 28.6	41.5 28.6	43.7 28.6	43.6 30.2	42.9 30.4	36.5 28.1	41.4 28.5	43.0 29.3
Government borrowing (net) 2/ Continental EU countries 1/ United States	0.3 -1.3	-3.5 -1.7	-4.2 -3.0	-5.6 -3.9	-2.5 0.1	-2.0 1.7	-2.2 -1.3	-4.6 -3.1	-4.0 -2.4

Source: For continental EU countries, European Commission, 1999; for United States, 1999

1/10 country members of the EMU

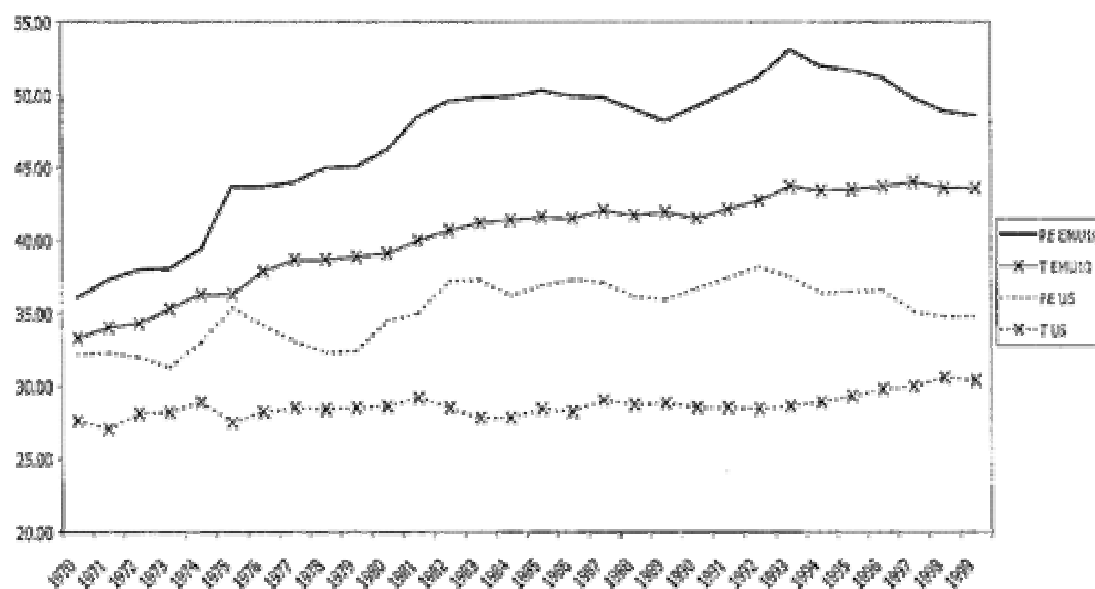
2/ (-)

3/ 1971-80

4/ 1981-90

5/ 1991-99

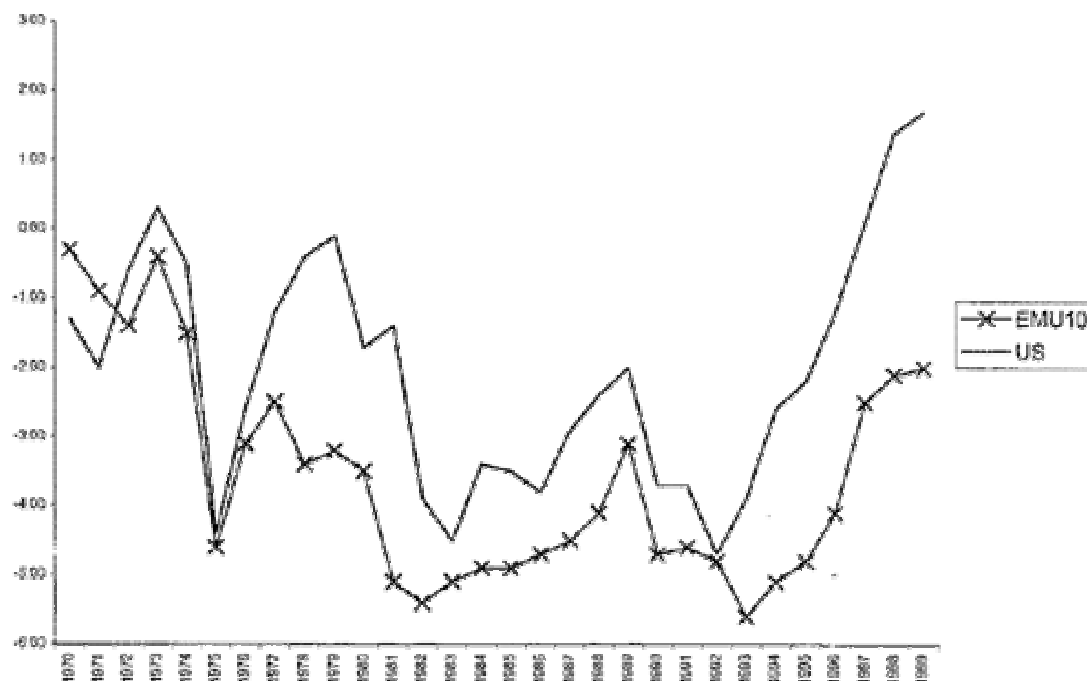
Figure 1. EMU Countries and the United States of America: Public Expenditure and Taxes, 1970-99
(As per cent of GDP)



Source: European Commission, 1999

**Figure 2. EMU Countries and the United States of America:
Government Borrowing, 1970-99**

(As per cent of GDP)



Source: European Commission, 1999

Both longer-run structural determinants and short-term cyclical influences have contributed to the relatively low rate of economic growth and increased unemployment in EMU countries. The high tax burden, together with labour-market rigidities, social conflicts, the shift in labour demand because of technology, the failure of wages to adjust to the slowdown in underlying productivity growth, weak educational systems, an aging population, and constraints on competition are considered the main causes of slow growth and high unemployment. However, there is no overwhelming evidence that any one single factor can fully explain slow growth and rising unemployment.

Daveri and Tabellini (1997) cite evidence that, in EMU countries, tax increases on both labour and profits were the main causes of the declining economic growth, increasing unemployment, and the growth of the shadow economy, which has been increasing since the mid -1980s. These authors estimate that about one-third of total unemployment could have been avoided if tax increases had not been implemented. This evidence has found further support in recent research that shows a highly significant and very large effect of labour taxes on the unemployment rate in EMU countries (Daveri and Tabellini, 2000). Similar results, although with estimated smaller coefficients of labour taxes on unemployment, were reached by Nickell and Layard (1999), and by Blanchard and Wolfers (1999).

The research of Bleaney, Gemmel, and Kneller (1999) and OECD (1997b) moves in the same direction. Bleaney, Gemmel and Kneller show that taxes that seriously distort relative factor prices (taxes on income and profit, movable property, and payroll and manpower, as well as social security contributions) reduce growth. OECD finds that high taxes on labour led to a reduction in the demand for labour, particularly for low-skilled labour. Therefore, reducing taxes on labour may increase the demand for labour and reduce unemployment (for an exhaustive review of previous empirical studies, see Zee, 1997). These studies give additional empirical support to policy suggestions that taxation reform that minimizes distortions can foster a favourable environment for growth and for employment.

These outcomes should be cautiously considered because they could be the joint product of other determinants, such as the interaction of economic shocks with labour-market rigidities over time. Blanchard and Wolfers (1999) quantified the impact of different labour-market rigidities on unemployment in a group of 20 countries over eight five-year periods from 1960-65 to post-1995. They found that labour-market rigidities produce structural unemployment and magnify the effect of shocks. Moreover, the effects on productivity produced by the expenditure financed by taxes on labour and profit cannot be ignored because the differential effects on productivity produced by them could somewhat offset the negative impact of the payroll tax burden on competitiveness (Atkinson, 1999).

However, in spite of these cautions, the generous social insurance schemes and the associated high payroll taxes are widely considered a major cause of the high unemployment rates that have persisted in Europe over the past 15 years. In the period 1980-95, the tax wedge on labour increased from 34 percent to 42 percent, while taxes on capital declined from 44 per cent to 37 per cent. The relative increase in taxes on labour vis-a-vis taxes on capital brought out in EMU countries is considered by the European Commission to be an important determinant of the increasing unemployment. Policy suggestions have been developed for restructuring social insurance programmes to have less adverse impact on the unemployment rate. Stiglitz (1999) has developed a theory of the dynamics of employment, which suggests how redesigned programmes could mitigate fluctuations in unemployment.

How much taxes should be reduced is, however, a debatable issue. To reach the tax-GDP ratios of the United States and Japan, taxes in EMU countries would have to be reduced by more than 9 per cent of GDP. In any case, to fight unemployment in the EMU countries, taxes on labour should be substantially reduced. A meaningful reduction would, however, be dependent on substantial cuts in public expenditure. Furthermore, major public expenditure reforms will be required to meet new needs, such as those to help the ageing population, to protect the environment, and to move the expenditure composition toward more productive expenditure. Without these cuts and changes in expenditure composition, employment and economic growth will continue to suffer. However, as noted, major cuts in public expenditure are politically difficult to make.

4. Needed reforms of political systems are likely to be introduced only in response to external shocks

The relationship between the type of political system and fiscal discipline is discussed below. In general, government coalitions elected by slim margins experience larger fiscal deficits and government debts (Roubini and Sachs, 1989; Hallerberg and von Hagen, 1998 and 1999). This lack of fiscal discipline is also found in governments with proportional representation systems (Grilli, Masciandaro and Tabellini, 1991; Siniscalco and Tabellini, 1993; Reviglio, 1996 and 1998; Persson and Tabellini, 1999a and b; and Stein, Talvi, Grisanti, 1999).

An important role in controlling government size is also played by the territorial features of the proportional electoral systems. Milesi-Ferretti, Perotti and Rostagno (1999) discuss several measures of the degree of proportionality of electoral systems and investigate their relation to fiscal policy outcomes. They find that OECD countries with more proportional electoral systems tend to have a higher share of transfers in government expenditure and a higher share of total spending to GDP.

The United Kingdom, which is characterized by a strong “first past the post” political system, has been able to control the size of government. From 1995 to 1997, the average annual British public expenditure was held to 42.3 percent of GDP, against an average of 51.4 percent of GDP in the three major EMU countries (Italy, France, and Germany). Thanks to this relatively small size of government, the British tax-GDP ratio has been about 8 percentage points of GDP lower – comparable to levels in the United States and Japan.

Other studies show that presidential government systems, such as that of the United States, tend to lead to smaller government both in terms of fewer public goods and less redistribution. Using data from 64 countries, Persson and Tabellini (1999 a and b) find that public expenditure in countries with a presidential system is considerably lower (by about one-third) than in those with a parliamentary system.

Lumping together presidential and parliamentary countries does not take into account political systems that are highly diverse. Most presidential systems are in Latin America where, typically and for a very long time, they were under military dictatorial rule. France, a country where the size of government is relatively large, has a presidential system, but in the study it is classified as parliamentary, because its government depends on a parliamentary majority. The study does not explain why Japan, where public expenditure is relatively low, has a parliamentary and a quasi-proportional system. The United Kingdom, a country also successful in the control of public expenditure, has a majoritarian but not a presidential system.⁴⁸

The merits of majoritarian systems are their capacity to overcome the short-term desires of politicians and to give more attention to longer-term financial consequences, enabling tougher decisions that reduce the growth in expenditure. By ensuring a longer stay in power, they can

⁴⁸ But it does have an “elected dictatorship”, giving quasi-presidential powers to the prime minister.

persuade politicians to place the longer-term welfare of their constituents over their own short-term electoral interests. Other research suggests that when voters cast party-based votes, collective policy issues are preeminent and those elected do not pursue the small-scale interests of their constituents. These positive trends are found not only in proportional representation systems, but also in the mixed member representation systems, which complement a single candidate district mode of election with a second tier seat allocation adopted by many countries.⁴⁹

Other studies claim that federalism and decentralization may reduce the size of government. When fiscal decentralization or federalism is correctly implemented, it may help control the size of government because it increases the importance of fiscal considerations in voters' location choices and increases competition among governments; however, if decentralized entities are not held accountable, its benefits may be seriously reduced and the management of public expenditure distorted.⁵⁰

Recent evidence drawn from a large sample of countries (20 Latin American and 17 OECD countries) confirms that decentralization, measured by intergovernmental transfers to local governments as a percentage of total revenues, reduces the size of government only if the degree of vertical fiscal imbalance and borrowing autonomy is low. But it can also increase the size of government if the degrees of vertical imbalance and borrowing autonomy are high (Stein, 1998). The above-mentioned studies show the complex links between political systems and fiscal outcomes, suggesting that the crucial tools in controlling the size and efficiency of government are bringing fiscal decisions closer to voter preferences, and making fiscal decision-makers more accountable. To facilitate reforms of public expenditure, the trend should be toward systems with majoritarian elections (instead of proportional) and toward decentralized systems. Presidential systems may help strengthen their capacity to bring about reforms. The same result, however, may be reached by increasing the governing power of the relative majority with a majoritarian electoral system. This conclusion seems well supported by the experience of the major continental euro countries (France, Germany and Italy), where evidence of a strong relationship between political systems and fiscal outcomes may be easily found.

These reforms, however, are not likely to be made voluntarily by the existing political system, because they might disturb the national political equilibrium or even destroy the smaller political parties. Particularly enlightening is the case of Italy, where in the last few years, several attempts to reform political institutions have failed, in spite of the need to reform the political system to make it to function efficiently in the new global economy. This scenario is common even to other EMU countries. Reforms are likely to be made only when driven by external economic

⁴⁹ Shugart (1999), as quoted by Milesi-Ferretti, Perotti and Rostagno (1999).

⁵⁰ The conditions to be expected to have a successful devolution are reviewed in general by Tanzi (1995). For a discussion of why devolution should work and how it should be done, see Rivlin (1992).

shocks: for example, Italy's successful 1992-93 implementation of the stabilization program after the devaluation of the lira.

If the budgetary authorities cannot react to a recession, in part, through monetary instruments – as they have in the past, under the EMU – budget deficits may get out of control, causing GSP violations (Buti, Franco and Ongena, 1997). This situation will be even more difficult where budgetary positions are structurally weak. When GSP violations occur, public expenditure reforms will be enforced. They will be unavoidable if further tax increases are not considered feasible

Therefore, reforms of the political systems and institutions may be needed if there is no other way to reach agreement on the required budgetary policies. The EMU authorities may have to compel these countries to implement a predefined multistage reform of their own political systems and institutions, based on national solutions (Perotti, Strauch and von Hagen, 1997).

C. Budget transparency may help public expenditure control

1. Better management, accrual accounting and elimination of gimmicks could drive public expenditure reforms

Are there substitutes for the political system reform that will drive public expenditure reforms? Might improving public expenditure management and accounting help overcome the inability of political systems to control public expenditure?

Reforms aimed at improving budgetary transparency – such as the strengthening of budget procedures, integration of accrual into cash accounting, and elimination of gimmicks to escape from fiscal constraints – may generate results that are qualitatively similar to major changes of public expenditure. They may compel governments to adopt measures to reduce expenditure in an effort to offset the impact of gimmicks on the deficit. However, they are not a substitute for fundamental expenditure reforms and should not be considered a panacea because, in fact, other gimmicks could be used to avoid fiscal constraints.

In most EMU countries, the search for gimmicks to avoid fiscal constraints continues. Budgetary gimmicks reduce transparency and may create (or disguise) structural economic weaknesses that limit medium and long-term growth potential. Moreover, they allow governments to avoid expenditure reforms. Moving public expenditure accounting closer to economic reality may eliminate some of the loopholes created by the present cash accounting system. Fiscal discipline could, therefore, be tightened, making fiscal constraints effective and compelling governments to implement, at least partially, those public expenditure reforms that the political systems avoid.

In Italy, sustained expenditure cuts and improvements in public expenditure composition could be achieved by integrating cash with accrual accounting and by avoiding budgeting gimmicks. Although the problem of unpaid commitments is mainly Italy's, other EMU countries have used budgeting gimmicks to bypass difficult fiscal constraints. These countries could also benefit from the avoidance of gimmicks to help push governments to reduce public expenditure. These

reductions may be sizable, even if they are only a very partial substitute for the structural public expenditure reforms needed to reduce tax rates.

2. Strengthening budget procedures would lead to better expenditure management

Many studies have examined the role of budget institutions in the fiscal performance of industrial and developing countries. Weak institutions are often associated with larger deficits, in both industrial economies (von Hagen and Harden, 1996; Alesina and Perotti, 1995 a and b, and 1999; de Haan, Moesen and Volkerink, 1999) and Latin American countries (Alesina, Hausmann, Hommes and Stein, 1996; and Stein, Talvi and Grisanti, 1999). Budget reforms may lead to different fiscal policy decisions in different political situations.⁵¹

It is argued that the fragmentation of the political process, particularly when measured by the number of participants in budget deliberations, affects fiscal policy outcomes (Kontopoulos and Perotti, 1999). Strengthening budget procedures through performance budgeting, programme budgeting, or “value for money,” may weaken the effect of proportional representation on fiscal policy outcomes (Stein, Talvi and Grisanti, 1999). Entrusting power to a strong finance minister may be effective in reducing the “common-pool” problem typical of plurality systems with cabinet negotiations (Hallerberg and von Hagen, 1999). Moreover, reforms that reduce the power of lobbyists, such as campaign finance reforms, may help improve fiscal discipline.

To ensure that spending units implement central government decisions aimed at controlling public expenditure, a system of incentives and penalties for public managers is needed. Such a system is not easy to implement where there is no political will for fundamental reform. Experience shows that these mechanisms are sometimes lacking, and the lack of such a mechanism is responsible for the lack of control. More effective monitoring of expenditure, increased responsibility, and administrative autonomy of senior civil servants are required. The number of units involved in the budget process has to be reduced, and their relationship with spending targets and allocated resources should be made easily recognizable.

Such reforms are being implemented in Italy. A new legislation, enacted in 1997 to reform the budget process, enables the government to monitor expenditures more effectively, and increases the responsibility and administrative autonomy of senior civil servants. The number of units involved in the budget process has been reduced. Each unit is now responsible for an area of activity within each ministry and is managed by a single administrative entity. By making the relationship between spending targets and allocated resources easily recognizable, this simplification increases the overall transparency of the budget process. Other mechanisms aimed

⁵¹ A review of budgetary procedures introduced in various European countries may be found in OECD (1995); OECD Economic Surveys (various years); and de Haan, Moesen, and Volkerink (1999). For Italy, see Alesina, Mare and Perotti (1995), and Milesi-Ferretti (1997)

at increasing the efficiency and improving the performance – such as quasi-markets, user fees, and vouchers – have been suggested.

Procedures for monitoring management performance and accountability are needed to ensure that parliament's spending decisions are implemented, so that the spending generates as high a value as possible to the citizens. Greater budget transparency may help enforce the implementation of national decisions to cut expenditure by decentralizing institutions. Moreover, decentralizing public expenditure management can improve management and transparency, which is a necessary precondition for economic efficiency and effectiveness. Public institutions, such as schools, may be better managed through decentralized operations.

Improved performance may even be achieved with other public expenditure management reforms, such as the so-called agency reforms aimed at enforcing a careful distinction between principal agent activities within the public sector, and the setting of performance contracts, measurements and indicators for those operating public services. These improvements may be reflected in increased output, more effective delivery of public services and more efficient services.

3. Computing accrual accounting carefully would help confront public expenditure and debt problems

Control of public expenditure could also be improved through changes in fiscal accounting systems. In fact, appropriate fiscal accounting would force public expenditure reforms and cuts by making it more difficult to pursue budgetary gimmicks used to bypass fiscal constraints. This outcome may become the result of accrual accounting adopted by the revised *Manual on Government Finance Statistics* (IMF, 2000). Accrual accounting is already utilized by the EMU countries to comply with the GSP, in line with EUROSTAT rules (National Accounts SEC95).

The switch from cash to accrual accounting would require that changes in payment arrears and public expenditure carryovers (unspent commitments) be included in the measurement of total annual public expenditure. Moreover, previous years' arrears and commitments should also be included in outstanding government debt. With the new accounting, the creation of further arrears would not necessarily be eliminated. However, the countries that use accrual accounting to avoid the fiscal discipline required by external budgetary constraints such as deficit-GDP and debt-GDP ratios, would be compelled to enforce more effective budget ceilings.⁵² Under the circumstances discussed below, arrears and unspent carryovers would have to be included in the calculation of expenditure, deficit and government debt. Building arrears would not reduce any more the operational deficit as they do in a cash accounting system.

⁵² In Anglo-Saxon countries, such as the United Kingdom, Australia and New Zealand, the role of accrual accounting is a strongly debated issue; in the 1980s and 1990s, these countries were able to cut back significantly the size of their public sectors thanks to their political systems and new budget procedures.

Adopting accrual accounting would help assessing budgetary performance, such as government deficit and debt, and enhance the effectiveness of fiscal constraints. As a by-product, governments would be forced to cut public expenditure or raise taxes to offset the resulting computation of arrears and unspent carryovers in the expenditure. In countries where tax increases are politically unfeasible, the only way to change accounting is to make reforms in public expenditure. Accrual accounting can produce expenditure cuts, and allow better cost-price calculations, focusing on expenditure management through a result-oriented system.⁵³ With cash accounting, public expenditure and deficit are artificially reduced, and incentives for efficiency in expenditure are lacking.

Today, cash accounting allows countries to maneuver the size of unspent commitments (budget carryovers) that do not have to be financed by governments in the same year in which they are recorded, avoiding fiscal constraints that are related only to cash accounting. Although this carryover provision can be justified for capital allocations not yet committed, it is typically not justified for new commitments. This manoeuvre may be used one time as a gimmick; it can also become a sustained policy, repeated annually until it becomes financially unsustainable.

Under the accrual accounting system, new commitments (orders) would be counted as liabilities and added to cash expenditure when the service is delivered, and they thereby incur government debt when the payment is overdue. Central and local governments' new annual fulfilled, but unpaid orders (arrears) would be included as government expenditure in the consolidated general government operating statement. Only commitments concerning yet to be provided services would be excluded under accrual accounting. Unpaid, but fulfilled, commitments should be carefully assessed when accrual accounting is utilized. In practice, however, this assessment may be difficult to perform correctly, as the case of Italy shows.

According to the ESA 95 accounting system followed by the Italian National Statistic Institute (ISTAT), government operations are recorded in accordance with the accrual principle (*competenza economica*). The recording procedure followed by ISTAT is based on the 1993 System of National Accounts (SNA 1993) and is the same as those utilized by all European countries and by most other countries worldwide.

In accrual terms, a transaction must be recorded when it produces its economic effects. Therefore, the timing of recording seldom coincides with the timing of cash transactions. Expenditure commitments are used as an approximation of the accrual principle of recording for all expenditure items that constitute production costs. Uncommitted appropriations (*residui di stanziamento*) are excluded because they do not represent true debits for public administration.

Enforcing these procedures in practice is difficult. Transparency on carryovers necessary to consolidate general government expenditure commitments and revenues and to single out

⁵³ The merits and limits of accrual accounting are analyzed by Potter and Diamond (1999); OECD (1997a); and Premchand (1995).

committed appropriations is somewhat lacking. Available data are supplied with a large delay and without necessary details for their analysis. Accrual expenditure is sometimes underestimated.

In 1997-98, the annual average increase in such central government unpaid carryovers reached Lit 41.6 trillion (over 2 per cent of GDP), compared to an annual average of only Lit 2.8 trillion for the previous three years (Table 2). These data were reported with a considerable time lag (about 15 months). Local government carryovers increased by Lit 18.2 trillion (0.9 per cent of GDP) in 1997, and by Lit 30.4 trillion (1.5 per cent of GDP) in 1998.

In 1997 and 1998, the average increase in central government arrears was thus sizable – about almost 15 times the average of the previous three years. The stock of unpaid central government carryovers (*residui passivi propri*) at the end of 1998 was about Lit 201 trillion (20 per cent of GDP). To this amount, a stock of local government unpaid carryovers of over Lit 254 trillion (12 per cent of GDP) should be added. This latter amount is the sum of the 1998 stock of unpaid carryovers by the regions and the 1997 stock of unpaid carryovers by provinces and municipalities. At the end of 1998, the stock of unpaid health care arrears was estimated to be over Lit 30 trillion (1.5 per cent of GDP).

Table 2. Italy: Increase of Unpaid Carryovers and Health Care Arrears, 1994-98
(In billions of lire)

	1994	1995	1996	1997	1998	Average	
						1994-96	1997-98
Unpaid carryovers 1/ Central government 2/	-148	16,716	-8,000	40,222	42,989	2,855	41,605
Local government 3/	-7,036	965	22,729	18,254 4/	30,481 4/	4,609	24,367 4/
Health care arrears 5/	7,443	278	3,251	9,187	8,835	3,657	9,011

Source: For the unpaid carryovers, see Italy, Ministero del Tesoro (various years, 1996-2000); for the health care arrears, see Italy, Ministero del Tesoro (1999).

1/ As assessed comparing carryovers at the end of the year with the previous year amount.

2/ *Residui propri*.

3/ Regions, provinces and municipalities. Local government include unspecified uncommitted budget carryovers (*residui passivi di stanziamenti*).

4/ For 1998, only regions (data for municipalities and provinces are not available).

5/ Regional overruns of the National Health Service.

To comply with the GSP, in line with EUROSTAT rules (National Accounts SEC95), annual changes in unspent carryovers and health care arrears should be computed in public expenditure only when actual services are provided or when legally binding rights exist to exercise

commitments at a later date. The process of general government accounting should carefully respect this convention, and should not simply assume that all central and local government unspent carryovers and regional health care arrears do not correspond to actual services or to binding rights to exercise commitments at a later date.

The central government's unspent carryovers could actually be unpaid commitments if they have been fulfilled, but not yet paid. Information on these commitments not yet available should be collected and provided in a reasonable time, together with the information on the composition of general government carryovers.

In the last few years, an important component of central government carryovers has been represented by unpaid transfers to local governments. These transfers were not computed as the central government's unpaid commitments because they were not legally committed. However, they could become local government's unpaid commitments and should be included in general government accounts. A properly consolidated general government account should not include claims of one level of government on another level of government.

Moreover, accrual expenditure should be carefully forecast, avoiding possible underestimation. For the sake of eliminating new arrears in NHS health care managed by regions from budgetary accounts prepared for the European Union, accrual accounting was utilized. However, this useful innovation did not eliminate new arrears, and these new arrears were not fully recorded in accrual computation. As the 1999-2000 experience clearly shows, 2000 health care expenditure calculated in general government accounts was underestimated. The impact on general government accounts produced by actual 1999 health care expenditure has not been adequately taken into account, and health care institutions have undervalued their accrual expenditure because they have not fully calculated the expenditure financed by suppliers (Reviglio, 2000).

Health care arrears are produced because the institutional system does not assign full expenditure responsibility to regions. The Italian case shows that a devolution of health care services not accompanied by adequate fiscal responsibility can produce distortions and excessive spending.

Some recent measures in the financing of health care expenditure attempted to solve the problem of lack of expenditure responsibility by better relating revenues received by the regions to their needs. Moreover, the "State-Region Conference" agreed to end the state financing of regional health care expenditures. But this agreement lacks an enforcing penalty and does not ensure that new regional deficits will not be created when the standards of the services provided by the regions will continue to be decided by the central government's three-year health care plan.

A careful accrual calculation in accounting prepared for the EU would encourage better fiscal discipline because it may be most successful when rules on discretionary spending are set up. Without EU rules, accrual accounting might make the budget situation more embarrassing, but it might not have the same impact on behaviour. As the case of Italy shows, accrual accounting should be carefully pursued, avoiding underestimates of expenditure and calculating unpaid commitments correctly. To comply with the GSP, the Italian government increased unpaid commitments together with a very effective control of cash deposits. The unusually large cash

deposits in the Treasury, mainly by the regions and local authorities, were gradually reduced and used to offset the inadequacy of new cash transfers from the central government budget. This successful operation, however, was not matched by an equal reduction of expenditure commitments.

Unpaid commitments should be accounted for as expenditure only if they are liabilities from the general government to the private sector. For example, such commitments between central and local governments will disappear in the general government consolidation. Moreover, the liability for items recorded as unpaid commitments should not be taken for granted. The nature of the claim should be carefully assessed and, if a commitment was not fulfilled, then no liability would exist.

Under accrual accounting, the annual increase in unpaid fulfilled commitments should be included in the operating statement of expenditure, where it corresponds to goods and services or goods delivered that year. Some measure of arrears in receipts, such as tax revenue and social security contributions, should also be included under accrual accounting, but they have to be assessed realistically, that is, based on what the government can expect to collect. The stock of the previous years' unpaid commitments should be included in government debt, and the stock of arrears in revenue and social security contributions considered an offsetting item of the debt should be assessed realistically.

Assessing the arrears in receipts and in expenditures is not an easy task. Governments struggling to reduce the size of deficit tend to overestimate the revenue to be collected and underestimate the expenditure that corresponds to goods and services delivered that year. Therefore, they should be required to specify the assumptions of their valuation, and the assumptions should be scrutinized for their realism on the basis of previous years' treatments. This issue is essentially the same as the one to be faced when forecasts for the new budget are approved.

Budget procedures aimed at reducing recorded expenditures or increasing receipts artificially should not be permitted. For example, procedures designed to bypass fiscal constraints by excluding from expenditure accounting transactions that reduce the net worth of government should not be allowed. Two of these procedures are (1) government acquisition of financial assets matched by new liabilities, and (2) the inclusion, as cash revenue, of the receipts received by government institutions (e.g., social security funds) for bonds issued in the market through the securitization of unpaid contributions.⁵⁴ Both procedures were used in Italy: (1) the valuation of equity capital was increased in public enterprises, mainly in the transportation area, as central and local governments underestimated losses; and (2) in 1999, social security funds were financed through the securitization of unpaid contributions.

⁵⁴ According to the Maastricht Treaty, the numbers to establish whether a country met the quantitative performance criteria set out in the Treaty were to be provided by EUROSTAT. Starting with the end of 1999, EUROSTAT has insisted that the portion of the transfer that corresponds to covering operating losses of the companies be recorded above the line. Moreover, the securitization of unpaid contributions was disallowed.

The first procedure transforms the losses of public enterprises (e.g., railways, local transportation and postal service) into capital stock increases in these institutions. Instead of financing public enterprise losses with government transfers included in the expenditure calculation, the losses are indirectly covered by the government increasing the capital stock of the enterprise. According to the established convention, the increase in capital stock of a public enterprise is considered a financial operation aimed at raising government wealth and, therefore, is not included in the expenditure or the deficit. However, capital stock increases of public enterprises aimed at covering their losses do not raise the government's net worth.

The increase in equity capital of Italian railways (*Ferrovie dello Stato S.p.A.*) was a result of the restructuring process aimed at privatization. Thanks to an European Commission intervention, after 2000, the gimmick of underestimating railways losses, which increased the value of equity capital, is not allowed any more.

The second procedure counted the securitization of unpaid social security contributions as revenue. This procedure is inappropriate for two reasons: (1) the proceeds from the sale of the social security fund's unpaid contributions should not be counted toward reducing the deficit because these contributions were due in the past; and (2) the anticipated receipts were not a definitive payment for the sale of an overdue taxpayer contribution but a loan received by the social security fund. However, the operation allowed the government to record above the line social security contributions that were higher (by Lit 5.5 trillion) than originally estimated. This was equivalent to a budget gimmick, and created about Lit 5.5 billion in social security contribution arrears.

Unpaid credits may be calculated in accrual budgeting, but they have to be assessed realistically – based on what the government expects to collect. Furthermore, receipts from the securitization of unpaid social security contributions fund should never be included in government receipts, because they are used to finance government deficits. They are a loan received by issuing bonds in the market, that is, an item of deficit-financing.

After 2000, receipts from the securitization of unpaid social security contributions will not be recorded as general government revenues because the securitization is considered a financial operation. Only new credits expected to be recovered and resulting from the budget of the National Social Security Institute (INPS) are recorded as additional general government revenues.

D. Conclusions

To function efficiently within the new global economy, political systems of the EMU countries need to be reformed. These reforms, however, are being resisted because they threaten to disturb the political balance, destroy small political parties, eliminate the veto power of components of coalition governments, and increase the governing power of the relative majority. Such changes to political institutions are not likely to be made. Political reforms are likely to take place only when driven by external economic shocks. In the meantime, what public expenditure reforms might be pursued without changing the political system?

Technical improvements made to increase budget transparency, such as strengthening budget procedures, integrating of accrual and cash accounting, and removing gimmicks that bypass fiscal constraints could indirectly affect public expenditure by improving public expenditure management and eliminating gimmicks that bypass fiscal constraints. Strengthening budget procedures would improve managerial performance and the enforcement of legislation. These improvements would make a real contribution to enhanced accountability and budgetary transparency. Better expenditure management may help enforce the implementation of tough policy decisions. This paper has tried to show how the efficiency of budgetary policies could be improved.

This paper reviewed some budgetary gimmicks used in Italy to bypass fiscal constraints. Some of these practices have been recently removed through improvements in budgetary transparency and expenditure management and control.

For example, the government is no longer engaged in underestimating public enterprise losses (e.g., railways losses) in order to increase the value of equity capital or in counting receipts from the securitization of unpaid social security contributions as new revenues. The latter financial operation has recently become a below the line operation, because the corresponding social security contributions were due in the past. This treatment, however, did not change budgetary policy, because the government has moved to a new assessment of higher social security contributions than originally estimated by about the same amount as expected to be received from the securitization. It is, however, unclear to what extent this new treatment is a realistic and appropriate practice rather than creative accounting. The interpretation of the GSP should be dynamic in order to prevent new “creative” accounting.

Another example, excluding health care overruns from budget accounting, also has been corrected. However, the integration of accrual with cash accounting has yet to be implemented.

Since 1996, Italy has been very successful enforcing budgetary cash limits, providing an effective constraint to the spending process of decentralized bodies and contributing to deficit reduction. A significant amount of liquidity that the decentralized bodies had accumulated on their Treasury accounts was absorbed, but this enforcement led to an increase in carryovers. In recent years, these carryovers did not result in an expenditure increase, because decentralized bodies utilized their cash balances at the Treasury.⁵⁵

In future years, however, this outcome cannot be easily repeated when liquidity stocks outstanding are no longer available. Unpaid carryovers may become expenditure if they are not reduced to zero. This outcome may be attained only when unpaid carryovers are not legally binding and when they may be removed with an administrative decision not requiring a difficult reform of expenditure laws.

⁵⁵ For this successful maneuver, see Giarda (1998).

Timely, adequate information on revenue and expenditure carryovers allowing a properly consolidated general government account is desirable. Moreover, it would be useful to provide a breakdown, allowing the identification of commitments fulfilled but not yet paid. It may also help to specify carryovers that may be deleted simply remodeling future appropriations from those requiring instead difficult reforms of expenditure laws. Accrual expenditure should be forecast, avoiding possible underestimates.

Accrual accounting should discourage the practice of using unpaid commitments to bypass fiscal constraints. This paper tried to show how this underestimation may occur in Italy. Moreover, reporting on general government carryovers is too poor and delayed to allow exhaustive checks and controls of the fairness of budgetary accounting. Factual descriptions to back this conclusion were quoted. A more exhaustive reporting on general government carryovers built on an adequate and timely collection of data may help to improve budgetary transparency.

Although the problem of unpaid commitments is mainly Italian, gimmicks to bypass difficult fiscal constraints are also used in other EMU countries. “Creative” public accounting, for example, is used in almost every country. The appropriate recording of both the deficit and the debt would have a huge benefit in terms of transparency in the political and social debate, by showing the government’s role in the economy. In other countries, the avoidance of gimmicks may also help to push governments to reduce public expenditure. Albeit sizable, these are only a partial substitute for the structural public expenditure reforms that are necessary to reduce tax rates.

These changes, though technical in nature, may have considerable political impact. They will receive strong political opposition, because they will force the introduction of tougher fiscal constraints, which will have a pro-cyclical impact on countries now experiencing slow growth. They will also be opposed because of the fear that they will reduce the country’s credibility and increase its vulnerability in financial markets. The reality, however, is that governments/countries are more vulnerable if they do not change their public finance policies.

This opposition will be unjustified. These reforms need to be made to eliminate structural weaknesses and to achieve medium and long-term growth. These reforms will make the EMU less fragile, by helping it realize sound macroeconomic policy and prepare for future external economic shocks. Moreover, the expenditure cutbacks that are necessary on macroeconomic grounds may become more acceptable if they produce microeconomic improvements in service delivery.

Improving public expenditure management by strengthening budgetary procedures, integrating accrual and cash accounting, and removing gimmicks that bypass fiscal constraints, will also foster transparency, improve budgetary credibility, encourage further public expenditure reform, and stimulate preparedness for future external shocks. More accurate deficits have to be calculated. Budgetary gimmicks are not consistent with the GFS.

All EMU members should abide by ESA95 rules and follow the same methods for calculating the deficit. These changes should be considered an important component of the second-generation reforms considered by the international financial institutions to be indispensable in promoting higher medium and long-term economic growth”.⁵⁶

⁵⁶ On the new challenge of the second-generation reforms, see Camdessus (1999), IMF (1999) and Tanzi (1999).

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THE IFAC PUBLIC SECTOR STANDARDS PROJECT

by John Stanford⁵⁷

It is a great privilege to tell you a little about the work of the International Federation of Accountants (IFAC). In particular I want to highlight the work of IFAC's Public Sector Committee (PSC) and consider progress on the project to produce a core set of financial reporting standards for the public sector.

First some general information about IFAC. IFAC was formed in 1977. The mission of IFAC is the worldwide development and enhancement of an accountancy profession with harmonized standards; a profession which is able to provide services of consistently high quality in the public interest. IFAC is a non-profit, non-governmental, non-political organization of over 150 accountancy bodies in well over 100 countries.

Membership in IFAC is open to accountancy bodies recognized by law or general consensus within their countries as substantial national organizations of good standing within their accountancy profession. The membership of IFAC member bodies comprises more than 2,000,000 accountants in public and private practice, education and government service.

IFAC's governance arrangements include a Council with one representative of each member body and a Board of 17 members. The Council agrees on the financial contributions of member bodies and adopts changes to the IFAC Constitution, whilst the Board supervises the general IFAC work programme and budget and oversees the work of the standing committees. It is worth noting that there has recently been a Task Force Review of the International Auditing Practices Committee, and this will soon be known as the International Auditing and Assurance Standards Board

The IFAC Committee on which I want to focus is the Public Sector Committee (PSC). Currently we have 12 members. Shortly, we shall have 13, because Argentina will join in 2002. The current proposal is that members should have three-year terms and individual members have recently been given details of their terms. Because the primary focus of the PSC is on standard-setting, there is some concern that three-year terms may be insufficient and that longer terms should be introduced.

Each member is entitled to have two technical advisers. There are a number of observers. These include the World Bank and the Asian Development Bank, as well as the IMF, INTOSAI, representing national supreme audit bodies, the International Accounting Standards Board, the Organization for Economic Cooperation and Development and the United Nations Development Programme.

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The PSC was established in 1986. Initially its remit was very broad. It fulfilled this remit by producing a number of studies and guidelines. The areas covered have included topics such as the definition and recognition of assets, liabilities, revenues and expenses and the boundary of the reporting entity. The development of these standards and guidelines meant that the PSC gathered a considerable amount of information on financial reporting and accounting approaches worldwide. Recently the PSC has adopted a sharper, more focused role.

This involves the PSC as a standard-setter, producing high-quality standards for a global constituency. The PSC assumed this role in 1996 following a background scoping exercise. The approach has been to produce a set of core standards quickly. These are based on International Accounting Standards in existence at August 1997. We are currently coming to the end of the first phase of the project, and by the middle of next year we should have issued 20 International Public Sector Accounting Standards (known as IPSASs). Whilst four years may appear to be a long time, it is a fairly short period for standard-setting and the production of a core set of standards represents significant progress. A number of important public sector-specific issues have been identified for development in the second phase of the project, which will start early next year.

At present both exposure drafts and standards have been issued only in English. However, a Spanish translation of the first eight IPSASs, supported by the Inter-American Development Bank, should be available shortly. It is also aimed to have translations into a number of other languages, including French, Arabic, Russian and Mandarin. The PSC is working closely with the International Accounting Standards Board, and this should provide benefits in terms of consistency of translations between International Accounting Standards (now to be known as International Financial Reporting Standards) and IPSASs.

A study entitled *Governmental Financial Reporting* was issued in May 2000. One of the main purposes of this study was to consider the various bases of accounting in use and to come to a decision as to which basis the standards project should focus on. This study also aimed to give standard-setters a common understanding of different accounting policy issues and considered the identification of the users of general purpose financial statements in the public sector, probably a more complex issue than in the private sector.

A number of accrual-based standards have already been issued. Each standard has a comparison with its private sector IPSAS counterpart. The main difference is that in the public sector, the majority of assets are held for service delivery purposes rather than primarily for the generation of cash, so we talk about service potential and use terms which are more appropriate in a public sector context, such as revenue (income) and statement of financial performance (income statement).

Standard-setters, whether national or international, are very concerned about due process. A sound due process is important in conveying authority on a set of standards. Each IPSAS is issued as an exposure draft for a period of at least four months. We list specific matters on which

we want comments. The comments are then evaluated by the Secretariat in considerable detail and the issues raised considered by the full PSC.

A further four IPSASs were issued earlier this year. IPSAS 12, “Inventories” does not allow the use of “last in, first out” as a method of estimating the cost of inventories. It was decided that such an approach is inappropriate in the public sector. It is interesting that the IASB is currently considering this issue as part of its improvement project.

IPSAS 9 on “Revenue” only deals with what accountants call exchange transactions – generally those conducted at market rates. It therefore excludes revenue generated from the use of sovereign powers – direct and indirect taxes, duties and fines, grants and donations. Of course there is not full agreement on what is and is not an exchange transaction. In the course of our discussions it became clear that in some jurisdictions the notion of exchange is defined more broadly than in others.

The IPSAS on “Construction Contracts” had to consider the fact that, in the public sector, a number of agreements, whilst binding, are not legally enforceable. The terminology it employs reflects this.

These IPSASs have all been agreed upon and will be released very shortly. In most instances they do not differ greatly from their IAS counterparts. Possibly, the most controversial aspect of the IPSAS on “Investment Property” is the requirement that where land is held for an undetermined future purpose, it should be treated as investment property and measured accordingly. On events after the reporting date there was considerable discussion on processes for authorizing and amending financial statements and on the issue of going concern in the public sector, where there are different considerations than in the private sector.

The IPSASs on both “Leases” and “Property, Plant and Equipment” (P, P and E) have now been approved. They will be issued early in the new year. The leases standard is very close to the corresponding private sector standard, IAS 17. The standard on P, P and E had to consider the issue of heritage assets; these are assets which are held on behalf of the community. Examples include historic and religious buildings and buildings of cultural significance. It has been decided to scope these out of the standard, so that there is further time to consider the key issues and learn from the experience of individual jurisdictions.

Segment reporting has been considered by the Committee on a number of occasions because the approach in the private sector standard, IAS 14, did not fit public sector circumstances very well. Following consultation, it has been decided to adopt a more rigorous approach to the identification and reporting of segments. As a result, there will be a further limited consultation before this is finalized for publication. This is an indication of the importance of “due process”. We feel that it is important that we ask constituents their views, because the approach has been materially modified from that proposed at consultation.

The consultation period on ED 20 and ED 21 ends today. We’ve had to make quite a lot of changes to these from their IAS counterparts. For ED 20, this reflects the fact that the main

reason for disclosures on related parties in the public sector – accountability – differs from that in the private sector, where it is to give users of financial statements information on factors which might distort performance. For ED 21, social policy obligations have been scoped out for consideration in the second phase of the project.

When the decision was made in 1998 to focus on the accruals basis of accounting, it was also decided to produce a single comprehensive IPSAS on “Financial Reporting under the Cash Basis of Accounting” – in global terms, the majority of jurisdictions report on the cash basis. It is fair to say that development of the IPSAS has been difficult. Whilst it received strong support at consultation, there were few responses from developing nations – the constituents for which the ED has been developed. A sizeable minority of respondents also felt that the requirements in the ED were too onerous and complex. Following a limited further consultation and the comments of both multi-lateral and bilateral agencies, it has now been decided to re-examine the ED early next year. In a recent related development, the donor agencies and nations have asked the PSC to consider producing an IPSAS on “Accounting for Development Assistance”. This request is now under active consideration.

Impairment is a very tricky issue in the public sector. The approach to the measurement of impairment losses in the private sector generally involves the use of discounted cash flows. Such an approach does not fit the majority of public sector assets, which are used for service delivery purposes. Even where assets generate cash flows, there are often subsidies or what are known in some jurisdictions as community service obligations. Such subsidies or obligations again make a reliance on cash flows problematic in measuring impairments. Generally it is quite easy to spot indicators of impairment – less straightforward to decide what such triggers actually mean in terms of the carrying value of assets.

A guide to transition from the cash basis to the accruals basis of reporting is very close to publication. This will be available on the IFAC web site shortly. It will be a living document which can be updated as circumstances require. The production of transitional guidance has been strongly advocated by many of the PSC’s constituents.

The PSC decided to defer work on two areas – for two different reasons. The issues on employee benefits are very complex, particularly those relating to pension entitlements. After some consideration it was decided that an IPSAS on entity combinations would have fairly limited application in the public sector, and that resources would be better put into other issues. In any case, the whole basis of merger accounting may well change fundamentally in coming years.

The second phase of the project is due to start early next year. This is potentially the most exciting part of the project. More importantly, it will bring the greatest benefits to the users of our standards.

However, there are a number of other important activities that we need to consider. Most standard-setters have developed conceptual frameworks to underpin their standards. The PSC has not done this, but there are a number of countries which have moved towards the development of frameworks which recognize the importance of public sector circumstances. They include

Sweden, France and my own country, the UK. The PSC will monitor the progress of these jurisdictions in producing conceptual frameworks for the public sector.

With the creation of the new International Accounting Standards Board and the EC requirements in relation to listed companies, there will be a great deal of change to international accounting standards over the coming years. We need to monitor these changes and evaluate their significance for IPSASs and for the public sector generally.

We must now give greater emphasis to the promotion of our standards and to their translation, which I have already mentioned. Finally we must maintain the standards which we have already issued.

These are some of the issues which are likely to be tackled in the second phase of the project. From a public sector perspective they are very significant. For example, taxation and other duties are the main source of revenue for many public sector entities, so producing a standard which deals with their accounting treatment must be a priority. Similarly, the liabilities arising from social policy obligations are huge – state pensions, key social programmes involving transfer benefits, unemployment entitlements and the like – and, potentially, entitlements to state, health and education provision. Should we start to recognize these liabilities in financial statements when someone is born, or when they start school, or should the approach be much more restrictive?

The harmonization of accounting and reporting requirements and those for GFS and SNA is a major issue for many. Whilst the frameworks are similar, they have different objectives.

The donor agencies, in particular the World Bank, have been very keen on budgeting and the establishment of minimum requirements.

In 2002 it has been decided that three projects will be launched on non-exchange revenue, social policy obligations and budgeting.

In order to make progress on these complex and contentious subjects, the PSC has recently reviewed the way in which it works. One of the key decisions it has taken is to set up steering committees which will develop proposals in particular areas. These steering committees will contain members of the PSC and will always be chaired by a member of the PSC. However, they will include individuals who are neither members of PSC nor technical advisers. This will enable the project to benefit from experts in the particular areas where proposals are being developed.

The PSC is also considering reactivating a large regionally based consultative group to provide user views and influence the agenda of the Committee. This issue will be considered further in 2002.

A feature of meetings is that we have regional workshops and seminars with local groups. Earlier this year we had a very successful seminar in Zagreb, which covered developments and issues

affecting public sector accounting in Croatia. In Washington, earlier this month, there was a seminar with multi-lateral donor agencies.

We are also starting to look at the governance arrangements of the PSC, although no decisions are likely to be made in the short term. We differ from a number of the other IFAC committees in that a considerable amount of our funding is provided by outside bodies. In this respect the World Bank and the Asian Development Bank have, along with the IMF and the United Nations Development Programme, been very generous.

It is likely that in a couple of years we shall be considering specific governance issues. Should we remain fully under the umbrella of IFAC or should we modify our governance arrangements to ensure appropriate involvement from other stakeholders? Should there be the creation of an oversight board? These are just two of the issues which might be considered.

STANDARD PROJECT UPDATE

by John Stanford⁵⁸

<p>International Federation of Accountants (IFAC)</p> <ul style="list-style-type: none">• Membership - 153 member bodies, 113 countries• Technical committees including:<ul style="list-style-type: none">– Audit practices– Public sector– FMAC– Ethics– Education	<p>PSC Members and Observers</p> <ul style="list-style-type: none">• Members Australia, Canada, France, Germany, Mexico, The Netherlands, New Zealand, Pakistan, South Africa, Thailand, UK, USA• Observers ADB, IASB, IMF, INTOSAI, OECD, World Bank, UNDP
<p>IFAC Public Sector Committee</p> <ul style="list-style-type: none">• Established 1986• Initial role and objective to address public sector needs re:<ul style="list-style-type: none">– Financial reporting– Accounting– Auditing• Issued studies, guidelines• New role evolving	<p>Standards Project</p> <ul style="list-style-type: none">• Established late 1996• Stage 1 Objectives<ul style="list-style-type: none">– Background Paper– Core Set of Standards <i>quickly</i>– Identify public sector specific issues for consideration in stage 2– Translation

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<p>Progress to Date: Stage 1</p> <ul style="list-style-type: none"> • Study 11 - <i>Governmental Financial Reporting</i> 	<p>Accrual IPSASs</p> <p>(International Public Sector Accounting Standard)</p> <ol style="list-style-type: none"> 1. <i>Presentation of financial statements</i> 2. <i>Cash flow statements</i> 3. <i>Net surplus or deficit for the period, fundamental errors and changes in accounting policies</i> 4. <i>The effects of changes in foreign exchange rates</i>
<p>Accrual IPSASs (continued)</p> <ol style="list-style-type: none"> 5. <i>Borrowing costs</i> 6. <i>Consolidated financial statements and accounting for controlled entities</i> 7. <i>Accounting for investments in associates</i> 8. <i>Financial reporting of interests in joint ventures</i> 	<p>Accrual IPSASs (continued)</p> <ol style="list-style-type: none"> 9. <i>Revenue from Exchange Transactions</i> 10. <i>Financial Reporting in Hyperinflationary Economies</i> 11. <i>Construction Contracts</i> 12. <i>Inventories</i>
<p>Accrual IPSASs (continued)</p> <p>Agreed - to be issued by end of 2001</p> <ul style="list-style-type: none"> • <i>Events After the Reporting Date</i> • <i>Financial Instruments: Disclosure and Presentation</i> • <i>Investment Property</i> 	<p>Accrual IPSASs (continued)</p> <p>Anticipated issue end of 2001/early 2002</p> <ul style="list-style-type: none"> • <i>Leases (end 2001)</i> • <i>Property, Plant and Equipment (end 2001)</i> • <i>Segment Reporting (early 2002)</i>

<p>Exposure Drafts</p> <ul style="list-style-type: none"> • <i>ED 20 Related Party Disclosures</i> • <i>ED 21 Provisions, Contingent Liabilities and Contingent Assets</i> (Comment period ends 30 November 2001) • <i>ED 9 Financial Reporting Under the Cash Basis of Accounting</i> (comments closed) • <i>Further consultation on ED 9 being undertaken</i> 	<p>Currently Under Development</p> <ul style="list-style-type: none"> • ED on Impairment (<i>ITC issued July 2000</i>) • Guide on Transition - to accrual basis (issue first quarter 2002)
<p>Development Deferred</p> <ul style="list-style-type: none"> • Employee Benefits • Entity Combinations 	<p>Stage 2 of Standards Project</p> <ul style="list-style-type: none"> • Deal with public sector specific issues • Framework for financial reporting • Monitor IASB • Promotion and communication • Translation • Care and maintenance
<p>Public Sector Specific Issues</p> <ul style="list-style-type: none"> • Non-exchange revenue (e.g. taxes) • Social policy obligations/liabilities • Harmonisation of accounting and GFS • Inventories of services to be provided “free” • Government budgets • Measurement of heritage assets • Non-financial performance indicators 	<p>Potential Changes to Operating Procedures</p> <ul style="list-style-type: none"> • Steering Committees (including Non-PSC members) - to broaden base of expertise • Consultative Groups <ul style="list-style-type: none"> – To discuss/report on public sector issues/PSC work program – To widen input to PSC process • Regional Workshops/Presentations <ul style="list-style-type: none"> – To communicate with constituents

Governance <ul style="list-style-type: none">• Mandate – just standards?• IFAC• Board of Trustees ?• IASB?• Funding (Governments?)	ATTACHMENT PSC STUDIES:Background Framework <ul style="list-style-type: none">– Study 1 <i>Financial Reporting by National Governments</i>– Study 2 <i>Elements of the Financial Statements of National Governments</i>– Study 5 <i>Definition and Recognition of Assets</i>– Study 6 <i>Accounting for and Reporting Liabilities</i>– Study 8 <i>The Government Financial Reporting Entity</i>– Study 9 <i>Definition and Recognition of Revenues</i>– Study 10 <i>Definition and Recognition of Expenses/Expenditures</i>
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