

Unclassified

GOV/PGC/SBO(2004)1



Organisation de Coopération et de Développement Economiques
Organisation for Economic Co-operation and Development

03-Feb-2004

English - Or. English

**PUBLIC GOVERNANCE AND TERRITORIAL DEVELOPMENT DIRECTORATE
PUBLIC GOVERNANCE COMMITTEE**

**GOV/PGC/SBO(2004)1
Unclassified**

Working Party of Senior Budget Officials

REALLOCATION: THE ROLE OF BUDGET INSTITUTIONS

DRAFT PROJECT REPORT

**Meeting of the Expert Group
OECD, Paris, 11 February 2004**

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JT00157646

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REALLOCATION: THE ROLE OF BUDGET INSTITUTIONS

1. OVERVIEW OF THE PROJECT

1.1. Background

1. The economic slowdown in a large part of the OECD area has changed the landscape of budgetary policy. After the long, unprecedented period of high economic growth in the nineties, budgetary authorities in many countries are facing again the problems of fiscal stress that were characteristic for previous periods of recession. The present economic situation is also uncertain. Whereas international organisations have estimated that the low point of the recession has passed, they have recently also acknowledged that recovery is unusually slow and that there are many uncertainties as to future developments.

2. Fiscal stress in a recession is due to upward pressure on expenditure stemming from increasing unemployment benefits and other means tested entitlement programs on the one hand and slow growth of tax revenues on the other. The wish for tax relief or new investment programs in order to stimulate the economy may put additional pressure on the budgetary process. These pressures can to a certain extent be mitigated by shifting of resources from existing programs of lower priority to programs of higher priority or tax relief. Such shifting of resources is one of the forms of reallocation that is explored in this study.

3. In the present situation many OECD countries are facing complicating circumstances that were not present, at least not to the same extent, in previous periods of recession. Four of these are mentioned here. First, citizens have become more demanding towards publicly provided services. During the nineties private incomes increased substantially and markets responded by offering a larger choice and higher quality products and services to larger groups of people. Citizens have come to expect similar improvement in the provision of public services. Until now, such expectations have not been satisfied. On the contrary, many citizens feel that the quality of publicly provided services, such as education and public transport, has declined. This deviation between reality and expectations adds to the upward pressure on expenditures.

4. Second, several OECD countries face significant problems in respect to the integration of new immigrants. Immigration and failing integration has caused segregation in various domains of social participation. Some urban neighbourhoods have deteriorated in spite of increasing prosperity. Social tensions between ethnic groups and crime have increased. Schools have become more segregated. Living conditions have grown apart. Participation in social activities (cultural, recreational, religious, charitable, political) has increased for the large majority but decreased for significant minorities.

5. Third, increasing international tensions have contributed to the threat of terrorism. This has given rise to new programs of internal security and expansion of the system of law enforcement. In some countries defence expenditure has been increased. The US and the UK have funded the war in Iraq and a part of the reconstruction efforts in that country. Other countries intend to contribute as well. Expenditure for internal and external security is a high growth sector in many national government budgets.

6. Fourth, many OECD countries have ageing populations. Furthermore, some countries have fully funded pension systems for public sector employees, but others have systems based on pay-as-you-go principles. The latter will be facing increasing deficits in their pension funds. Moreover, the prevalence of pay-as-you-go systems tends to coincide with overly generous benefits and early retirement rights. Most of the countries concerned are only in an early stage of pension reform. As far as general public pension (social security) is concerned, all OECD countries have pay-as-you-go systems. Benefits differ substantially between countries. In this area too, reform efforts have been launched, but most are only in a first stage of development. The problem of ageing populations is exacerbated by the simultaneous improvement of medical technology. Health expenditures will start to grow at an unprecedented rate in the near future. This leads to the so-called double ageing: the share in the population of the age group that retires increases and simultaneously this group will live longer. Both effects compound the problems in the health sector as well as the pension sector.

7. The circumstances mentioned will keep a systematic upward pressure on expenditures, even if the recession will recede and growth will resume. In this light it seems plausible that the search for funding methods through reallocation will remain high on the political agenda for the foreseeable future.

1.2. Aims and methods of the study

8. The study aims to gain insight in the impact of four institutions of the budget process upon reallocation:

- (1) multi-year expenditure frameworks;
- (2) rules of budgetary discipline;
- (3) the authority of the minister of finance;
- (4) the role of program review

9. Some attention will also be paid to two other institutions that in some countries have an impact on reallocation: earmarking of revenues for investment expenditures and budgeting for investment expenditures on an accrual basis. The study also looks at what can be said about the effect of these budget institutions on reallocation in terms of allocative efficiency. The latter is a normative question. It supposes that reallocation is not good by definition: there may also be bad reallocation -- in the sense of welfare reducing.

10. For the purpose of this study reallocation is defined as the readjustment of expenditures compared to the current budgetary or medium term estimates. This definition gives rise to a number of observations. First, reallocation as defined here, regards only expenditures, not revenues (although changes in taxation or public borrowing or retributions/fees do change the existing allocation of resources in the economy). Second, reallocation does not only refer to shifts in the pattern of expenditures that amount to decreases for some purposes and increases of exactly the same size for other purposes. A general or specific decrease without an off setting increase is also a form of reallocation. Similarly, a general or specific increase without an off setting decrease. Third, reallocation concerns a change in an existing pattern of expenditures. This pattern of expenditures is conceived as being determined by expenditure estimates. For the current budget year, these estimates are the estimates authorized by appropriations law. For future years these estimates are the latest official estimates for out years based on the principle of "current law"¹.

¹ Current law estimates take into account the changes in the number of eligible users of publicly funded services on the basis of entitlement legislation as well as cost changes due to input prices, but assume that discretionary expenditures remain constant in real terms.

11. An expert group has provided guidance to the study. Twelve member countries participated in that group. They included a mix of small and large countries in terms of population and GDP, of parliamentary and presidential systems, and of relatively old and new members of the OECD. The group consisted of Canada, the Czech Republic, France, Germany, Italy, the Netherlands, New Zealand, Mexico, Spain, Sweden, the UK, and the US. The governments represented in the expert group answered a questionnaire about institutions and provided case studies to the project. The financial support of the Governments of Canada and the Netherlands for this activity is gratefully acknowledged.

2. MOTIVES FOR REALLOCATION

2.1. Demand and supply factors

12. Reallocation is a change of an existing pattern of expenditure. The most evident forms of reallocation require authorization from legislators in appropriation bills and are motivated by new policy ideas or priorities. Yet changes in political preferences are but one demand-driven motive for reallocation, other motives relate to changes in both the demand and the supply of publicly funded services.

13. Reallocation pressures are likely to be produced by two specific demand side factors. First, changes in (structural)² tax revenue will create pressures for expenditure change in both directions. If tax revenue rises above the level on which existing spending commitments are based then pressure for new spending priorities (or for tax relief) is likely. Alternatively, if structural tax revenue falls below the level on which existing spending commitments are based, then expenditures reductions (or tax increase) will become more likely.

14. Second, reallocation can also be motivated by changes in the demand for publicly funded services by citizen-consumers. When the public services are guaranteed in entitlement legislation, changes in private use can cause either overspending or underspending with respect to current estimates. This change in demand will trigger expenditure reallocation.

15. The primary supply-side pressures for reallocation are associated with changes in the cost of delivering government services and the quality of services. Improvements in production technology are likely to reduce the cost of delivering public services and may give rise to new products or better quality products and thus increase demand (for example, medical technology). Similarly, changes in the price of inputs (including wages) can make a service less or more expensive. In both instances the price elasticity of demand will determine whether this will increase or decrease expenditure on the service, and it will be a policy decision about whether and how reallocation occurs.³ Finally, the cost efficiency of production is an important factor. This includes both the allocative efficiency of production (the optimal combination of inputs) and the technical efficiency of production (the rate of products and inputs sacrificed for their production). The incentives for cost efficiency in the public sector are not as straightforward as in the market sector. Many public agencies are monopolistic suppliers or can apply price discrimination; often the profit motive is a secondary objective. This is why many argue that reorganisation of public production can yield relatively large gains in cost efficiency and, subsequently, through the price effect, on expenditures. Again, the elasticity of demand will determine the direction of the expenditure change.

² Governments that pursue trend oriented budgetary policies tend to discard cyclical changes in tax revenue as a motive for reallocation. More about this in the section 3.2 of this report medium term frameworks).

³ If demand is highly elastic (< -1) expenditures will increase, if demand is not elastic (> -1) expenditures will decrease.

2.2. Clustering of motives

16. To gain a better understanding of the motives behind some recent reallocation exercises, we have clustered the case studies provided by the expert group according to the dominant motivation behind the subject exercises. The five clusters or types that emerged from this exercise are summarised in the table below and explained in the following text of this section. The case boxes extend the discussion by comparing the main features of process and practice in each of the relevant cases. We recognise that this listing is incomplete and that similar reallocation exercises will be found in most countries. But the objective here is to provide a preliminary description of the forms, causes and practice of reallocation, rather than an exhaustive history.

Table 1 -- Motives for reallocation initiatives

Types	Motives	Indicative Cases
1. Fiscal stress	Revenue shortfall (demand) Reprioritization across the board (demand) Overspending due to increased use of all social services (demand) Overspending due to increased costs across the board (supply)	Canada: Program Review 1994 New Zealand: Budget 1991 Sweden: Fiscal Consolidation 1995
2. Fiscal abundance	Revenue windfall (demand) Reprioritisation across the board (demand) Underspending due to decreased use of all social services (demand) Underspending due to decreased costs across the board (supply)	Canada: Departmental Assessments Netherlands: Policy Review/ Labour Market Policies New Zealand: VFM reviews UK: Spending Reviews
3. Program overspending	<i>Main motive:</i> Overspending due to increased demand for specific program (demand) Overspending due to increased cost of specific program (supply) <i>Secondary motive (applicable to other program):</i> Drop of political priority of other program (demand) Underspending due to decreased cost of other program (supply) Underspending due to decreased use of other entitlement service (demand)	France: Control of Health Expenditures Mexico: Voluntary Retirement
4. New political priority	<i>Main motive</i> Rise of new priority for specific program (demand) <i>Secondary motive (applicable to other program):</i> Drop of political priority of other program (demand) Underspending due to decreased cost of other program (supply) Underspending due to decreased use of other entitlement service (demand)	Czech Republic: R&D Initiative Germany: Investment Initiative Netherlands: Investment Fund Sweden: Defence/Health Exercise UK: Capital Investment planning USA: Homeland security
5. Substitution of inputs	Change in production technology (supply) Change in input prices (supply) Change in cost efficiency of production (supply)	France: Autonomie des Préfectures Germany: Restructuring the Bundeswehr

17. The first type of reallocation exercises stem from *fiscal stress* and occur when overspending is more or less across the board and/or there is a structural revenue shortfall. This typically occurs during periods of macro-economic recession when spending on social services increases and revenues fall below the trend, leading to higher annual deficits (or a lower surplus) than estimated in the medium-term estimates. Reallocation exercises in New Zealand in 1991, in Canada in 1994 and in Sweden in 1995 all occurred during periods of fiscal stress. In each of these cases, the reallocation exercise was motivated by multiple demand- and supply-side stimuli including: replacement of a high spending cabinet with a low spending cabinet (demand), an increase in the use of social services due to recession (demand), a reduction of tax revenue (demand), and general cost increases due to higher input prices (supply). In each exercise the government sought to deliver a program of targeted expenditure reductions rather than proportional cuts. Demonstrating, perhaps, the political difficulty of these exercises, most were accompanied by the selective expansion of a few programs portrayed as investments to facilitate economic recovery or expenditures that otherwise strengthen economic performance (for instance, education).

Case Box 1 – Reallocation under conditions of fiscal stress

Type 1 case studies

- New Zealand Budget 1991
- Canada Program Review 1994;
- Sweden Fiscal Consolidation 1995

Case studies by New Zealand, Canada and Sweden each describe government-wide reallocation exercises that occurred during a period of high and rising annual deficits. In 1991, the New Zealand annual fiscal deficit was projected to increase from 4.8% to 6.3% of GDP over three years. Canada faced a similar fiscal situation in 1994 with an annual deficit of 5.9% of GDP and rising. During the same period the annual budget balance in Sweden declined from a surplus in 1990 to a deficit equal to 12% of GDP in 1993. All three countries set an initial deficit target of 3% of GDP within three years, moving to a balanced budget shortly thereafter. In practice, the deficit targets were achieved more quickly than expected in all three countries. Whether this was due to the reallocation exercises conducted by each government, or the impact of economic growth and falling interest rates, remains a moot point.

Although a declining fiscal situation was the major impetus for these reallocation exercises, each case study indicated that far-reaching reallocation exercises may be an ‘instrument of last resort’ when dealing with fiscal crisis, and only occur when coupled with changes in the political environment. The fiscal situation in New Zealand and Canada had been declining continually throughout the 1980s and governments in both countries implemented a variety of restraint measures during this period: both implemented wage freezes, across-the-board cuts, and extensive public sector reform measures, including the State Sector Act 1988 in New Zealand and the Spending Control Act 1990 in Canada). In Sweden the budgetary decline was more rapid but also more extreme yet the resultant reallocation exercise did not occur for almost five years from the commencement of these pressures. Yet extensive reallocation exercises did not commence in any of the three countries until the election of a new government that had focused on the fiscal problems during the election and explicitly rejected the idea of across-the-board cuts in favour of targeted expenditure reviews that ‘reallocated funding from low-priority areas to continue high priority spending’. The case study from Canada argues that even with a change of government, political support was only forthcoming after further pressure from the financial markets:

...the Program Review exercise did not commence until the first Liberal budget was widely criticized as fiscally ill-disciplined and when Moody’s downgraded Canada’s risk rating (from A++ to A+). At that point prime ministerial support became unequivocal.

Markedly similar processes underpinned all three reallocation exercises. As mentioned above, all three exercises spanned a broad area of government expenditures, although major tracts of spending were protected in each instance – some even receiving new money. The processes (described below) were initiated and co-ordinated by the centre of government which set the policy and financial frameworks. The detailed reviews were undertaken and initial plans developed by individual departments and ministers working within the framework articulating by

the centre. These plans were then reviewed and decisions taken by a smaller group of senior cabinet ministers working collectively and supported by a group of senior officials. All three cases highlight the importance of ‘unequivocal’ and sustained political involvement in the cross government reallocation exercises, and the extensive exercise of reallocation is often iterative as the difficulties in achieving fiscal targets become more apparent.

Finally, discussions in the expert group suggested that the ‘physiological impact’ of these exercises shaped subsequent behaviour by both officials and ministers for up to 10 years afterwards. All three countries point to budget and institutions reforms that occurred. While these reforms were implemented in New Zealand before the reallocation exercise, it is argued that they only took hold after the crisis of reallocation. In Sweden an extensive program of budgetary reform was implemented after the reallocation exercise in a bid to avoid future crises: ‘a lax budgetary process with no medium term fiscal targets was once of the forces behind the crisis, and the big issues was not just to consolidate the financial situation but to improve budgetary institutions’. In Canada a system of prudent budgeting was maintained after the program review and the budgetary role of cabinet and spending agencies was significantly diminished. More important was moral suasion gained by the department of finance, as ministers and public servants both vowed ‘never again’ would it engage in such a painful exercise of consolidation.

New Zealand: Budget 1991

The government sought to reduce total government spending by ‘channelling resources to high priority areas’ and ‘seeking greater value for money’. This process commenced in early 1991 when the Prime Minister met with chief executive and ministers to urge the importance of fiscal restraint, and in February the Cabinet agreed to stringent rules for the 1992 budget (no compensation for increases in their input costs; extra funding limited to statutory or demand-based expenditure policies (e.g. welfare benefits); new policy initiatives funded from reallocation within existing budgets and restricted capital injections).

But the extensive reallocation exercise did not really begin until the draft budget produced in April showed substantial further savings were required to achieve the fiscal targets. As that time chief executives were instructed to identify additional savings options, produce technically sound and administratively feasible savings options, while leaving political judgements to the Government.

The detailed decision-making fell to the newly formed Cabinet Expenditure Control Committee (ECC), chaired by an Associate Minister of Finance and supported by the Officials Committee on Expenditure Control (OCEC). Officials undertook preliminary reviews of departmental submissions to ensure they identified substantial savings and areas of lower priority expenditure, and identify three tiers of savings options ranging from readily achievable to ones requiring more complex or legislative issues. In May-June, minister held extended meetings with individual Ministers and chief executives to discuss proposed initiatives and recommendations. The full Cabinet made decisions in late June 1991.

Canada: Program Review 1994

The process in Canada followed a similar pattern with two major differences. More emphasis was given to establishing the guiding principles for the review: qualitative criteria by which programs should be assessed and specific departmental savings targets were both stated up-front. Second, in accordance with norms of budgeting in Canada, the cabinet committee developed recommendations for the Minister of Finance and Prime Minister, rather than the full cabinet.

Program Review operated in two broad stages. First, broad parameters were set. The exercise focused exclusively on direct government program spending, excluding transfer payments (38% of total expenditures), and interest payments on the debt (26% of total expenditures). Each department was allocated a reduction target of 25, 15 or five percent, and six ‘program review assessment criteria’ were developed:

1. Does the program area or activity continue to serve a public interest?

2. Is there a legitimate and necessary role for government in this program area or activity?
3. Is the current role of the federal government appropriate, or is the program a candidate for realignment with the provinces?
4. What activities or programs should or could be transferred in whole or in part to the private or voluntary sector?
5. If the program or activity continues, how could its efficiency be improved?
6. Is the resultant package of programs and activities affordable within the fiscal restraint? If not, what programs or activities should be abandoned?

Spending departments then conducted cross departmental reviews in with these financial and policy criteria, and prepared implementation plans for the necessary changes. The two central budget agencies (Department of Finance, and Treasury Board Secretariat) prepared alternative source of advice.

During the second stage of Program Review the cabinet committee for program review developed recommendations for the Minister of Finance. A shadow committee of deputy ministers (departmental heads) met to ensure reduction targets had been met and the six criteria applied, and to recommend non-binding changes to departmental plan. Spending ministers then presented the finalised plans to the Cabinet Committee, who developed specific recommendations for the Minister of Finance. During several iterations of this process the direct program spending base was broadened to include some previously-exempted programs. The committee of ministers then made specific recommendations on departmental programs to the Minister of Finance who incorporated them into the 1995 budget, which was tabled in February.

Sweden: Fiscal Consolidation 1995

In Sweden the core processes within the executive follows a similar pattern where the centre set guidelines; departments undertook the review and the centre and ministers decided actions at the political level. Two major differences are evident between this and the previous two cases. First the minority government status of the Social Democrats meant they had to include opposition parties in setting the guidelines and developing final recommendations. Unlike the previous two examples, Sweden reduced the deficit by a combination of one third revenue increases and two thirds expenditure cuts. These were undertaken in a two-part strategy designed to acquire the support required in parliament to pass the bills. The first part of the exercise focused on revenue increases and was passed with support from the Left party. The second part involved expenditure reallocations and was developed in consultation with and support from the Centre party. Second, the guiding principles developed to frame the reallocation exercise highlight important policy differences between Sweden and New Zealand in particular. The exercise in Sweden was designed to limit the extent to which expenditure reductions impacted on the welfare programs. In particular 'core services' delivered via transfers to local government, health care and education were largely protected and the burden of the cuts fell on direct transfers to households and businesses.

18. The opposite case of fiscal stress is that of *fiscal abundance*. Here we observe cases of underspending across the board and/or revenue windfalls. This will typically occur in a situation of high macro-economic growth when spending on social services decreases and revenues grow faster than the trend. In general, fiscal abundance leads to a lower deficit (or a higher surplus) than foreseen in existing multi-year estimates. This produces upward pressures on expenditure. On the other hand, it also provides an opportunity to reduce a few specific expenditures. Some social benefits are not entitlements and will thus not shrink automatically in accordance with current law estimates. One can think of active labour market policies, or social services for the elderly. If unemployment shrinks and prosperity of the elderly increases, there is good reason to curtail those programs. An example is the Review of labour market policy in the Netherlands in 2001⁴. The motives for reallocation may again stem from the demand or the supply side and will be of a general nature. We may think of the replacement of a low spending cabinet by

⁴ This exercise was undertaken as part of a more general planning or review procedure (to be looked at in the next chapter), but represents a typical usage of such a procedure in times of fiscal abundance.

a high spending cabinet (demand), or a decrease in the use of social services due to economic growth (demand), or a tax revenue windfall (demand), or cost reduction with a general impact, for instance as a consequence of a lower price of oil (supply). Revenue windfalls occurred frequently in OECD countries during the nineties. They gave rise to demands for better quality of public services on the part of citizens, in accordance with the increased prosperity prevailing in the private sector.

Case Box 2 – Reallocation under conditions of fiscal abundance

Type 2 case studies

- United Kingdom: Spending Reviews 1998
- Netherlands: Interdepartmental Policy Reviews (adapted from Reconsideration Process which commenced 1981)
- New Zealand: Value for Money reviews (VFM) 2001
- Canada: Departmental Assessments 2001-2

Motivated by changing policy demands rather than immediate fiscal stress, all four of these reallocation exercises were designed to provide a vehicle for on-going, targeted expenditure reallocation *across government*. As with the previous cases, all of these exercises were coordinated by the centre of government and involve a cabinet body as decision maker. The role of line agencies differs between each case: in the Netherlands detailed reviews are undertaken by a secretariat located in the Ministry of Finance, in the UK reviews were undertaken in line agencies but in consultation with Treasury analysts; in Canada and New Zealand departments were the primary drivers of the exercises operating (in theory at least) with little input from the centre. Despite the objective of permanency, only the systems in the Netherlands (since 1981) and the United Kingdom (since 1998) have passed the test of time. As these four cases provide the main examples of on-going program review examined in section 3.6 of this report, more details of each case are provided in that section and case box. The following discusses some of the differences between reallocation exercises conducted under conditions of fiscal stress and conditions of fiscal abundance highlighted by these cases.

Whereas the financial objectives of reallocation predominate in an environment of fiscal stress, the primary (but not the only) justification for reallocation under conditions of fiscal abundance is improving policy/program design and allocative efficiency. Experience in the Netherlands provides the best example of these changing priorities. Interdepartmental Policy Reviews emerged from existing mechanisms - known as the Reconsideration procedure – which were designed in 1981 to achieve reallocation during a period of fiscal stress. The process retains many features of its predecessor including a selective focus (approximately 10 policies reviews are conducted per year) and the use of small interdepartmental working parties supported by the Ministry of Finance to conduct reviews designed to provide the government with number of possible alternatives. Under the budget surpluses of the 1990s, two main changes were made to the system. First, the requirement that each review produced at least one alternative that would lead to a 20% reduction of expenditure after 4 years was abolished. Secondly, the reviews shifted in focus from budget cuts *per se* to institutional changes, including options for demand-led programme funding, out-sourcing, privatisation, decentralisation to other levels of government. As a consequence, any financial reallocation must be justified by recommendations for policy change, or institutional redesign. However, during the high growth late nineties, the procedure was also used to cut expenditures that are less needed during an economic upswing but that do not shrink automatically (because they are not based on entitlements). The review of Active Labour Market policies that proposed cuts to the sum of 1,1 billion euro is an example of such use.

Reallocation under conditions of fiscal abundance does not necessarily equate to expenditure cuts. The reallocation can be additive – meaning that additional funds is directed toward new policy priorities (UK) or to facilitate program redesign (UK and Netherlands) - subtractive – meaning that resources are moved from lower to higher priorities (NZ and Canada) – or both. The biannual Spending Review exercise conducted in the UK since 1998 is designed to ensure departmental spending is allocated to improving performance in areas of government priority. Spending Reviews were developed in 1998 to replace the annual spending round and shift negotiations from the annual increment to medium term operating budgets. The exercise is co-ordinated by the Chancellor, Treasury and the cabinet committee on Public Services and Public Expenditure (PSX). Conducted over one year, the process examines key performance targets and “key strategic challenges” for the upcoming three years. Departments submit an Analysis of Resources

and Public Service Agreements to Treasury for analysis and discussion, on the basis of which departmental budgets are set for the up-coming three years, and performance delivery targets are negotiated. The system was designed and has operated under benign fiscal conditions and focuses on questions of prioritisation, performance and design rather than expenditure restraint. It is debateable whether this system could support reallocation under conditions of fiscal stress.

The experience of NZ and Canada suggests that the absence of hard fiscal constraints makes it much more difficult to couple program redesign with subtractive reallocation. The process of Departmental Assessments (DAs) in Canada was provided as an example of unsuccessful reallocation. This system was designed to facilitate negative reallocation: provide departments with the political and legislative authority to reallocate within their overall budget limits to ensure program structures were 'sustainable'. Departments themselves chose whether to become involved in the exercise, and then worked with the TBS to design recommendations. While the primary objective of this exercise was to improve allocative and operational efficiency within departments by facilitating resource reallocation and program redesign. Significantly, the system was based on an assumption of budget discipline. Departments would only choose to reallocate funds if they believed that no other mechanisms for resolving operating difficulties existed. In particular that additional money was not available. Program redesign would only be coupled with reallocation within the department, if ministers accepted that no other form of financial support was possible. In practice, these conditions of budget discipline were difficult to maintain as the budget surplus grew and new funds were made available. In some instances, the DA submission was used to argue for incremental funding to assist in the process of program redesign, but this was a complicated process not supported by the central agencies. In addition, departments were able to gain access to additional funds from both the Minister of Finance and the Treasury Board Secretariat, by arguing they faced immediate and 'critical issues'. Under such circumstances, reallocation did occur: additional money was allocated to leverage program change and manage operational crises. However this contradicted the objective set down by the government that sustainable programs would be achieved via reallocation within existing departmental budgets.

The New Zealand experience with VFM reviews provides a vivid example of the difficulties in maintaining political support for reallocation during periods of fiscal abundance. During the 2000 election, ministers had agreed to a self-imposed fiscal cap of \$6.1 billion on new operating spending over the three-year term of the government. Spending during the first two years meant that in the government entered its third year (2002/03) facing an election and with only \$8.15 million available for new spending. The VFM process was conducted during the lead up to the 2002 budget "to provide ministers with the information they needed to identify reallocation options to fund new programs" so that they could remain within the fiscal cap. While cabinet agreed to review seventeen specific areas of spending, the only significant instances of reallocation occurred under two ministers who participated in the exercise voluntarily. The lessons of this exercise are summarized as follows;

The key lesson from the process is that an exercise needs strong support from the spending Ministers and departments to be successful... While the fiscal cap provided a constraint for 2002/0, the positive fiscal outlook allowed for higher expenditure in outyears.

19. The third type of reallocation initiatives focuses on a single program or group of programs that causes *overspending* (main motive) but may also involve a few other programs that can contribute to the solution of the resulting budgetary problem (secondary motive). The main motive may again stem from the supply side or the demand side, but it is limited to a specific program or group of programs and does not apply to the public sector as a whole. However, the program(s) causing the overspending is (are) so large that doing nothing would have a significant impact on the deficit. The reallocation initiative will firstly aim at curtailment of the program(s) causing the problem. However, if this is not possible in view of political preferences, the initiative may also involve other programs that can contribute to the solution because they have dropped in political priority or because they cause underspending due to lower costs or less use of the services. The ageing problems that necessitates pension and health care reform in many countries belong to this cluster.

Case Box 3 – Reallocation under conditions of program overspending

Type 3 case studies:

- Mexico: Voluntary Retirement
- France: Control of health policies

Most countries represented in the expert group provided examples of ‘unplanned’ reallocation during to overspending in one or more particular spending areas. Dealing with this type of ‘expenditure creep’ was generally seen to be the type of problem faced by budget analysts within central and line agencies every day; it was seen as the ‘bread and butter’. In most countries it appears that this problem was typically managed by reallocation within individual departments. It is only cases of systemic overspending that require a more sustained, or government wide solution.

The case of program overspending presented by Mexico stemmed from increases in personnel service, pension and administrative costs (supply side) over a sustained period. As a result, current expenditure grew from 37% to 63% of total programmable expenditure over thirteen years. Government-wide voluntary retirement programs had been in place throughout the 1990 however, these were viewed as largely ineffective. In 2002 the government redesigned existing voluntary retirement program in an effort to both reverse this trend. Each department received additional funds in the form of a fully repayable four-year “investment plan” to be used on programs that stimulated voluntary retirement. Departments retain the savings achieved by reducing posts, as long as they are allocated in accordance with the overall government strategy of promoting investment and social expenditures.

In France there has been continuous overspending in the health sector. The Law on the Funding of Social Security states a national target for health insurance costs which since its introduction in 1997 has only been complied to in one year (namely 1997). In all years from 1998 to 2002 there has been considerable overspending. The annual average increase in spending has been 4,6 %. For 2002 the increase in the target has been 3.8%, the realisation 7.3%. The rate of growth of actual spending is unsustainable because it exceeds the growth rate of premium revenue, which causes a widening deficit. A recent rapport of the World Health Organisation has shown that the quality of French health care belongs to the best in the world, but that nevertheless the life expectancy in France is lower than those of countries like Italy and Japan that spend much less on health. The reasons is that there are other factors (alcohol, tobacco, accidents), which have to do with alimentation and behaviour are more important for the health situation of the population than health care. The high costs of French health care are mainly due to the high consumption of pharmaceuticals and the high number of hospital beds per inhabitant (almost double that of Canada, Denmark, Spain, Sweden, UK en US). Since 1996 there have been attempts to reform the health care system and to control expenditures. Until now these attempts have not been successful, mainly because it has not been possible to control the salaries of the medical professions, because sanctions against overspending by practitioners have not been effective and because of the increasing costs of hospitals mainly due to the reduction of working time and the increasing cost of pharmaceuticals. The present government is now preparing a new approach towards the reform of the health care system.

20. The fourth type is the complement⁵ of the third: it focuses on single program or group of programs that has risen in *political priority* (main motive) but may also involve a few other programs that can contribute to the solution of the resulting budgetary problem (secondary motive). The main motive concerns the demand for the provided services. The program(s) that have risen in political priority is (are)

⁵ The reason for change of the multi-year estimates in this case is not citizen-demand or supply conditions as in type 2 reallocations, but a rise in political priority. Note, that the *opposite* of the third case, namely underspending or drop in political priority is usually not a cause of reallocation, *if it concerns only a single program*. In contrast, underspending or rise of priorities *across the board* (the opposite of general overspending or general downturn of priorities) does trigger reallocation (type 2). Cuts in single programs (not across the board) are only made *in connection with proposals to spend the freed money* (type 2 or type 3 as described above). This is an example of the phenomenon of universalism (single program can be expanded but not be cut), known from the public choice literature.

so large that funding them without off setting measures would have a significant effect on the deficit. The reallocation initiative will first aim at efficiency gains in the new priority program(s). However, if this is not possible, the initiative will also involve a few other programs that can contribute to the solution because they cause under-spending due to lower costs or less use of services or because they have dropped in political priority. The increased concern for the integration of immigrants and the priority for internal and external security that can be observed in many OECD countries belong to this cluster. Examples provided by the case studies are: the Investment Initiative 2000 in Germany and the Health/Defence Exercise 1998 in Sweden.

Case box 4: reallocation due to changing political priorities

Type 4 case studies:

- Netherlands: Investment Fund 1993
- Germany: Investment Initiative 2000
- UK: Capital Investment planning
- Sweden: Defense/Health Exercise 1998
- USA: Homeland security

Germany, the Netherlands and the UK

Of the reallocation exercises motivated by changes in political priorities, three (Germany, Netherlands and the UK) stem from a renewed emphasis on capital and investment programs. Both Germany and the Netherlands effected this reallocation by earmarking specific streams of revenue that can only be accessed for investments. The Netherlands established the Fund for Economic Structure Enhancement in 1993 to ensure that revenues from gas exports were “invested rather than to consumed”. The Federal German Government established a similar fund in 2000 and it used a wind-falls revenue of €50 billion from selling third generation mobile phone licenses to repay outstanding debt. This in turn reduced expenditure on interest charges by €2.5 billion per year and the additional funds was earmarked as the ‘future investment fund’. In both countries the type of project that can be financed through this fund are set out in budgetary regulations and laws but they are relatively broad. In the Netherlands, projects are primarily associated with ‘enhancing economic infrastructure’ including transport infrastructure, technology and telecommunications but also knowledge infrastructure. In German, money from the fund has been allocated across a broader range of projects including € 800 million in additional capital for education, science and research; €1.7billion for investment in the transport sector; €184m to modernise universities; €25.6m for development in the old East Germany; €41m on modernising computer facilities in trade schools and €56.2m annually for national genome research into five categories of disease; €250m is foreseen for renewable energies.

The UK has developed quite different mechanisms in pursuit of the same reallocation objective. The fiscal and budgetary regime introduced in 1998 reformed the allocation system in an effort to remove a perceived bias against capital spending. Two fiscal rules were established which required over the economic cycle that a) the government only borrow to invest and not to fund current expenditure and b) public sector debt remain around 40% of GDP. Compliance with these rules required departments and the government as a whole to develop separate current and capital budgets, and ensure limited flexibility to transfer resources between them. As of 2003-04, departments require Treasury authority to move spending between these categories. In addition, the introduction of accrual accounting principles under the auspices of Resource Accounting and Budgeting (RAB) is intended to ‘give departments the incentives to manage their capital assets more effectively, by reflecting the economic costs of holding and using assets in budgets’.

All three initiatives appear to have been successful: both Germany and the Netherlands reallocated resources from interest repayments to a range of investment projects; and in the Netherlands the real annual growth of investment (as a percentage of GDP) exceeded the real annual growth GDP throughout the 1990s. In Britain capital investment is set to rise to 2.3% of GDP by 2007-08 compared with 0.7% in 1998-99. However, how these reallocations are to judged from the point of view of allocative efficiency is a different matter (see discussion in section 3.7).

Sweden

The fourth case study focused on reallocation due to changing policy priorities involves the politically difficult task of explicitly transferring funds from a low priority spending area – in this case defence – to fund increased spending in an area of higher priority (health). In Sweden, the Social Democratic government was re-elected 1998 after a campaign focused on health care, schools and care of vulnerable groups in the community. While this exercise was not directly motivated by fiscal constraints, the government remained fiscally cautious after the 1994 consolidation exercise and just one budget surplus. Consequently the government sought to provide a source of additional funding for health care spending through reallocating funds from the defense spending. After considerable negotiation, the Government reached a consensus with the Centre Party that defense appropriations should be reduced by SEK 4 billion (10 per cent) from 2002, and that the defense programs should be aligned and reorganised. To compensate for the initial costs of restructuring, defense received an additional appropriation of SEK 3 billions 2002 and SEK 1 billion 2003 (current prices). The net saving on the defense would then be SEK 1 billion 2002 and SEK 3 billions SEK 4 billion 2003 and 2004. It was agreed that the full amount of this reduction was to be transferred from the defense appropriation to the appropriation for local government block grants (which deliver health programs) and to be spent on health care. The fact that local governments are funded through a general grant system meant that this money could not be earmarked but representatives from the local governments were asked to sign a contract to allocate resources towards healthcare.

The primary success of this process was not in delivering new funding to the local governments - they were likely to receive higher grants with or without the defense cuts – but in allowing these increases to be delivered as a quid pro quo for reductions in the defense portfolio. Joining these two initiatives together actually facilitated the political viability of reallocation because the government had something – increased social spending – to offer its negotiating partner.

USA: Homeland Security

The broad range of policies designed to ‘secure the United States from terrorist attack’ (or homeland security) gained immediate priority after the attacks of September 11, 2001. The subsequent reallocation exercise was designed to increase the resources dedicated to homeland security and to consolidate these within a single cabinet department. This involved three major tasks:

- defining and tracking the ‘universe of homeland security activities’,
- implementing institutional reforms that established cabinet and departmental machinery to co-ordinate and take accountability for these programs, and
- allocating additional resources to this policy area.

The political impetus created by September 11 made the task of legislating institutional reform relatively simple: the Office of Homeland Security (OHS) was established in October 2001, and legislation to establish a Department of Homeland Security was tabled in June 2002, and passed in November 2002. This reorganization eventually consolidated 22 components from 11 agencies into the DHS and unified more than half of the homeland security resources.

By contrast the job of articulating the status quo expenditure and program base for homeland security was particularly complex and often highly contested. Existing resources cut across 30 executive branch agencies, and incorporated aspects of law enforcement, border security and healthcare; activities were often embedded in a range of programs and difficult to identify. This meant that the OMB had to develop resource and program data from the bottom-up, using historical datasets developed by agencies and the Annual Report resource estimates. Debates about whether or not specific programs contributed to homeland security were guided by the strategic framework being established by the OHS but these debates were finally decided at the political level.

The process of allocating additional resources initially relied on emergency supplemental appropriations act, but once the OHS was established it worked with OMB to develop a budget submission for FY2003. Based on joint cross cutting reviews the budget submission focused on four priority areas which sought to: a) focus resources where there were known gaps in capacity, b) ensure resources could be effectively utilised in the short term, and c) where agencies were in a position to begin long-term prioritization. OMB sought to maintain a clear and understandable definition of this category to facilitate the measurement of real policy change and performance. Nonetheless the status of homeland security as a ‘favoured-category’ has resulted in pressure to include more resources within the definition.

21. The fifth type focuses on *substitution of inputs* (production factors or intermediate products) within the same program or set of programs in order to make the program(s) more efficient. This is a type of effort that is motivated exclusively by supply factors. Reallocation is necessary in this case if separate production factors or intermediate products are appropriated on different accounts. Substitution of production factors may be desirable in order to improve the allocative efficiency of the production process in response to changing input prices or to accommodate the production process to technological innovations leading to new products or lower costs. It may also be the case that substitution is desirable in view of preceding reforms directed at improvement of cost efficiency. To the extent that the budget is reformed in the direction of performance accounts, this type of reallocation is less necessary. The reform in the direction of performance accounts can also be seen as a type of reallocation initiative in this cluster since it is aimed at making this type of substitution possible. Examples are the “*Autonomie de gestion dans les Préfectures Françaises 2004*” reforms in France and the Modernisation of the “Bundeswehr” (Federal Armed Forces) in Germany.

Case box 5: Reallocation to facilitate the substitution of inputs

Type 5 case studies:

- France: Autonomie de Préfectures 2000
- Germany: Restructuring the Bundeswehr 2001

The drive to aggregate appropriation structures in most of the countries involved in this study means that exercises designed to reallocate funds from one input area to another within a single program area are largely invisible. In Sweden and New Zealand for example, the centre does not track expenditures at the level of input and even in countries where this information is collected (eg Canada), allocation is decided by line agencies not the centre or legislature. As a result the centre often finds it difficult to implement reallocation exercises in the interest of operational efficiency, and typically rely on blunt or indirect instruments such as efficiency dividends or administrative reform initiatives.

Germany sought to improve operational efficiency within the defence budget by ensuring that all savings were reinvested in the portfolio, rather than reducing overall spending. Under this programme, the armed forces (“Bundeswehr”) are being reduced in size: military personnel will be reduced from 340,000 to 255,000 troops and will also be accompanied by a reduction in civilian personnel posts. Intensive co-operation with the private sector in the field of information technology, clothing, and fleet and real estate management is intended to cut running expenses. The savings generated will be invested in the modernisation of the armed forces and their equipment. For example, strategic airlift and reconnaissance capabilities will be improved and several initiatives are designed to improve training and education, thus making military service more attractive. Since 2002, proceeds up to a ceiling of €600m on the sale of moveable and immovable properties may be retained and added to the defence budget.

In contrast to the move to truncate running cost votes in many OECD countries, the budgetary system of France remains highly disaggregated. In 2000, the budgets for procurement and salaries were consolidated in a part of the network of French Préfectures (who are responsible for the co-ordination and management of the services of the State at the territorial level in the department or the region). This experiment is considered as a pilot for the reform of public management in France and for the implementation of the new organic budget law that was approved in 2001. The experiment gives to the Préfectures authority over their entire budget for current expenditure (procurement and salaries). The budget is calculated on the basis of real expenditure in the year preceding the start of the experiment. The budget is increased annually, independent of its use (with 0.3% annually between 2000 and 2002). It is adjusted for general salary measures in the public sector. When a vacancy occurs, the Préfet can allocate the resources involved for procurement or the creation of new post. This can modify the structure of employment, provided that two ceilings are simultaneously complied with: total employment and the total salary sum.

In 2000, about 18% of the appropriation freed up was used for supplementary operations, 17% for bonuses for officials, and 55% for additional procurement. It is therefore seen to facilitate public sector modernisation and improved working conditions. It has allowed the recruitment of new staff and the contracting out of tasks that were previously carried out by public officials. The expected benefits of this experiment include more responsibility for local managers; a better allocation of resources in the management of missions; the development of human resource management at the local level (reform of the hierarchical structure of the organisation, development of qualifications, contracting out of certain tasks); and a reduction in external preventive financial control.

3. THE ROLE OF INSTITUTIONS

3.1. Diagnosis and redress

22. All institutions that have been studied appear to have a double function. In the first place, they are a diagnostic tool in the sense that they help to establish the need for reallocation. If, for instance, the expenditure targets of a multi-annual framework are exceeded, this might trigger a reallocation initiative. In the second place, they are a tool for redress in the sense that they help to formulate the reallocation proposal. Extending the example: a medium term framework contains itself the quantitative targets determining the size of the cuts that are required to offset the overspending.

23. The study aims to assess the working of institutions on the basis of the criterion of allocative efficiency. However, this criterion is not directly operational. Allocative efficiency cannot be measured in practice. Therefore, the study makes use of proxies. In particular, attention will be paid to the institutional guarantees that information about the allocative efficiency of alternative policies is available at the right time to those particular decision-makers who experience the incentives to use this information. In general, these authorities are to be found in the centre of government. The Minister of Finance is the traditional “friend” of the tax payer and as such has a strong interest in allocative efficiency. The Prime Minister and/or the President are other players with a strong positional interest in allocative efficiency. The same is true for the budget committees and financial (tax) committees of the legislature. The study will also look at the competences of these authorities in the budget process as a proxy for the direct measurement of the impact of institutions on allocative efficiency.

3.2. Medium-term expenditure frameworks

24. All OECD countries have medium-term expenditure frameworks. They are based on a medium term forecast of the macro-economic variables that are important for the budget: economic growth, inflation, price of oil, exchange rates, etc. They specify medium-term targets for total revenues, total expenditures, the deficit and sometimes a number of major subdivision of expenditure. Derived from that is an expenditure path starting in the upcoming budget year and finishing in the medium-term target year.⁶

25. Medium-term expenditure frameworks may be rolling or periodical in nature. Rolling frameworks are drawn up during budget preparation every year (or every two years⁷). Each year (every two years) the target year (the last year of the framework) is passed on to a next year (period of two years). Periodical frameworks are drawn up at the beginning of the period to which they apply and then stay in place until this period has lapsed. Both rolling and periodical frameworks may be amenable to revision in the middle of their life time. If a medium-term framework is periodical, the upcoming budget year may take any position in the sequence of years to which it applies. Of the countries that have provided information to this study, Sweden, the Netherlands and the US had periodical medium-term frameworks (the US until 2002); all others had rolling frameworks.

26. The medium-term framework may cover 2, 3, or 4 years, including the upcoming budget year. Table 2 shows the length of the framework among the countries that have provided information to this study.

⁶ For the role and effects of medium-term frameworks see also OECD 2003.

⁷ The UK revises its medium term framework every two years in the procedure of “Spending Review”.

Table 2: Period covered by medium-term expenditure framework

2 years	3 years	4 years
Italy	Canada	Netherlands
United Kingdom	Czech Republic	New Zealand
	France	Mexico
	Germany	United States
	Sweden	

27. *The primary aim of a medium term expenditure framework is to provide intertemporal consistency to budgetary policy. For this purpose, the framework makes clear how in subsequent annual stages the medium term targets will be realised. In particular, the government that publishes a medium term expenditure framework will have to make clear that its proposals for the upcoming budget year are consistent with its medium term targets, and that it does not postpone all necessary painful measures to the out-years of the framework⁸. Secondary aims of a medium term framework may be to strengthen the stabilisation function of the budget and to bring more tranquillity in the budget process. For these purposes, it is necessary that the time path of total expenditures leading to the medium term target is considered as a series of fixed caps that can not be adjusted anymore during annual budget preparation. In other words, even if the framework is rolling, the caps of last year can not be touched anymore, even for the out-years. Only a new out-year (or two years) can be added at the end of the time path. This means that the expenditure total of the upcoming budget year must be consistent with the cap of last year's corresponding out-year. Indeed, from year to year, the expenditure total of the budget has to be reconciled with the expenditure cap of a medium term framework that was established in some previous year. A medium term expenditure framework that has only the primary aim is called a *flexible* framework because it allows for the adjustment of total expenditures to economic and budgetary circumstances from year to year. A framework that has also the secondary aims is called a *fixed* framework, because it does not allow for such adjustment from year to year. Of the countries that provided information to this study the Netherlands, Sweden, the UK and the US (until 2002) had fixed medium term frameworks. The others: Canada, Czech Republic, France, Germany, Italy, Mexico and New Zealand had flexible frameworks.*

28. A fixed medium term framework leads automatically to a fluctuating annual deficit. Since expenditures can not be adjusted and tax revenue will fluctuate according to the economic business cycle, the deficit will fluctuate accordingly. Sometimes an upper limit is established for the allowed fluctuation of the deficit. If the limit is exceeded, the expenditure cap of the framework has to be adjusted. This is the case for example in the Netherlands (in the period 1998-2002 the upper limit was 1% GDP higher than the structural deficit derived from structural tax revenue and the expenditure cap). A fluctuating deficit contributes to the macro-economic stabilisation function of the budget. The general budget fund acts in this way as an "automatic stabiliser". This means that its effect on the economy is cyclical, not that it is countercyclical (for the latter it would be required that expenditures were increased if tax revenue fell behind the trend).

29. A fixed medium framework also brings added tranquillity to the budget process because tax revenue fluctuations are no longer a reason for expenditure adjustment. Of course, there remain annual adjustments at the level of spending ministries and budget accounts but these focus exclusively on the division of the total available under the cap. They are not affected anymore by the revenue side of the budget.

⁸ The out-years are the years after the upcoming budget year.

30. Medium term frameworks, regardless of whether they are flexible or fixed, are directed at a certain balance between expenditures, revenues and the deficit in the medium term. In view of the reasoning behind this balance, the framework can be characterized as (a) debt oriented, (b) supply side oriented, or (c) demand side oriented.

31. In a debt oriented framework, the medium-term structural deficit target is the central aim and the expenditure and structural revenue targets are determined by it. A low deficit is deemed important for reasons of monetary policy. If a country is heavily indebted and runs a high deficit, the market will require a high rate of interest for its loans and this may in turn affect the interest rate levels in global capital markets. In addition, debt repayment is deemed important in countries that face the problem of an ageing population in the near future. It is possible that part of that problem has to be solved by public borrowing and this can only be done, without severe repercussions on the private sector, if public debt is low at the start. Examples of debt oriented medium term frameworks are the ones that aim at a balanced budget over the cycle. These are used in Canada, Mexico, New Zealand and the UK. The Growth and Stability Pact of the EU is an example of supranational medium term framework that is primarily motivated by monetary and demographic considerations.

32. In a supply side oriented framework, tax relief is the central aim and the structural deficit and expenditure targets are determined by it. Tax relief is thought important because of its effects on incentives in the market sector of the economy. In a strict sense, only marginal tax rates are important for incentives and in theory the decrease in marginal rates could be compensated by the increase of average rates. This would not affect total receipts. However, this only applies to progressive tax system (where the rate increases with the base), not, for instance, to sales or value added taxes which are typically not progressive. Furthermore, in practice, the decrease in marginal rates sought by supply side oriented tax reform is often not compensated by the increase of average rates.

33. In a demand side oriented framework, the structural deficit is the central aim, similarly as in a debt oriented framework. However, in this case the deficit target is not based on monetary and demographic considerations but rather on the supposed “structural savings surplus” in the market sector of the economy. This is a concept from Keynesian macro-economic theory. At the time this theory was dominant in the world of academic economics, many OECD countries adopted this type of medium term policy. Examples were: the “Konjunktur Neutrale Haushalt” in West-Germany, the “Structureel Begrotingsbeleid” in the Netherlands and the “Full Employment Surplus” in the US⁹. In the nineties, Japan still followed a medium term policy that was partially motivated by Keynesian ideas about demand management. At present, most OECD governments have abandoned these ideas as motivation for their medium term budgetary policies.

34. Medium term expenditure frameworks are based on macro-economic assumptions and forecasts. The organisation that is responsible for these assumptions is usually the same as the one that makes the short term assumptions and forecasts for the upcoming budget. This unit may or may not be part of the Budget Office. The rationale for separating it from the Budget Office is to provide it with a certain degree of independence. In this way, the tendency of incumbent politicians to base financial planning on assumptions that are too optimistic may be held in check. Of the countries that have provided information for this study, Canada, Germany, the Netherlands and the US have created some form of independence for the organisation responsible for the macro-economic assumptions and forecasts. In Germany and the US, this task is given to a committee that is not entirely under the control of the Budget Office. In Canada and the Netherlands, this task is given to an independent bureau. The organisation that is responsible for the assumptions and forecasts may do the econometric modelling underlying the forecasts by itself, or contract

⁹ The “Surplus” in this expression referred to the government budget. This was a euphemism for saying that the budget should be in deficit as long as there was no full employment (as was usually the case).

it out to a research institute or private firm, or use existing forecasts produced by research institutes and private firms.

35. Some of the governments that have provided information to this study claim to use deliberately “cautious” macro-economic assumptions, while drawing up medium term expenditure frameworks (Canada, France, Netherlands, Sweden, UK). This implies that they use assumptions that are somewhat more pessimistic than the average forecasts of other research institutes and firms, especially as far as economic growth is concerned. The UK Treasury subtracts 0,25% GDP from its own growth forecasts by way of prudence margin.

36. Medium term expenditure frameworks tend to concentrate interdepartmental reallocation packages in the decisions about the (extension of the) framework. After the framework has been established, interdepartmental reallocation becomes more difficult because of the division of the expenditure caps across the departments. Furthermore, if frameworks require across the board retrenchments or allow across the board expansions, these operations tend to be smaller in scale than the reallocation exercises that sometimes occur when medium term frameworks are established (extended) due to the fact that the development of tax revenue plays a less important role. This effect is even stronger for fixed than for flexible medium term expenditure frameworks. Therefore, fixed frameworks bring even more tranquillity in the budgetary process than flexible frameworks.

37. From the point of view of allocative efficiency, medium term expenditure frameworks are largely neutral. They have a stabilising effect on the expenditure pattern once they are established, but whether this is desirable from an efficiency point of view is entirely dependent on the efficiency of the expenditure pattern that is being stabilised. However, a negative efficiency effect could be that frameworks make it somewhat more difficult to change an existing expenditure to new external circumstances. On the other hand, a positive efficiency effect follows from the concentration of interdepartmental reallocation in the periodic design or revision of the framework. The order and tranquillity that expenditure frameworks typically impose upon the budgetary process leads to savings in decision-making costs. This effect too, is stronger for fixed than for flexible frameworks and can be a significant source of savings for governments that are considering moving from a flexible to a fixed framework.

3.3. Rules of budgetary discipline

38. In order to be effective medium-term expenditure frameworks must be accompanied by rules of budgetary discipline. These rules require that all budgetary estimates, for the current budget year as well as the out-years (including the upcoming budget year), must comply with the caps of the medium term framework and that all overspending with respect to those caps must be compensated. The compensation requirement applies in the first place to the current budget year. Of course, there are formal barriers against overspending in the current budget year to begin with, because this requires supplementary appropriations bills. In some countries there are quite elaborate control systems in place in order to prevent this from happening (Czech Republic, France, Italy). In the US, the Congress supervises the adherence to appropriations laws once they are established. However, overspending can never be entirely excluded, and in the cases where it occurs, rules of budgetary discipline require compensation. In order to be effective, the compensation requirement must also extend to the out years of the medium term framework. This implies that overspending with a structural cause must be compensated with measures with structural effects, so that the amount of overspending is compensated year by year through the effects of the compensating measures. It also implies that policies that only cause overspending in later years (“camel noses”) must be compensated with measures that equally take effect in the future. This includes the upcoming budget year, to which the caps of the first out year of the current budget apply.

39. Rules of budgetary discipline typically attribute the first responsibility for the compensation of overspending to the spending minister. This requires that the spending caps of the framework are divided over the departments. The spending minister can always try to share the burden with other ministers, but this requires the agreement of those ministers and the cabinet or president. The rules may differ on the treatment of overspending on entitlement legislation. Sometimes the spending minister is made responsible for timely change of the legislation in order to halt the overspending (the Netherlands, Sweden). If this is not explicitly stated, the cabinet or the President is responsible. In the US, mandatory spending (mostly on the basis of entitlement legislation) was exempted from the compensation requirement under the Budget Enforcement Act of 1992 (expired in 2002)¹⁰. The UK makes a distinction between spending that is subject to Departmental Expenditure Limits (DEL) and Annually Managed Expenditure (AME). AME covers social benefits and other volatile or non-discretionary items and is exempted from compensation requirements. In contrast, AME programmes are subject to biannual scrutiny and forecast to ensure that spending in these areas does not threaten fiscal stability.

40. There seems to be a certain inverse relation between the effectiveness of rules of budgetary discipline and the strictness of control systems that aim to prevent overspending of separate accounts in the budget year. If rules of discipline are effective, spending ministers can be allowed to reallocate relatively easily between accounts. There is then no need for heavy preventive control systems. Supplementary appropriations bills can be used to regularize those reallocations after the fact and supervision of those bills on the part of the minister of finance and cabinet or president can be marginal, namely limited to compliance with the rules of discipline and of compatibility with general cabinet/presidential policies. This supposes that the reallocations do not involve shifts of political priorities, but rather substitution of inputs (type 5 reallocations in the sense of section 2.2), or, if they do change political priorities, for instance in cases of overspending or the rise of a new priority (types 3 and 4 reallocations in the sense of section 2.2), that this does not effect major directions of government policy, but rather shifts of emphasis within broad policy areas that can be considered to belong to the sphere of discretion of individual spending ministers. In this respect, it is also relevant that rules of budgetary discipline are usually executive rules that bind ministers only. They do not apply to the legislature. Even if spending control within the executive branch has largely shifted from appropriations laws to rules of budgetary discipline, then the legislature will still focus on appropriations. To a certain extent this will be the case in every country because spending ministers are responsible for appropriations to parliament, but it is particularly true in the US, where Congress is the dominant authority with respect to appropriations. The upshot is then that, apart from the US, the introduction of rules of budgetary discipline tends to facilitate reallocation on the initiative of spending ministers, while it strengthens at the same time the control of the departmental totals, not only in the budget year, but also in the out-years.

41. Rules of budgetary discipline not only facilitate but also trigger reallocations and, moreover, they point at the form they should take. They trigger reallocation in cases of overspending or underspending across the board or revenue shortfall or windfall (types 1 and 2 reallocation in the sense of section 2.2), and in cases of overspending for a specific program or rise of a new priority (types 3 and 4 reallocation in the sense of section 2.2). Overspending across the board in times of fiscal stress requires reallocation in the sense of retrenchment across the board. Underspending across the board in times of fiscal abundance makes it possible to fund new priorities across the board or to provide tax relief. This was the prevailing type of reallocation during much of the nineties in many OECD countries. Revenue shortfalls or windfalls can only trigger reallocation if the framework is flexible and leaves some room at all for effects of revenues on expenditures. Apart from that, revenues can of course have an effect on expenditures when the framework is first made up or extended (in a rolling system). Reallocations motivated by fiscal stress

¹⁰ Under the Budget Enforcement Act the US had rules of budgetary discipline however for Congressional action to *change* entitlement or tax legislation (the so called Pay-as-you-go principle or PAYGO). See Blöndal, Kraan, Ruffner (2003).

(type 1) and fiscal abundance (type 2) are typically government wide operations of great political significance that are undertaken under the supervision of the cabinet or the President. The Minister of Finance will play an advisory and supportive role, but will usually not lead the operation. Overspending for a particular program (type 3) or the rise of a new political priority (type 4) requires compensation on a smaller scale, usually in one or only a few programs. According to rules of budgetary discipline, the spending minister is responsible for compensation and the Minister of Finance will usually play a strong supervisory role. An example is the compensation of the salary adjustment of teachers in the Czech Republic in 2002 discussed in case box 3. The cabinet or the President will only be involved if the programs involved are of major political significance or if the spending minister seeks to share the burden of compensation with other colleagues. The Voluntary Retirement Program in Mexico, the Investment Initiative 2000 in Germany and the Health/Defense Exercise 1998 in Sweden, mentioned in section 2.2 are examples of the latter case.

3.4 The role of the Minister of Finance

42. The rules and conventions delimiting the authority of the minister who is responsible for the budget differ from country to country. In most OECD countries, the Minister of Finance (or Secretary of the Treasury or Chancellor of the Exchequer) is responsible for the budget as well as for monetary and fiscal affairs. In some countries, the Minister of Finance is also responsible for economic affairs. However, in a few cases the responsibilities for financial affairs are split up in a different way. In Canada, monetary, fiscal and macro-budgetary affairs are the responsibility of the Minister of Finance and departmental spending and estimates are the responsibilities of the Treasury Board Secretariat. In the United States, budgetary affairs are taken care of by the Office of Management of Budget, which is part of the Executive Office of the President. It is headed by a Budget Director who has cabinet rank. Monetary and fiscal affairs are the responsibility of the Treasury Department. The degree to which authority for the budget and fiscal affairs are separated, may limit how other budgetary institutions can be used by a Minister of Finance to facilitate reallocation.¹¹

43. Ministers of Finance share a common set of functional roles and authorities. These include the development of the medium term expenditure framework and enforcement of the rules of budgetary discipline. During the budget formulation process, Ministries of Finance are responsible for setting the procedural rules, reviewing the budget documentation submitted by spending ministries – typically but not always within the guidelines and expenditure ceilings established by the Ministry -- and providing cabinet with alternative options. Once the budget is formulated, the Minister of Finance typically develops and tables the budget documentation in parliament. Many countries that provided information to this study also mentioned the authority to set executive level expenditure controls in addition to those set in appropriations laws, including the authority to approve reallocations between expenditure items that occur during the budget year.

44. Ministers of Finance will have an interest in reallocation for the purposes of enforcing (1) medium term frameworks, (2) current appropriations laws, (3) rules of budgetary discipline and (4) to improve cost efficiency. All five types of reallocation in the sense of section 2.2 may be required for these purposes. However, this does not mean that the Minister of Finance, can on his own, order the commencement of a reallocation operation of any of those types.

¹¹ For brevity this report refers to the minister responsible for the budget as the “Minister of Finance”, regardless of the other responsibilities of this minister and regardless their official title. In Canada, for example, this can either be the Minister of Finance or the President of the Treasury Board.

45. There are few areas in which a Ministry of Finance can act autonomously, and this applies in particular to the domain of reallocation. Whilst the Minister of Finance can diagnose the need for reallocation, this does not necessarily translate into a leading role in the subsequent reallocation effort. The support of other ministers, the cabinet, the Prime Minister or the President is likely to be necessary. Even if reallocation is considered to be an appropriate course of action, the degree to which Ministries of Finance can identify the scope, target and details of policy change required differs significantly between countries. This study highlights that this capacity will be affected by the degree to which the relationship between the Minister of Finance and other ministers is based on compromise and accommodation among relative equals, is a more directive principal-agent style relationship as far as budgetary matters are concerned, or operates within clearly defined spheres of responsibility (often legal distinctions).

46. Reallocation operations of type 1 and 2 in the sense of section 2.4 are the least likely to be initiated by the Minister of Finance unilaterally. Whereas in theory authority over the budgetary framework could enable the Minister of Finance to instigate government-wide reallocation, this does not appear to be the case in practice. These exercises only succeed with the support of the Prime Minister/President and this is translated into acceptance, if not support, of the cabinet more broadly. Once this support is garnered, the Ministry of Finance will typically work with the Prime Minister/President to establish the broad framework of the reallocation exercise. This will include setting a budgetary balance target and identifying the distribution of expenditure cuts either by setting reduction targets for each department, or by recommending new departmental spending caps. While individual ministries are asked to develop the specific cutting options, the Ministry of Finance will typically review the options developed by departments and provide the cabinet with possible alternatives. In Canada, for example, this co-ordinating role was in fact given to the Privy Council Office (essentially the Prime Minister's Department); in New Zealand the task was shared across a number of central agencies.

47. Tight rules of budgetary discipline enable devolution but also reduce the authority of the centre of government (Minister of Finance, Prime Minister/President) over the detail of reallocation. While this may be a necessary trade-off, it does limit the extent to which the centre can ensure reallocation decisions improve allocative efficiency. The countries in this study are differentiated by the extent to which spending ministries bear responsibility for their departmental budgets. Countries with effective rules of budgetary discipline, such as Sweden, New Zealand, the Netherlands and the United Kingdom are characterized by strong devolution; countries with a more legalistic tradition, such as Germany, France, Italy and the United States, are characterized by a stronger authority of the centre over the detail of reallocation.

48. While devolution of authority over departmental budgets may facilitate some types of reallocation exercises (types 3-5 in the sense of section 2.2), the pervasiveness of this culture seems to build an expectation of budgetary autonomy that both diminishes the authority of the Minister of Finance and builds a non-negotiable expenditure base. In doing so, it hampers cross-government reallocations (types 1 and 2) or even those versions of types 3 and 4 reallocation that cut across departmental boundaries. Some recent attempts to increase the authority of the Minister of Finance to conduct cross-departmental reallocation can be seen in the Value For Money Reviews 2001 in New Zealand and the Departmental Assessment process in Canada (see case box 1). In both instances, the Minister of Finance sought cabinet approval for the objectives and the content of the reallocation process and provided departments with 'impetus and resources'. But successful reallocation depended almost entirely on the degree of buy-in from individual ministers. There were only a few instances where the exercise led to identifiable reallocation across departments.

49. Ministries of Finance also differ with respect to the impact of their decisions in the annual cycle of budget formulation. Usually there are two stages when the Minister of Finance takes decisions on actual expenditure estimates. The first occurs at the beginning of the cycle as the minister sends out target numbers or guidelines to the spending departments. These numbers may already incorporate

interdepartmental reallocations that the Minister of Finance considers necessary in order to maintain the medium term framework. Here the authority of the minister determines how much importance the spending departments will attach to these numbers. The second occurs at the end of the cycle as the Minister of Finance puts forward the final proposal. A “weak” Minister of Finance will not be able to impose such a final proposal on spending ministers unilaterally. In case of difference of opinion, the decision will be taken over by cabinet or a cabinet committee. A “strong” Minister of Finance is able to impose a final proposal on spending ministers unilaterally, with at most an appeal procedure to the Prime Minister or the President. France, Canada, the UK, and the US are examples of countries with strong Ministers of Finance in this sense.

50. The Finance Ministry in New Zealand, Sweden and the Netherlands use authority to set procedural rules and targets for the annual cycle of budget formulation to ensure that spending ministries reallocate as a routine part of the budget management. In establishing a system of ‘fixed nominal baselines’, New Zealand has separated out the management of funding for existing programs from management of the funding for new programs. In the former area, departmental budgets are supposed to remain largely unchanged from year to year and spending ministers must manage any cost pressures through reallocations within accounts or specific output areas. Importantly this occurs without recourse to or approval from the Minister of Finance, leaving departments with sole authority to assess the allocative efficiency of these reallocation decisions. Departments are also prompted to undertake priority driven reallocation (type 4 in the sense of section 2.2) by the requirement that the cost of new policy initiatives is fully off-set by commensurate cuts within the existing budget. It should be noted that while the latter mechanisms provides the information required to fund new policy development through reallocation, it may still be cabinet, and not the Minister of Finance that decides to fund new programs through reallocation. In an effort to provide an impetus for cabinet to pursue this objective, the governing coalition in New Zealand established a cap on total new expenditures over the life of the government. There are three reasons why this proved difficult to enforce in practice: (1) there is a budgetary surplus, (2) the fiscal squeeze occurred at the end of a government’s mandate i.e. just before an election, and (3) the Minister of Finance could only provide ministers and cabinet with information to facilitate reallocation decisions (see the VFM process mentioned above), spending ministers bore the ultimate responsibility. In this instance, ministers collectively decided not to adhere to the rules of budgetary discipline; the Minister of Finance has little recourse.

51. Most of the countries represented in this study have implemented reforms in the direction of results oriented budgeting. This has involved: (1) efforts to assess the outputs and outcomes of spending programs through quantitative indicators or policy evaluation, (2) relaxation or elimination of rules that restrict the discretion of managers to decide about inputs, and (3) the use of output or outcome information in the budgetary process. The second type of reform has meant among other things the revision of the account structure of budgets in the direction of output oriented items. In view of expected gains in technical and allocative efficiency, these reforms have often been initiated or supported by Ministries of Finance. Examples are the 1990 reforms in New Zealand and more recently, the Program Assessment Rating Tool (PART) in the United States (see the case box below).

52. In the United States the PART has been developed by the Office of Management and Budget (OMB) in order to further the integration of performance information in the budget process. PART is in essence a questionnaire that requires spending departments and other agencies to provide information about performance as part of the regular budgetary process. The questionnaire consists of a relatively limited number of questions and focuses on key aspects of performance. For the Presidential Budget 2004 PART has been used for a part of all spending programs by way of experiment. OMB intends to expand it to all programs in the coming years. The position of OMB as part of the Executive Office of the President both constrains and enhances its capacity to promote reallocation. The diagnostic role of OMB is enhanced by a direct line to the President but operating within a highly competitive environment including actors from both the public and private sectors. Also, the extent to which OMB is able to use its authority over the

budgetary process to build incentives for reallocation is constrained by legislation setting out how the estimates must be calculated. As the PART initiative in the US suggests, an interested President can provide both mandate and authority to undertake review exercises designed to identify programs ripe for reallocation. That being said, the strategic role of the legislature means that any recommendations developed by OMB on the basis of these reviews remain advice to the President and the public more broadly. The authority of OMB to initiate reallocation exercises is highly constrained.

Case box 6: The Programme Assessment Rating Tool (PART) in the USA

The Program Assessment Rating Tool (PART) was introduced to assess government programs in an on-going, systematic and transparent manner in the lead up to fiscal year 2004. Development of this tool was primarily driven by a change in leadership and priorities in 2001. The new President articulated the integration of budget and performance as one of the five priorities on the President's Management Agenda, and the PART was developed on the premise that both the allocation of resources and accountability for the management of those resources are critical to optimizing results. While fiscal pressures did not drive the development of the PART, they made it more widely relevant. PART was developed by a task-team in OMB in consultation with a range of experts and stakeholders. Essentially, the system requires departmental managers to assess twenty percent of their programs each year, and report the results back to OMB who then provide an overall rating of the department. OMB program examiners in consultation with the agencies have the discretion to select which programs are to be assessed.

A series of approximately 30 questions evaluate four critical areas of a program: program design and purpose (20%); strategic planning (10%); program management, including financial oversight and program improvement efforts (20%), and accountability for programs results (50%). PART also includes in each section questions that have been tailored for a particular type of program in addition to the questions which apply to all programs. Seven program types were identified:

- 1) Competitive grant: Programs that distribute funds through a competitive process.
- 2) Block/formula grant: Programs that distribute funds by formula or block grant.
- 3) Regulatory-based: Programs that employs or issues regulations to achieve goals.
- 4) Capital assets and service acquisition: Programs that achieve goals through development and acquisition of capital assets or the purchase of services from a commercial source.
- 5) Credit: Programs that provide support through loans, loan guarantees and direct credit.
- 6) Direct federal: Programs that provide support and services by federal employees.
- 7) Research and development: Programs that focus on creating knowledge or applying it toward the creating of systems, devices, methods, materials or technologies.

Upon receipt of agency responses, OMB assesses each section and allocates a numeric score of 0 to 100 to each agency. Section scores are combined to produce overall qualitative ratings of Effective, Moderately Effective, Adequate, or Ineffective. Programs that do not have acceptable performance measures or have not yet collected performance data generally receive a rating of Results Not Demonstrated.

The process of completing the PARTs generally involves one OMB program examiner and several relevant program managers and staff within an agency. The program staff provide the evidence to support positive responses which is discussed and evaluated for sufficiency with the OMB examiner. When responses are negative, the budget examiner works with the program managers to identify the cause of the weaknesses and recommendations for correcting it. Overall recommendations for future performance and funding are also jointly developed. Agencies can appeal their PART ratings ultimately to the President, however, appeals were reduced by the establishment of an internal interagency panel that was considered independent and balanced enough to resolve further appeals in a way that was considered fair and consistent.

In the first year of its use (FY 2004 Budget), PART led to the incorporation of performance information in the budget and results influenced some budget allocations between programs with similar goals. However, the impact was not at a scale so as to be demonstrated in the budget numbers. It is reasonable to expect that, as a larger percentage of programs are assessed, and multiple years of data demonstrate persistent problems, the PART data will support greater reallocations. The wide variation across agencies in the number, funding level and definition of programs can be confusing to audiences of the PART data and adds to the difficult of comparing program funding levels to budget data, particularly because the account structures are also not uniform across agencies. Efforts are underway to better trace budget accounts to programs for aggregate use in future budgets.

3.5 Program Review

53. Program review is defined in this study as a specific form of policy evaluation. It is characterized by the fact that it is initiated and supervised from the centre of government, namely the Budget Office or the Office of the Prime Minister/President. Most countries that provided information for this study reported that they had standard procedures for policy evaluation, but only a few reported that they had standard procedures for program review in this sense. Some other countries reported that they had used program review procedures on an ad hoc basis in order to support large retrenchment operations in the past (type 1 reallocations).

54. At present, policy evaluation supervised by spending departments is common practice in many OECD countries. This type of evaluation is closely connected with the move towards performance management. Policy evaluation is commonly seen as the best alternative for performance indicators as informational device for the steering and control of expenditures. Since the goals and outputs of many programs can not be measured in a reliable way, evaluation is widely used by program managers to acquire feed-back information about their activities, in terms of effectiveness and cost efficiency. However, program review fulfils different functions: (1) it looks at the allocative efficiency of programs for the government and the citizen/consumer, and (2) it looks at the consequences of alternative funding levels. The first function requires the answering of questions such as: (1) is this program motivated by a valid motive for government intervention or should it be left to the market or the private non-profit sector? (2) should this program be organized at the level of national government or should it be left, for instance, to the municipalities (3) does this program use the appropriate instrument or should it, for instance, use regulation or a tax instead of a subsidy? (4) is this program designed appropriately from the point of view of allocative efficiency for the government/consumer, for instance the right subsidy base, regulatory object, criteria of eligibility, etc.? The second function requires the answering of questions such as: (1) what would be the consequences for the quality of services, the level of provision, the private funding contribution and the demand for substitute services, if public funding were reduced by, for instance: 5%, 10% or 20%. These two functions are typically not fulfilled by policy evaluation under the supervision of spending departments. Of the governments that provided information to this study, the UK and the Netherlands have standard procedures of program review.

55. Program review can be used for all types of reallocation in which the Minister of Finance or the Prime Minister has to play an important role. This applies in the first place to across the board reallocation exercises of types 1 and 2 (fiscal stress and fiscal abundance). In the case of type 2 reallocation, program review will particularly be applied to the programs that have to be curtailed. Program review is less suitable to the design of program expansion. Spending departments see this as part of their core task and do not need help from the centre of government to produce such proposals. Program review can also be useful for type 3 and type 4 reallocations (program overspending and new priority), again only with regard to the programs that have to be curtailed. In these cases it will particularly be applied if the reallocation is so politically significant that it can not be left to the spending minister or in the case that a spending minister wants to transfer a (part of a) retrenchment commitment to one or more colleagues.

56. Program review tends to be a controversial institution. Spending departments resist being subjected to it. The review exercises themselves often do not run smoothly and sometimes turn into interdepartmental battle fields. Special rules such as used in the Dutch procedure may alleviate these problems (external chairman, no veto-right, secretariat provided by the Ministry of Finance, supervisory committee wherein the spending departments are not represented). Nevertheless, in the years of high economic growth during the nineties, the Dutch Minister of Finance had to give up the obligatory 20% retrenchment variant in order to save the procedure. Also, there were years that the procedure hardly survived. The British procedure exists only since 1998 and has a relatively mild obligatory retrenchment alternative of 5%. Nevertheless these procedures are important. They provide for opportunities to build

reallocation into the regular budgetary process. If they are combined with multi year expenditure frameworks, it becomes somewhat easier to find compensatory measures. They thus provide for some additional flexibility to adjust the budget to changing external circumstances. Program review yields information on the allocative efficiency of programs and alternative scenarios. Furthermore, program review tends to strengthen the position of the Minister of Finance and the Prime Minister/President in the decision-making process. These are exactly the ministers that have a positional interest in allocative efficiency because they are judged by the electorate on the costs and benefits of government as a whole. Although introduction of program review is a difficult reform, it might therefore be worthwhile for governments that do not have it to start with it. Especially in the changed budgetary landscape of the 21st century, program review may be a preferable alternative to big periodical retrenchment exercises that are applied in spasmodic fashion and for which the procedures have to be hammered out at every new occasion.

Case Box 7: Designing successful program review mechanisms

Relevant cases:

United Kingdom: Spending Reviews 1998

Netherlands: Interdepartmental Policy Reviews

Despite numerous efforts to establish ongoing program review exercises that facilitate targeted expenditure reallocation, only the Netherlands and the United Kingdom appear to have been successful. Case Box 1 discussed attempts made in New Zealand and Canada to establish a similar system but neither of these processes were sustainable, although both countries continue to move toward this objective (see reforms introduced in Canada in 2004). In addition, the PART system introduced in the USA may prove successful, although it is still too early to judge. Given the interest in establishing program review mechanisms, the processes of Spending Review and Interdepartmental Policy Reviews are described below.

Spending Review Process:

The UK Government introduced a new biannual spending Review process to set departmental spending plans for the following three years, as the process of spending reviews as part of broader budget reforms in 1998. The reforms were intended to address criticism of the previous control regime that did not distinguish between capital and current spending, it was focused on cash inputs instead of outcomes and because the annual spending round was too short a planning horizon. The Spending Reviews cover discretionary spending (with the exception of transport and health spending) and sets new spending and performance plans (PSAs) for two additional years beyond the existing plans. Non-discretionary, so-called Annually Managed (AME) spending, that Departments is also excluded from the Spending Review process.

While the process has been adapted each year since implementation, the basic features steps remain constant. The review process lasts about one year and includes the following key milestones (based on the 2002 Spending Review).

- The Chief Secretary (Budget Minister) writes to departments setting out the framework for the Review.
- The Cabinet Committee on Public Services and Public Expenditure (PSX) (chaired by the Chancellor) meets with Secretaries of State of spending Departments to discuss progress against targets and objectives, and considers papers from each department setting out key strategic challenges.
- Departments submit an Analysis of Resources and a draft Public Service Agreements to the Treasury. The latter sets out what the Department proposed to achieve with its resources over the Spending Review period.
- The Budget in March forecasts revenues over the period covered by the Spending Review and, on the basis of this forecast an 'envelope' for total public spending for the period is derived, split into current and capital spending.
- Analysis of Resources and draft PSAs are scrutinized by Treasury Spending Teams and Treasury Ministers; negotiations take place at official and Ministerial level between Treasury and spending Departments.
- Departmental Spending Plans and PSA's are discussed and agreed between the Chancellor, the Prime Minister

and the relevant departmental Minister. The outcome of the Review is published; spending plans decided on in the Spending Review are fixed and are not subsequently reopened.

Interdepartmental Policy Review

The Reconsideration Procedure introduced in the Netherlands in 1981 forms the basis of the current system of program review. Under this system policy reviews were conducted with the purpose of developing alternatives that would yield savings that were preferably based on efficiency measures but if necessary on reduction of service levels. Only alternatives costing the same or less could be considered. Each review had to produce at least one alternative that would lead to a 20% reduction of expenditure after 4 years compared to the current estimate of the last out-year. In the nineties, the Reconsideration procedure has gradually been adapted to changing economic circumstances. The mandatory 20% savings alternative has been abolished and reviews became more focussed on institutional changes.

Nonetheless, the procedural and organisational aspects have remained unaltered since 1981 and include the following stages:

- Policy areas are proposed for review by the Minister of Finance, and cabinet approves approximately 10 reviews each year.
- The reviews are conducted by small working parties in which the spending ministry, the Ministry of Finance and the Ministry of General Affairs (the Prime Minister) are represented (often there are interdepartmental subjects so that more spending ministries are represented). The Ministry of Finance provides the Secretariat for all reviews.
- External experts can also be invited to participate and at present the working parties conducting the review are mostly chaired by independent persons (university professors, officials who do not bear responsibility for the policy to be reviewed). In the working parties there is no veto-right against proposals for policy alternatives or against inclusion of factual information in the report.
- The whole procedure is supervised by a small interdepartmental committee of senior officials chaired by the Director-General of the Budget and a Ministerial Committee consisting of a few ministers chaired by the Prime Minister.
- All reports are made public and submitted to Parliament. Reviews have to be finished in the spring so that their results can be used by the spending minister as well as by the Minister of Finance during budget preparation. The spending minister can use it, for instance, to comply with compensation requirements under rules of budgetary discipline. The Minister of Finance can use them in negotiations with spending ministers or while preparing general retrenchment operations. Apart from use in the budgetary process, the spending minister has to produce a cabinet statement on each review, to be submitted after approval in cabinet to parliament. A summary report of all reviews is submitted to Parliament as part of the annual Budget Memorandum.

In summary, both processes are intended to provide budget decision makers with advice on resource allocation and possible reallocations; however, differences in budgetary procedures and political systems have produced quite different models of program review. The UK system is biennial and incorporated into the broader system of resource allocation and performance management. The reviews cover all areas of departmental program spending, and undertaken by line agencies (albeit in consultation with the Treasury). While the final report is published, the alternative recommendations constitute advice to the minister and cabinet. In contrast the process in the Netherlands focuses on relatively few policies (approximately 10) every year and is designed to focus exclusively on undertaking those reviews and developing recommendations. Reviews are conducted by cross departmental working groups that include and are often chaired by external participants. The recommendations developed in the reviews are made public and can be used by line or central agencies, the cabinet or by opposition parties.

Finally, recent experience in the Netherlands highlights the fact that in both countries, reviews undertaken by the bureaucracy constitute advice to politicians and it is they who must then decide whether and how to implement those recommendations. In 2000/01 Active Labour Market Policies were reviewed in an effort to make them more cost effective, less complex, and more aligned with the shift toward private sector delivery agents. Finished during the summer of 2001, the review recommended a range of policy redesign measures that would enable substantial budgetary reductions. The political sensitivity of these reforms made implementation difficult and it was not until a right wing coalition government was elected in May 2002 that any changes were implemented.

3.6 Other institutions

57. Earmarking of revenues for specific expenditures is a method that is sometimes used to facilitate reallocation (see case box 4). In general, earmarking is used to protect certain expenditures that are funded from the special fund in which the earmarked revenues flow. The expectation is usually that the revenue from the earmarked tax is more stable or will grow faster than general tax revenue, so that the stability or the growth of the expenditures concerned is guaranteed. Since earmarking will in general have an effect on allocation, it is a relevant budgetary institution for this study.

58. Earmarking of revenues is a common practice in all OECD countries. It is applied in the areas of social security, public health, education, road construction and many others. In general, earmarking is problematic from the point of view of allocative efficiency. If an increase (or decrease) of the earmarked revenues does not exactly match the political priority, the use or the cost changes of the services that are funded, then the special fund in which the earmarked revenues flow must be supplemented with revenues from the general tax fund or the special fund will swell over time. This can easily harm the transparency of the budget, especially if there are many special funds. Special funds may also be exempted from the caps of a medium term expenditure framework. New priorities or overspending may then be approved if they are funded from the special fund more readily than if they are funded from the general fund. The expenditures concerned are then also protected against compensation requirements stemming from rules of budgetary discipline. This may harm allocative efficiency. Nevertheless, there may be some purposes for which earmarking can be sensible.

59. Public investment is a kind of expenditure that is sometimes thought to merit special protection through earmarking of revenues. Three arguments play a role in this view. First, investments are expenditures for the production or purchase of commodities that last longer than a year. It is sometimes thought that in government, unlike in private firms, the prevailing incentives work against expenditures for the long term. Therefore, investment expenditures would always be cut first and increased last. Second, in some policy areas, investment have a fluctuating character. If this is the case, budgeting is usually troublesome because it requires periodic fluctuations in appropriations. Third, investments are notoriously difficult to plan in time. If they are on budget, appropriations have often to be transferred from year to year, which, too, may be difficult, depending on the prevailing regime of appropriations transfer. Each of these arguments is controversial. As for the first: it is not clear why expenditures for the long run should merit special protection if these expenditures are not productive. Not all durable commodities can be considered as productive. This holds for the public as well as for the market sector. Much public investment can be considered as production of durable consumption goods. This could be said for the purchase of wilderness land for conservation purposes, but also for war planes, or office construction. In fact, it could be said for every publicly funded capital good that does not yield monetary proceeds, including roads (apart from toll-roads), waterways and railways, that is to say for almost all government investment. From this perspective, it is not obvious why such durable consumption goods should merit special protection, for instance vis-à-vis goods that do contribute to production in the short run. As for the second argument: in many policy areas investments do not lead to fluctuating appropriations. Often the flow of investments is so large that the pattern is flattened out by the law of large numbers. In the few areas where this is not the case (government office construction is a notorious example) other constructions are possible in order to avoid fluctuating appropriations (for instance renting from the private sector, or borrowing from a central investment department or renting from a central on-budget investment fund). As for the third argument: this argument only holds for policy areas where investments would lead to fluctuating appropriations and this problem is automatically solved if the fluctuating appropriations problem is solved. It thus seems as if public “investment” (in the broad sense of durable commodities) is not a sensible criterion to distinguish expenditures that might merit special protection through earmarking. A different matter is whether there may be reasons to set apart certain special revenues, which can be

characterised as capital revenues (for instance from exploitation of national resources or sale of capital assets) for special purposes.

60. This report is not the place to treat the wider subject for which purposes earmarking and special funds might be a sensible solution or how the according spending areas or revenues ought to be delimited. Earmarking has been raised here because of its effects on allocation. However, in general, earmarking has disadvantages from the point of view of allocative efficiency. Earmarking should only be considered if there are reasons to assume that in special cases these disadvantages are not important or exceeded by advantages stemming from the special character of the spending areas or revenues concerned.

61. The United Kingdom has put budgeting for capital investment on an accruals basis (see case box 4). This institutional reform too, was motivated by the wish to reallocate in favour of investment. For this purpose, a clear separation of current and capital spending has been introduced. Capital investment has been removed from the expenditure caps of the departments (DEL's: Departmental Expenditure Limits) but depreciation of capital assets and a cost of capital charge has been included. This reform too, has an (intended) effect on allocation and is therefore relevant to this study.

62. The reasoning is different here than in the Dutch case. Investment is not exempted from the expenditure caps of the medium term framework, but it is only taken into account in so far as its burden is supposed to fall in the budget year. However, although the attribution of the burden of capital goods to the years in which they contribute to public production may be good practice for the purpose of gaining insight in the productive activities of the public sector, this treatment of investments weakens the allocative function of the budget. For this reason, the US government has recently decided to stand by the principle that investments should be budgeted up-front for the entire amount of the expenditure. This principle reflects the fact that the allocation of economic resources is changed at the time the investment is made and not during the life time of the capital good. This would be different if the government decided to rent a capital good from a firm in the market sector. Then the allocation of economic resources would be changed by the full amount of the investment in the private sector and not in the public sector. This is a case where the allocative function of the budget requires a different kind of budgetary information than the administrative function¹². Given the nature of the government "household", in which the productive branch can best be conceived as a subsector, there is also much to say for the US view that the allocative function ought to be decisive for the institutional set up of the budget and the appropriations laws and that accruals information on production in executive agencies should be collected and published in records of extra-budgetary accounts. Practical advantages of the US approach are that the definition of (productive) investment and depreciation rates will not lead to allocative consequences and will not be contested in the context of the budgetary process. This leaves open how the problems of fluctuating capital expenditures and timing of appropriations for such expenditures should be solved. However, for these problems exist other solutions, as mentioned before

4. An empirical perspective

63. It is well known that patterns of allocation in public finance vary substantially between OECD countries. Also they change over time, not always in the same direction, nor always in the direction of convergence between countries. The explanation of change in the pattern of allocation in the budgets of

¹² Note that not all steps in the direction of accruals principles weakens the allocative function of the budget. For instance, the new proposal in the US aimed at charging the employer's share of the full accruing costs of retirement benefits of public officials to the agencies concerned, can be seen as a strengthening of the allocative function of the budget. Indeed, in this case the allocation is changed at the same time as the costs are made, and the former budgetary practice of appropriating the budgetary benefits only in the year in which they were paid did neither reflect when the costs were made nor when the allocation was changed.

central governments has been an research theme since the end of the nineteenth century. Each of the demand and supply factors mentioned in chapter 2 has received attention and many particular theories have been put forward about their long term impact¹³. Lately there has been a particular interest in political factors. In particular much empirical research has been conducted about the effects of the electoral cycle (expansionary budgetary policy before elections, restrictive budgetary policy after elections) and partisan effects (more redistributive policies under left wing governments, more conservative policies under right wing governments)¹⁴. These factors can be subsumed under the demand factor of “political preferences” in the sense of chapter 2, but they are interesting in their own right. Budget institutions are not demand or supply factors, but rather constraints on the decision-making process that determine how demand and supply factors will impact upon outcomes¹⁵. In general it turns out to be very hard to identify and ascertain the effects of any particular factor or budget institution on outcomes. Effects of any factor or institution tend to be overwhelmed by the effects of other factors or institutions, working in different directions. Against this background it is not to be expected that the impact of any particular institution as described in chapter 3 can be identified by looking at empirical data.

64. Nevertheless it is worthwhile to look at empirical data in the context of a study on budget institutions and reallocation. This is the case for two reasons. The first is that it is useful to have insight in patterns of allocation, even it is not possible to identify the role of separate institutions. One sees the picture as it evolves under the impact of all relevant circumstances, budget institutions included. This enables one to say at least what outcomes prevailing institutions *have not prevented* to occur or what outcomes institutions *have not been able* to safeguard. The second is that patterns of allocation or the development in time of such patterns can be judged against the normative criterion of allocative efficiency. Although it is not possible to ascertain the role of institutions in the emergence of such patterns, it is still possible to evaluate the patterns, once emerged. Since institutions aim to contribute to allocative efficiency, it is at least possible to conclude that institutions do not function effectively or have to be strengthened if the emerging patterns are unsatisfactory from a normative point of view.

65. For both purposes it is necessary to avail of quantitative data about public expenditure that are relevant from an allocative point of view. Existing expenditure classifications such as the budget classification, the economic classification and the functional classification do not serve that purpose. The budget classification is often based on type of input and organisational structure, the economic classification is based on macro-economic impact and the functional classification is based on purpose of expenditure. What is needed is a classification which is based on economic motive, which allows the evaluation of allocative efficiency. Such a classification can be called a *micro-economic* classification. It should be especially helpful to *budgeteers*, as opposed to *macro-economists*.

66. A micro-economic classification was developed as part of the Reallocation Project. It is based on four criteria:

- public goods versus private goods (publicly provided)
- monetary transfers versus services in kind

¹³ For an overview of the older literature see Tarschys (1975).

¹⁴ For surveys of electoral cycle theory see Frey, Schneider (1982) and Alesina, Cohen, Rubini (1992).

¹⁵ In the sphere of institutions theories abound, especially in the sphere of organisational process theory (for a survey see Wildavsky 1988) and public choice. An early example was the wellknown displacement effect theory of Peacock and Wiseman (1961). A new strand of literature emerged in the 1990s on the basis of the Common Resource Pool paradigm (for surveys see De Haan & Sturm (1999) and De Haan, Moessen, Volkerink (1999)).

- services in kind aimed at income support (social services) versus services in kind generating external effects
- purpose of expenditure

67. The first three criteria are the essential ones. Their relevance follows from the fact that the conditions for optimal allocation of public goods (characterized by non-rivalry) are different from those of private goods, that the conditions for optimal distribution of transfers are different from those of the optimal allocation of services in kind and that the conditions for the optimal distribution of social services are different from those of the optimal allocation of services with external effects. The fourth criterion is added for recognisability of the expenditure groups. The macro-economic classification concerns the net expenditure (gross minus non-tax revenue) of central consolidated government (including the health and social security sectors). The micro-economic classification is added as annex 1. A database was formed on the basis of the micro-economic classification for 11 countries participating in the expert group. For this purpose data from existing databases were used, especially data from the Government Financial Statistics (GFS) of the IMF and from four separate databases of the OECD. Annex 2 describes the micro-economic classification and its construction in detail. Annex 3 presents the database (at the stage it had to concluded for the present version of this report) and illustrates it graphically.

68. The database is a rich source of information. It allows many kinds of observations and quantitative analysis. It can be used for that purpose in the future. Here it suffices to make some elementary observations, mainly in the factual (as opposed to the normative) sphere.

69. The present study confirms what is known from many earlier studies concerning the large disparity in the size of central government between OECD countries (graph 1). The countries included in the database can be divided in three groups on the basis of the size of the central government sector since 1995:

1. total net expenditure of central government less than 30% of GDP: Canada, Mexico, US;
2. total net expenditure of central government since 1995 between 30 and 40% of GDP: Germany, New Zealand, Spain, Sweden (since 1999), the UK;
3. total net expenditure of central government higher than 40% of GDP: Netherlands, Sweden (before 1999).

70. The disparity is mainly due to private goods. These are the services and transfers that are characteristic for the welfare state: social transfers, education, health and subsidies/public contributions.

71. It should be emphasised however, that the disparity in spending patterns of central governments is not only due to different policies. They are also strongly influenced by: (a) the division of responsibilities over the different levels of government, (b) the role of tax expenditures, (c) mandatory spending on private insurance schemes, (d) practices concerning guaranties on private loans and public-private partnerships. As far as the first factor is concerned (the division of responsibilities over levels of government), it may be relevant, that all countries in the first category are federal states (but Germany is in the second).

72. Since 1993 there has been a uniform tendency for the central government sector to decrease as a share of GDP, except in Germany and Mexico, where it has remained roughly constant. The decrease has almost exclusively taken place in the sector of private goods, in particular subsidies and public contributions and social transfers (see graph 4). This observation is not surprising considering the high economic growth in those years and the connection between high growth and low social transfers, social services and aid to industry. The whole period from 1993-2000 shows the typical pattern of reallocation type 2 (fiscal abundance). Also there has been a denominator effect, making that the central government sector has shrunk as a share of GDP even if it has been growing in absolute terms. In view of the high economic growth numbers of those years, it may even cause surprise that the sector of public goods has

remained more or less stable as a share of GDP. This means that this sector has grown at the same high rate as GDP in those years. Since multi-year estimates for public goods usually do not grow at a high rate, it seems plausible that substantial reallocation has taken place in those years in favour of expenditure groups, such as general transfers to subnational government, infrastructure, public safety and order and general public services (for this supposition see also graphs 5, 6 and 7). These are reallocations type 4 (new political priorities) made possible by abundant revenue.

73. The graphs on public goods (graph 2) make clear that there is also diversity in the expenditure patterns of central governments concerning public goods but not so wide as with respect to private goods. Here we find among other things the traditional government tasks of defence, public safety and order, and infrastructure. If the countries are again divided in three groups on the basis of their expenditures since 1995, the following picture arises:

1. total net expenditure of central government lower than 8% of GDP: Mexico, New Zealand;
2. total net expenditure of central government between 8 and 12 % of GDP: Canada, US, Germany;
3. total net expenditure of central government higher than 12% of GDP: Sweden, UK, Spain, Netherlands.

74. These differences are due to both goods in kind and transfers. Expenditures for goods in kind are very high (more than 5% of GDP) in the Netherlands, Sweden, the UK and the US. This is mainly due to high expenditures in these countries of public safety and order, and in the UK and the US also for defence. Expenditures for general purpose transfers are very high (more than 5% of GDP) in Canada, Germany, the Netherlands, Spain, Sweden and the UK. This is due to a combination of high interest expenditure (Germany, Netherlands, Sweden, Spain), high general grants to subnational government (Canada, Germany, Netherlands, Sweden) and high development assistance (Netherlands, Sweden).

75. There is no clear pattern in the development of expenditures for public goods in recent years. In Canada, Germany, the Netherlands, Spain and Sweden the level of such expenditures is more or less stable since the mid 90ies. In Mexico there is a weak upward tendency. In New Zealand, the UK and the US there is a weak downward tendency. Underlying these aggregate changes however, are somewhat more volatile movements of component expenditure groups (see graphs 5, 6 and 7).

76. Long term developments are more interesting in this respect. Since 1980 the growth of Defence has substantially stayed behind the development of GDP in almost all countries, including the UK and the US (graph 5). Public Safety and order has in most countries grown substantially faster than GDP, but not in Canada, where it has stayed behind, and not in the Netherlands and Sweden, where it has roughly grown in proportion to GDP (graph 5). Infrastructure is very volatile (graph 6). In the long term (since 1980) it has on average stayed behind GDP in some countries (Canada, Germany, Netherlands, UK, US), it grew faster in some countries (Mexico, Sweden, Sweden) and it kept more or less equal pace with GDP in some countries (New Zealand, Spain). Basic Research has on average stayed behind GDP in the long run (since 1980) in most countries except New Zealand, and the US, where it grew faster and the UK were it grew on average at an equal rate (graph 6). Interest is of course a function of the accumulation of public debt. In many countries the pattern is that interest (graph 7) has grown at a higher rate than GDP in the 80ies and at a lower rate in the 90ies (Canada, Mexico, Netherlands, New Zealand, Spain, but not in Germany where growth rates of interest and GDP have diverged at an accelerating pace in the nineties and only partially in Sweden where there has been a temporary upswing in the mid-nineties). General purpose transfers to subnational government (graph 7) have in a number of countries grown at an equal rate with GDP in the eighties and started to grow faster than GDP from the early or mid-nineties (Canada, Germany, Mexico, Spain, Sweden). This is probably due to reallocation initiatives aimed at decentralisation, which in many cases originate in fiscal stress (type 1 reallocations). In the Netherlands and the UK general purpose transfers to subnational government have on average kept equal pace with GDP, whereas in the US it has

stayed substantially behind GDP. Development assistance (graph 7) has in a number of countries grown on average at an equal rate as GDP (Germany, Netherlands, New Zealand, Spain), whereas in other it has stayed behind GDP, especially since the beginning nineties (Canada, Sweden, UK, US). Since development assistance is often expressed as percentage of GDP in multi-year estimates, deviations from GDP growth percentages will often be the consequence of deliberate policy decisions (type 1, 3 or 4 reallocations: fiscal stress, or compensation of overspending or of new political priorities in other areas).

77. As far as expenditures on private goods are concerned the classification leads to the same results as the classification of total expenditure of consolidated central government, which causes no surprise, because, as we have seen, the divergence of total expenditure is mainly due to the divergence of expenditure on private goods. Specifically, we have for the period since 1995:

1. total net expenditure on private goods less than 15% of GDP: Canada, Mexico, US;
2. total net expenditure on private goods more than 15% but less than 30% of GDP: Germany, New Zealand, Spain, Sweden (since 1996), UK;
3. total net expenditure on private goods more than 30% of GDP: Netherlands, Sweden (before 1996).

78. The composition of the expenditures on private goods shows a wide variety as well. Much depends on the organisation of education and public health. In some countries these tasks are mainly assigned to the subnational level so that central government expenditures are small or very small. This applies to Canada (both education and health), Germany (education), Sweden (health), UK (education) and US (education). Subsidies and public contributions have been smaller than 5% since 1995 in almost all countries except in the Netherlands, Sweden and the UK. In the latter two countries they have come down however since 1998. It appears (graph 4) that within this sector, subsidies to the market sector for goods other than social services is by far the largest component in some countries (Canada, Mexico, Spain, US). In other countries however social services are of similar size (Germany, Netherlands) and in still other ones social services are larger (New Zealand, Sweden, UK). The main component of expenditures on private goods is social transfers. It is much larger than education and health, also in those countries where the latter tasks are fully financed at the central level.

79. The reductions that have taken place since 1995 in the sector of subsidies and public contributions (not in Germany and Mexico) have exclusively focused on subsidies to the market sector for goods other than social services (not on subsidies/contributions to the non-profit sector nor on social services). This focus of retrenchments on subsidies to the market sector reflects a general tendency to reduce intervention in the private sector of the economy. It seems plausible that reallocations of this kind were mainly realized in connection with the funding of new priorities (type 4 reallocations).

80. In the long run (since 1980) the sector of private goods shows the following picture. Social transfers (graph 9) have on average grown faster than GDP in almost all countries except the Netherlands (roughly at the same rate, but since 1993 slower), New Zealand (faster in the 80ies, slower in the 90ies, on average equal) and the US (throughout slower). In Canada they have kept equal pace until the decentralisation of 1995 when they were roughly halved. Education expenditures (graph 9) have on average grown slower than GDP in almost all countries, except Mexico, the UK where they have grown faster (in the UK especially since 1991). Health expenditures (graph 9) grew faster than GDP in almost all countries except Canada (where they kept pace until the decentralisation of 1995 and were then reduced to roughly one tenth of their former size) and New Zealand, Spain, and UK (all at roughly equal rate). All of these expenditures are based on entitlements, so that their movements are mainly reflected in the multi-year estimates and do not constitute reallocation. Nevertheless it seems plausible that expansion of social transfers and education expenditure in the nineties and reduction of health expenditure throughout the period under consideration implies reallocation (of type 4, new priorities, in the case of expansions, of type 1, fiscal stress, in the case of reductions).

81. As far as subsidies and public contributions are concerned the long run picture shows that the reduction of subsidies to the market sector for goods other than social services (graph 8) has occurred mainly in the nineties. In the eighties most countries kept these subsidies still stable or even increased them (Netherlands, Sweden). In some countries social services (graph 8) have on average kept pace with GDP in the eighties and then started to grow faster in the beginning nineties (Germany, the Netherlands, New Zealand). In Spain they started to grow faster already in the mid-eighties). In Mexico and the UK they have grown much faster throughout the period (except in Mexico during the period 1994-1997 when they were temporarily reduced). In Sweden they grew roughly in proportion. In Canada they grew in proportion until 1996 when they dropped as a consequence of the decentralisation. In the US their growth stayed behind GDP throughout the period under consideration. Public contributions to the non-profit sector for goods other than social services finally (graph 8) is a relatively small expenditure group in all countries (culture, recreation, religious affairs). On average it has on average grown faster than GDP in Canada, New Zealand, Sweden and the UK, it has grown roughly in proportion in Germany, Spain and the UK and it has lagged behind GDP in the Netherlands and the US.

5. CONCLUSIONS

82. Reallocation is motivated by changes of demand or supply conditions. Demand conditions are political preferences, use of services by citizen/consumers and tax revenue. Supply conditions are production technology in the public sector, input prices and the cost efficiency of production. In order to gain insight to the role of the various motives for reallocation in practice, the case studies that were provided by the governments represented in the expert group for this study, were clustered. This led to five types of reallocation:

1. fiscal stress
2. fiscal abundance
3. program overspending
4. new political priority
5. substitution of inputs

83. All institutions that have been studied have a double function. First, they are a diagnostic tool in the sense that they help to establish the need for reallocation. Second, they are a tool for redress in the sense that they help to formulate the reallocation proposal.

Medium term expenditure frameworks

84. All OECD countries have medium-term expenditure frameworks. They specify medium term targets for total revenues, total expenditures, the deficit and sometimes a number of major subdivisions of expenditure. Derived from that is an expenditure path starting in the upcoming budget year and finishing in the medium term target year.

85. Medium term expenditure frameworks may be rolling or periodical. They may cover 2,3,4 or 5 years including the upcoming budget year. Most countries that provided information to the study have frameworks that cover three years. Periodical frameworks may be subject to revision during their life time.

86. The primary aim of medium term expenditure frameworks is to provide intertemporal consistency to budgetary policy. For this purpose, the framework makes clear how in subsequent annual stages the medium term targets will be realised. Secondary aims of a medium term framework may be to strengthen the stabilisation function of the budget and to bring added tranquillity in the budget process. For the latter purpose, it is necessary that the time path of total expenditures leading to the medium term target is considered as a series of fixed caps that can not be adjusted anymore during annual budget preparation.

This means that from year to year the expenditure total of the budget has to be reconciled with the expenditure cap of the framework that was established in some previous year. A medium term expenditure framework that has exclusively the primary aim is called a flexible framework, one that has also the secondary aims is called a fixed framework.

87. Medium term frameworks, regardless of whether they are flexible or fixed, are directed at a certain balance between expenditures, revenues and the deficit in the medium term. In view of the reasoning behind this balance, the framework can be characterised as (a) debt oriented, (b) supply side oriented, or (c) demand side oriented. In a debt oriented framework, the structural deficit is the central aim and the expenditure and structural revenue targets are determined by it. The structural deficit is specified in the light of monetary and demographic considerations. In a supply side oriented framework, tax relief is the central aim and the structural deficit and the expenditure targets are derived from it. Tax relief is thought important because of its effects on incentives in the market sector of the economy. In a demand side oriented framework, the structural deficit is the central aim, similarly as in a debt oriented framework. However, in this case the structural deficit is based on a supposed “structural savings surplus” in the market sector of the economy. At present demand side oriented frameworks have largely been abandoned in OECD countries.

88. Medium term frameworks not only facilitate but also trigger reallocations and, moreover, they point at the form they should take. They trigger reallocation in cases of overspending or underspending across the board or revenue shortfalls or windfalls (types 1 and 2 reallocations in the sense of section 2.2), and in cases of overspending for a specific program or rise of a new political priority (types 3 and 4 reallocations).

89. Medium term frameworks tend to concentrate interdepartmental reallocation packages in the decisions about the (extension of the) framework. Furthermore, if frameworks require across the board retrenchments or allow across the board expansions, these operations tend to be smaller in scale than the reallocation exercises that sometimes occur when medium term frameworks are established (extended), due to the fact that the development of tax revenue plays a less important role. Therefore medium term frameworks bring tranquillity in the in the budgetary process.

90. From the point of view of allocative efficiency, medium term expenditure frameworks are largely neutral. On the other hand, a positive efficiency effect follows from the concentration of interdepartmental reallocation in the periodic design or revision of the framework. The order and tranquillity that expenditure frameworks typically impose upon the budgetary process leads to savings in decision-making costs.

Rules of budgetary discipline

91. In order to be effective, medium term frameworks must be accompanied by rules of budgetary discipline. These rules require that all budgetary estimates, for the current budget year as well as for the out-years (including the upcoming budget year), must comply with the caps of the medium term framework and that all overspending with respect to those caps must be compensated. This implies among other things that overspending with a structural cause must be compensated with measures with structural effects, so that the amount of overspending is compensated year by year though the effects of the compensating measures. It also implies that policies that cause overspending in later years (“camel noses”) must be compensated with measures that equally take effect in the future.

92. Rules of budgetary discipline typically attribute the first responsibility for the compensation of overspending to the spending minister. This requires that the spending caps of the medium time framework are divided over the departments. The spending minister can always try to share the burden with other ministers, but this requires the agreement of those ministers and the cabinet or president. The rules may differ on the treatment of entitlement legislation. Sometimes the spending minister is made responsible for

timely change of the legislation in order to halt the overspending, sometimes entitlement legislation is (in holly or in part), exempted from the compensation requirements.

93. There seems to be a certain inverse relation between the effectiveness of rules of budgetary discipline and the strictness of control systems that aim to prevent overspending on separate accounts during the budget year. If rules of discipline are effective, spending ministers can be allowed to reallocate relatively easily between accounts. Supplementary appropriations bills can be used to regularise these reallocations after the fact and supervision of those bills on the part of the Minister of Finance and cabinet or president can be marginal, namely limited to the control of compliance with the rules of discipline and of compatibility with general cabinet/presidential policy.

The role of the Minister of Finance

94. Ministers of Finance will have an interest in reallocation for the purposes of enforcement of: (1) medium term frameworks, (2) current appropriations laws, (3) rules of budgetary discipline and (4) to improve cost efficiency. All five types of reallocation in the sense of section 2.2 may be required for these purposes. However, this does not mean that the Minister of Finance can, on his own, order the commence a reallocation operation of any of those types.

95. There are few areas in which a Ministry of Finance can act autonomously and this applies in particular to the domain of reallocation. Whilst the Minister of Finance can diagnose the need for reallocation, this does not necessarily translate into a leading role in the subsequent reallocation effort. Support of other ministers, cabinet or President may be necessary. Especially reallocation operations of type 1 and 2 in the sense of section 2.2. can in general not be initiated by the Minister of Finance unilaterally. Whereas in theory authority over the budgetary framework could enable the Minister of Finance to instigate government-wide reallocation, this does not appear to be the case in practice. These exercises only succeed with the support of the Prime Minister/President and this is translated into acceptance, if not support, of the cabinet more broadly.

96. Tight rules of budgetary discipline enable devolution but also mean a loss of authority of the centre of government (Minister of Finance, Prime Minister/President) over the details of reallocation. This seems to be a necessary trade-off. While devolution of authority over departmental budgets may facilitate some types of reallocation exercises (types 3-5 in the sense of section 2.2), the pervasiveness of this culture seems to build an expectation of budgetary autonomy that both diminishes the authority of the Minister of Finance and builds a non-negotiable expenditure base. In doing so, it hampers cross-government reallocations or even those versions of types 3 and 4 reallocation that cut across departmental boundaries.

97. The roles of Ministers of Finance are also differentiated with respect to the impact of their decisions in the annual cycle of budget formulation. A “weak” Minister of Finance will not be able to impose such a final proposal on spending ministers unilaterally. In case of difference of opinion, the decision will be taken over by cabinet or a cabinet committee. A “strong” Minister of Finance is able to impose a final proposal on spending ministers unilaterally, with at most an appeal procedure to the Prime Minister/President.

98. In many OECD countries there have been reforms in the direction of results oriented budgeting. This has involved: (1) efforts to assess the outputs and outcomes of spending programs through quantitative indicators or policy evaluation, (2) relaxation or elimination of rules that restrict the discretionary competence of managers to decide about inputs, and (3) the use of output or outcome information in the budgetary process. The second type of reform has meant among other thing the revision of the account structure of budgets in the direction of output oriented items. In view of expected gains in technical and allocative efficiency, these reforms have often been initiated or supported by Ministries of

Finance. These reforms have contributed to reallocation of type 3,4 and 5 in the sense of section 2.2 but there were only a few instances where this has resulted in identifiable reallocation across departments.

Program review

99. Program review in the sense of this study is characterised by the fact that it is initiated and supervised from the centre of government, namely the Budget Office or the Prime minister/President. Most countries that provided information for this study reported that they had standard procedures for policy evaluation, but only a few reported that they had standard procedures for program review in this sense.

100. Program review fulfils different functions than policy evaluation:(1) it looks at the allocative efficiency, as opposed to only the cost efficiency, of programs for the government and the citizen/consumer, and (2) it looks at the consequences of alternative funding levels.

101. Program review can be used for all types of reallocation in which the Minister of Finance or the Prime Minister/President has to play an important role. This applies to every reallocation that is so politically significant that it can not be left to the spending minister. It also applies to cases in which a spending minister wants to transfer a part of a retrenchment commitment to one or more colleagues. Program review is particularly useful when programs have to be curtailed. It is less suitable to the design of program expansion.

102. Program review tends to be a controversial institution. Nevertheless, these procedures are important. They provide for opportunities to build reallocation into the regular budgetary process. They facilitate adherence to rules of budgetary discipline. They thus provide for some additional flexibility to adjust the budget to changing external circumstances. This is an advantage from the point of view of allocative efficiency. Moreover, program review generally yields information about allocative efficiency and strengthens the position of those ministers who have a positional interest in allocative efficiency, namely the Minister of Finance and the Prime Minister/President.

Other institutions

103. Earmarking of revenues is sometimes used to protect certain expenditures against retrenchment or to ensure their increase. Earmarking harms the transparency of the budget, especially if there are many different special funds in which these revenues flow. Special funds may also be exempted from the caps of a medium term expenditure framework. This may harm allocative efficiency. Nevertheless, there may be some purposes for which earmarking can be sensible.

104. One purpose for which earmarking is used is the funding of capital investment. The arguments underlying earmarking for this purpose are controversial. A different matter is whether there may be reasons to set apart certain special revenues, which can be characterised as capital revenues (for instance from exploitation of national resources or sale of capital assets) for special purposes.

105. These are examples of budgeting for capital investment being put on accruals basis. This institutional reform has also been motivated in parts by the wish to reallocate in favour of investment. The reasoning is different here than in case of earmarking. Investment is not exempted from the expenditure caps of the medium term framework, but it is only taken into account in so far as its burden is supposed to fall in the budget year. Although the attribution of the burden of capital goods to the years in which they contribute to public production may be good practice for the purpose of gaining insight in the productive activities of the public sector, this treatment of investments weakens the allocative function of the budget. Given the nature of the government “household”, in which the productive branch can best be conceived as a subsector, there is also much to say for the view that investments should be budgeted up front and that accruals information

on production in executive agencies should be collected and published in records of extrabudgetary accounts. Practical advantages of this approach are that the definition of (productive) investment and depreciation rates will not lead to allocative consequences and will not be contested in the context of the budgetary process.

An Empirical Perspective

106. Effects of budget institutions on expenditure patterns tend to be overwhelmed by the effects of other factors and institutions working in different directions, so that it is not to be expected that they can be identified by looking at empirical data. Nevertheless it is worthwhile to look at empirical data, because the development of expenditure patterns may show what outcome prevailing institutions have not prevented to occur or have not been able to safeguard. Moreover, empirical data may allow evaluation from the point of view of allocative efficiency. For both purposes it is necessary to avail of data that are relevant from an allocative point of view. For this purpose a micro-economic classification of public expenditure was developed and a database was formed on the basis of this classification.

107. Patterns of central government expenditure show a large variety. This is partially due to different division of responsibility between levels of government, different roles of tax expenditure and mandatory private insurance schemes, different taxation of social benefits and different practices concerning loan guaranties and public-private partnerships. Apart from these factors, it seems plausible that there are large differences based on policy.

108. Patterns of expenditure differ both in the area of public goods and of private goods (publicly provided). The differences in the latter area are much larger than in the former, but also more determined by the roles of tax expenditure and mandatory private insurance schemes and the taxation of social benefits.

109. Since the mid nineties there has been a general tendency for the central government to decrease as a share of GDP. This decrease has almost exclusively taken place in the sector of private goods, in particular subsidies to the market sector, public contributions to the non-profit sector and social transfers. Expenditures for public goods have remained stable as share of GDP or have even increased, but there is no general international trend discernible in the nature of these reallocations.

110. In the long term (since 1980) the expenditure groups that have grown faster than GDP in most countries are Public safety and order, Social transfers and Health. Groups that have grown slower in most countries are: Defence, Basic Research and Education. For all other groups there is no common long term international trend discernible.

ANNEX 1
THE MICRO-ECONOMIC CLASSIFICATION

A. Public goods

I In kind

1. Defence
2. Public safety and order
3. Infrastructure
4. Basic research
5. General Public Services

II Monetary transfers

6. Development assistance
7. General transfers to subnational government
8. Interest

B. Private goods

I. In kind

9. Subsidies to the market sector for goods other than social services
10. Public contributions to the non-profit sector for goods other than social services
11. Social services
12. Education
13. Health

II Monetary transfers

14. Social transfers

ANNEX 2 PURPOSE AND CONSTRUCTION OF THE MICRO-ECONOMIC CLASSIFICATION

1. Purpose

The micro-economic classification has been developed at the occasion of the Reallocation Project of the OECD but serves a wider purpose: it aims to classify government expenditures on the basis of economic motive.

The new database refers to net expenditure (gross minus non-tax revenue) of central consolidated government (including the health and social security sectors). Expenditures by off-budget funds, fed by public levies, such as social security and public health insurance funds are included. Conditional and unconditional grants to subnational government are included. Tax expenditure, and obligatory private expenditure are excluded.

Existing classifications of expenditures are based on type of input and organizational structure (budget classification), macro-economic type of expenditure (economic classification) or purpose of expenditure (functional classification). The micro-economic classification is different from these classifications although there are also some similarities especially with the functional classification. The micro-economic classification is especially suitable to study the *allocative* impact of the budget, as opposed to the *macro-economic* impact. As such the classification should be especially helpful to *budgeteers* as opposed to *macro-economists*.

In view of its purpose, the classification is only applicable to separate governments or separate levels of government. Consolidation across levels of government is not possible. In this study the classification is applied to consolidated central government (including the health and social security sectors).

2. Criteria

The three basic criteria of the micro-economic classification are:

- Public goods versus private goods (publicly provided)
- Monetary transfers versus services in kind
- Services in kind aimed at income support (social services) versus services in kind generating external effects

The requirements for the optimal allocation of (publicly provided) private goods are essentially different from those for public goods. Similarly the requirements for the optimal distribution of

transfers are essentially different from those for the optimal allocation of services in kind. Finally, the requirements for the optimal allocation of services with external effects are essentially different from those for the optimal distribution of social services.

For recognisability some categories are subdivided according to:

- Purpose of expenditure

Education and health expenditures are treated as separate groups because they are motivated by considerations of income support as well as external effects.

The micro classification is shown in annex I.

3. Nature and use of the data base

The data that are used, are *not* provided by the countries for the specific purpose of building this data base. Rather the data are taken from existing data bases that have been developed for other purposes. Each of these data bases makes use of questionnaires to member countries that are accompanied by substantial explanation and documentation. This material will not be reproduced here.

In some cases the data in existing data bases do not exactly fit to requirements of the micro-economic classification. This will result in errors or rough and ready estimates. For the reallocation project this is not a problem. However, other purposes may require more exact data. For such purposes the new data base is not suitable.

After the initial use of existing sources, it turned out that there were many lacking data. These have partially been estimated, and partially been provided by members of the expert group of the Reallocation Project from national data sources. These estimations and additions are made for the specific purpose of this database. The data base will not be used to fill gaps in the existing data sources that have initially been used.

4. Sources

The database consists of time series from 1980 to 2001 of all groups of the micro-economic classification. The time series were constructed by using two main data sources, namely: (A) the Government Finance Statistics (GFS) maintained by the IMF, and (B) four different special data bases maintained by different Directorates of the OECD or associated with the OECD.

As far as the GFS is concerned the database makes use of (a) the functional classification, the so called COFOG (Classification of Functions of Government) and (b) the economic classification. With respect to COFOG the database makes use in particular of table B: Consolidated Central Government. COFOG has been revised in 2000 by the UN. The database makes use of the old COFOG for which the GFS provides long time series. The new COFOG is used by EUROSTAT but there are no long time series available that are based on it (and for many countries there are not yet any data available based on it). A problem however, is that some countries have stopped

providing data on the basis of old COFOG to the IMF. Since the COFOG data are an essential source for the database, for these countries the time series stops at the year where the countries stopped providing data on the basis of old COFOG to the IMF.

As far as the special OECD sources are concerned, the database makes use of (1) Research and Development Database (Directorate for Science, Technology and Industry), (2) Transport Infrastructure Database (Secretariat of European Conference of Ministers of Transport), (3) Development Assistance Committee Database (Development Co-operation Directorate), (4) Social Expenditure Database (Directorate of Employment, Labour and Social Affairs).

COFOG was not only used for the retrieval of data for specific expenditure groups, but also for the special purpose of providing consistency at the national level.

5. Construction

The time series for (a) Defence, (b) Public safety and order, (c) Public contributions for goods other than social services, (d) Education, and (e) Health, are taken directly from COFOG (Public contributions to the non-profit sector for goods other than social services = Recreational, Cultural and Religious Affairs).

The time series for Interest is taken directly from the economic classification of the GFS.

The time series for (a) Basic research, (b) Development assistance, and (c) Infrastructure, are directly taken from the special OECD databases (respectively the Research and Development database, the Transport Infrastructure database and the Development Assistance Committee database). Since the latter database only covers European OECD members, the data for the non-European countries were requested from and provided by the members of the OECD expert group on Reallocation. The Transport Infrastructure database only provides data for general government. It is therefore assumed that in all non-federal European countries, public transport infrastructure is funded by central government. This is a rough assumption that in some countries may lead to an overestimation. On the other hand the omission of maintenance costs and expenditure on communication infrastructure may lead to an underestimation (see below). In Federal Republic of Germany, the infrastructure data from the Transport Infrastructure database have been split in shares for central government and subnational government (Länder and other) in accordance with the average expenditures of these levels of government for transport and communication in general.

General transfers to subnational governments are estimated as the remainder of Other Expenditures (COFOG) after Interest (from the economic classification of the GFS) is subtracted. This is based on the consideration that General transfers to subnational governments and Interest are the main components of Other Expenditures. However this group also contains: Expenditures Not Classified by Major Groups and Other Expenditures Not Classified by Major Group, which may cause error.

Subsidies to market sector for goods other than social services is estimated as the sum of (a) Agriculture, Forestry, Fishing, Hunting Affairs and Services (COFOG), (b) Mining and Mineral

Resource Affairs and Services, Other than Fuels; Manufacturing Affairs and Services; Construction Affairs and Services (COFOG), (c) Economic Affairs and Services (COFOG), (d) the remainder of Transport and Communication (COFOG) after infrastructure (from the Transport Infrastructure database) has been subtracted, and (e) the remainder of Housing and Community Amenities (COFOG) after housing subsidies (from the Social Expenditure database) has been subtracted. Economic Affairs and Services contains labour market subsidies. The remainder of Transport and Communication contains all public funding for communication as well as all current expenditure for transport (especially maintenance and exploitation subsidies). The remainder of Housing and Community Amenities (COFOG) contains all public funding of environmental policy, water supply and street lightning.

Social services is estimated as the sum of (a) all social services in kind, except labour market subsidies and housing subsidies (from the Social Service Expenditure database), and (b) housing subsidies (from the Social Service Expenditure database).

Social transfers is estimated as the remainder of Social Security and Welfare (COFOG) after Social Services (from the Social Service Expenditure database) have been subtracted.

Appendix 1 summarizes the construction of the micro-economic classification. Furthermore appendix 2 shows that, in spite of the use the 6 different data sources, the total of all expenditures must necessarily be identical to the total of expenditures in COFOG. This is the case because COFOG groups that are split up, have “remainders” that guarantee that the total of the shares is equal to the total of the COFOG group. The sum of the third column of annex 3 (total expenditures in the micro-economic classification) is therefore necessarily equal to the sum of the first column of annex 3, which is total expenditures according to COFOG.

6. Definitions of groups

Defence is defined according to COFOG¹⁶.

Public safety and order is defined according to COFOG.

Infrastructure contains all investment expenditure for the construction of roads, railways, urban and suburban railway, metro and tramway, inland waterway and ports, oil pipelines, maritime ports and airports. Transport infrastructure is treated in the data base as a public good. This may not be self evident. Owners of railway networks are starting to charge railway companies for the use of the network. Airports are being privatized and start charging carriers for infrastructural facilities. Harbours are increasing port charges. Finally, toll roads are spreading. In spite of these developments, it is probably fair to say that the bulk of transport infrastructure is still being financed from the general tax fund. Furthermore, even if pricing became common, it may be argued that transport infrastructure remains still a public good (characterized by non-rivalry). It is also for this reason that optimal pricing, if it is applied, remains different from pricing in the market sector (public goods funded by pricing are known in regulatory economics as goods with

¹⁶ See A Manual on Government Finance Statistics, International Monetary Fund, 1986 for all COFOG definitions mentioned in this section.

diminishing marginal costs and have always been known to require special pricing arrangements). In view of these considerations, infrastructure is treated as a public good rather than as a subsidized private good. Note, that on the basis of this reasoning it would have been logical to include public expenditure on communication infrastructure in the infrastructure group. However, these data are not available in an existing database, so they have been left out for a pragmatical reason. Remark that by leaving them out these expenditures end up in the Subsidies to Market Sector group in view of the estimation procedures employed. It would also have been logical to include maintenance of infrastructure in the infrastructure group since these expenditures too are public goods (characterized by non-rivalry). However, these data are not available either and these expenditures are thus treated as subsidies as well.

Basic research is experimental or theoretical work undertaken primarily to acquire new knowledge of the underlying foundation of phenomena and observable facts, without any particular application or use in view. In the social sciences and humanities basic research is usually recognisable by the fact that it is not undertaken for the purpose of developing or evaluating public policy or business practice or strategy. Basic research is performed in business enterprises, government, institutions of higher education and private non-profit institutions. The definition is in accordance with the Frascati Manual¹⁷ (the basis of the Research and Development Database).

General public services are defined according to COFOG. Basic research and Development Assistance are subtracted. The COFOG definition includes: executive and legislative organs, financial and fiscal affairs, external affairs, foreign economic aid (differences with the subtracted Development Assistance from the OECD database are possible), fundamental research affairs and services (differences with the subtracted Basic research from the OECD database are possible), general services, general public services not elsewhere classified.

Development assistance comprises: Official Development Aid (ODA) and Other Official Flows (OOF). ODA is defined as those flows to countries on Part I of the DAC (Development Assistance Committee) List (of the OECD) and to multilateral institutions for flows to Part I aid recipients, which are: (1) provided by official agencies, including state and local governments, or by their executive agencies, and (2) transaction of which (a) is administered with the promotion of economic development and welfare of developing countries as its main objective, and (b) is concessional in character and conveys a grant element of at least 25 %. OOF is defined as development assistance that does not meet the ODA criteria, namely: (a) grants for representative or essentially commercial purposes, (b) transactions to promote development but having a grant element of less than 25%, (c) transactions, whatever their grant element, that are primarily export facilitating in character, (d) the net acquisition by governments and central monetary institutions of securities issued by development banks at market terms. Notice that although the definitions of ODA and OOF refer to both central and subnational government, only the central government data are used in the database.

¹⁷ Frascati Manual. Proposed Standard Practice for Surveys on Research and Experimental Development, Paris, 2002, OECD

General transfers to subnational governments is defined according to COFOG (Subgroup 14.0.2: transfers of a general character between different levels of government, that is, transfers not allocated to a particular function).

Interest is defined according to the economic classification of the GFS¹⁸.

Subsidies to market sector for goods other than social services is defined according to the COFOG groups: (a) Agriculture, Forestry, Fishing, Hunting Affairs and Services, (b) Mining and Mineral Resource Affairs and Services, Other than Fuels; Manufacturing Affairs and Services; Construction Affairs and

Services, (c) Other Economic Affairs and Services, (d) Housing and Community Amenities, and (e) Transportation and Communication Affairs and Services. Housing subsidies and infrastructure (from the OECE databases) are subtracted (differences between the housing expenditures included in (d) and the infrastructure expenditures included in (e) and the subtracted housing and infrastructure expenditures of the OECD databases are possible).

Public contributions to non-profit sector for goods other than social services is defined according to the COFOG group recreational, cultural and religious affairs and services.

Social services are defined as all social benefits in kind (not in cash) provided to individuals and families apart from education and health. The social services may be supplied by the profit sector or the non-profit sector (including central government itself). Social services are services that the government sees as necessary for the individuals and families concerned but that they might not be able or willing to buy for themselves if they had to pay the cost-price. This comprises: services for the elderly (residential care, home-help services), services for the handicapped (residential care, day-care and rehabilitation services) and services for families (housing, day-care, children's homes, social work). Labour market subsidies have been excluded (they are included in Other economic affairs and services of COFOG and thus in Subsidies to market sector for goods other than social services).

Social transfers have been defined according to COFOG.

Health has been defined according to COFOG.

Education has been defined according to COFOG.

7. Lacking data

Lacking data in one or two subsequent years, not at the beginning or the end of a time series, were estimated by interpolation in the deflated series (a single lacking number being estimated as the average of the deflated numbers in the years after and before and two subsequent lacking numbers being estimated at 1/3 and 2/3 of the difference between the deflated numbers of the years before and after the lacking numbers).

¹⁸ Explained in the Manual on Government Finance Statistics (see note 1).

Lacking data in one or two subsequent years at the beginning or the end of a time series were estimated by assuming the same average annual real growth as in the five subsequent or preceding years.

In case of lacking data for more than two subsequent years (including the absence of an entire time series) the members of the expert group on Reallocation were asked to provide the data from national sources.

Appendix 1

From Micro-economic classification to GFSY

Micro-economic CI	Subdivisions GFSY	Functional CI. GFSY	Sources
1. Defence		2. Defence	GFSY (Fu. Cl)
2. Public safety and order		3. Public Safety and Order	GFSY (Fu. cl.)
3. Interest	14.0.1 Interest	14. Other expenditures	GFSY (Ec. cl.)
4. Infrastructure	(Infrastructural investment part)	12. Transport and Communication	CEM
5. Basic research	1.3 Fundamental Research	1. General Public Service	STI Scoreboard
6. Development assistance	1.2 Development Assistance	1. General Public Service	(DCD)
7. General transfers to subnational governments	Remainder Other Expenditures	14. Other Expenditures	
8. General public services	Remainder General Public Service	1. General Public Service	
9. Subsidies to market sector for goods other than social services		9-11 and 13 Economic Affairs and Services	GFSY (Fu. cl.)
	Remainder Transport and Communication	12. Transport and Communication	
	Remainder Housing and Community Amenities	7. Housing and Community Amenities	
10. Public contributions to non-profit sector for other than social services		8. Recreational, Cultural and Religious Affairs	GFSY (Fu.cl.)
11. Social services	(social services part)	6. Social Security and Welfare	DELSA LSA
	7.1.1. Housing	7. Housing and Community Amenities	DELSA LSA
12. Social transfers	Remainder Social Security and Welfare	6. Social Security and Welfare	
13. Health		5. Health	GFSY (Fu.cl.)
14. Education		4. Education	GFSY (Fu.cl.)

Appendix 2**From GFSY to Micro-economic classification**

Funct. Cl. GFSY	Subdivisions GFSY	Micro-economic Cl.	Sources
1. General Public Service	1.3 Fundamental Research	5. Fundamental research	STI Scoreboard
	1.2 Development Assistance	6. Development assistance	DCD
	Remainder General Public Services	8. General public service	
2. Defense		1. Defense	GFSY (Fu. cl)
3. Public Order and Safety		2. Public Order and Safety	GFSY
4. Education		14. Education	GFSY (Fu.cl)
5. Health		13. Health	GFSY (Fu. cl)
6. Social Security and Welfare	(social services part)	11. Social services	DELSA LSA
	Remainder Social Security and Welfare	12. Social transfers	
7. Housing and Community Amenities	7.1.1.Housing	11. Social services	DELSA LSA
	Remainder Housing and Community Amenities	9 Subsidies to market sector	
8. Recreational, Cultural and Religious Affairs		11. Public contributions for goods other than social services	GFSY (Fu. cl.)
12. Transport and Communication	(infrastructural investment part)	4. Infrastructure	CEM (European Ministers of Transport)
	Remainder Transport and communication	9. Subsidies	
9-11 and 13.Economic Affairs and Services		9. Subsidies	GFSY (Fu. cl.)
14. Other Expenditures	14.0.1 Interest	3. Interest	GFSY (Ec. cl.)
	Remainder Other Expenditures	7. General transfers to lower governments	

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