Controlling Public Spending in Times of Plenty

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Introduction

Most economists, without much prompting, would claim that the annual rate of growth in public expenditure since 1990 has been “excessive”. However, the case is distinctly underwhelming if it relies on standard macro economic arguments. The general Government Deficit (GGD) has been kept below 3% of GDP each year since 1987 and this year we’re on track for a budget surplus. By the end of the year the debt-GDP ratio is likely to be about 66% - below the EU average and almost 30 points lower than in 1989. Hardly the stuff to engender a mood of restraint among decision makers.

Table 1
Fiscal Ratios and Current Government Spending, 1990-1997

	1990	1991	1992	1993	1994	1995	1996	1997
Budget Deficit* (% GDP)	2.3	2.3	2.5	2.4	1.7	1.9	1.0	(0.2)
Govt. Debt* (% GDP)	95.8	95.0	92.0	94.5	87.9	81.6	73.0	66.0
Spending Growth (% p.a.)**	6.9	9.9	10.0	7.8	7.3	6.9	4.9	7.3
Spending (% GDP)**	28.2	29.7	30.6	30.6	30.2	29.0	27.6	27.2

* General Government
** Gross Supply Services

If the case for spending restraint has not been found persuasive by decision makers in these circumstances, an appeal for restraint on the basis of possible fiscal pitfalls lurking up ahead is unlikely to be any more compelling. This line of argument has precious little galvanising effect on the decision-makers since the construction of scenarios in which fiscal imbalances emerge at some future date requires that assumptions and forecasts be made in relation to the key variables involved and these assumptions/forecasts are subject to dispute and uncertainty. Basing a particular spending rule (e.g., that real current spending growth be limited to 2% per annum) on a set of medium-term forecasts that envisage GNP growth of 4% per annum is an invitation to exceed the spending target if the GNP forecasts prove to be too conservative.

Clearly we are not suggesting that the rate of spending growth is a matter of indifference because of the present and prospective financial health status of the public finances. The enduring case in our view, for not so much restraint, as for prudent appraisal of public expenditure, rests on fundamental principles that are all too infrequently invoked in public debate. The most basic of the principles involved are: (i) that public resources are the property of the citizens of the State and not of politicians, civil servants, government departments or interest groups, and (ii) that, however strongly tax revenues are growing, resources remain scarce: their application in one area necessarily implies an opportunity cost in terms of foregoing options to spend in other areas or levying higher taxes than would otherwise be required. These principles imply the need for transparency in decision making and that government should be fully accountable to the citizens for the way in which public resources are spent.

The spending record since 1990 provides *prima facie* evidence that these principles were not to the fore in the deliberations of decision makers in recent years. Now one can suggest that this may have been due to an absence of a political willingness among successive governments to tackle powerful interest groups whose expectations were fuelled by a rapidly expanding economy. Its burgeoning coffers and an almost messianic desire to "share the fruits of growth" undoubtedly intoxicated government itself. By implication it might seem that a government, armed with no more than a conviction to stand up to the powerful lobbies, would have succeeded in curtailing “excessive” spending growth.

Our thesis, however, is that it is the *process* of determining the quantum of public expenditure that has contributed most towards the apparent failure to exercise greater spending restraint. This process we believe is characterised by a tendency towards fiscal illusion (von Hagen and Harden (1994) and Milesi-Ferrett1 (1997)). In this framework there is a failure to fully internalise the true economic costs of public expenditure. The narrow interests of individual spending ministers dominate over the collectivist concerns of the Minister of Finance and the Taoiseach. Consensus is arrived at in Cabinet on the basis of the spending ministers, either explicitly or implicitly, backing each other bids resulting in “something for everyone” and thus a sub-optimal overall level of spending. If this framework accurately reflects the actual process of public expenditure determination then intra-governmental institutional reform is required to redress the situation.

The failure of the Rainbow to adhere to its self-imposed and historic spending cap convinces us further of the need to introduce a thorough going reform of the political and administrative *process* of public expenditure determination.

In this paper therefore we set out a series of recommendations for reform of that process. They culminate in the radical proposal for legislative change. This step is needed in our view because nothing less than a cultural change in how our political, administrative and interest group institutions view public expenditure determination will succeed in promoting fundamentally-based restraint.

Internalising the costs of public expenditure

The literature would suggest that end point controls such as spending limits and process controls are competing options (von Hagen and Harden, 1994) in combating fiscal illusion. Our view is that in practice these approaches are complementary rather than competitive. Indeed we see a case for making such outcome targets an integral part of the control process. Proper control is required to ensure efficiency and effectiveness of public expenditure but overriding this is the need to ensure sustainability of the public finances. In principle one could argue that if an appropriate control process were in place the outcome of this process should be consistent with financial sustainability. A more pragmatic perspective would be that this outcome will only emerge fortuitously and hence the ultimate constraint must always be foremost in the minds of parties to the budget process. At the very least we suggest that there is a strong argument for end-point controls while a thorough-going and validated control process is being put in place. The argument is reinforced in the current Irish context by the fact that spending has been growing so rapidly over the past seven years.

We believe that there are five key elements in reforming the process of expenditure decision making:

- the promulgation of a medium-term sustainability framework
- the implementation of an expenditure “envelope”
- value for money (VFM) evaluation of public expenditure
- well-designed control incentives and disincentives
- a legislative foundation

A medium-term sustainability framework

What outcome constraints are possible? Logically one should start with the deficit. The *Stability Pact* provides for balance over the economic cycle which, implies an unchanged level of debt in absolute terms over the cycle and a secular decline in the ratio of debt to GDP. Assuming that the resultant trajectory for the debt is acceptable (a controversial assumption for highly-indebted governments like those of Belgium and Italy, if not also in the Irish case), this leaves Member States free to determine the appropriate mix between spending, taxation and the cyclical component of the deficit/surplus. Given a medium-term target for two of these components the target for the third emerges residually.

In the steady state, this mix is relatively easy to determine in terms of low and stable taxation and debt burdens with spending taking up the slack. In the Irish context there would clearly be a view that we are some way off this steady-state world. The widely held view is that the tax burden needs to be reduced, so it makes the striking of that balance a more overtly political act. A variety of approaches might be conceived of to determine this balance.

In the context of the *Stability Pact* one obvious way would be to determine spending increases and tax "givebacks" on the basis of projected trend GNP growth. Any excess over trend would perforce reduce debt. The balance between spending and tax "givebacks" can't be determined by simple rules. But what is clearly needed is a clear statement of a medium-term framework within which annual decisions can be made on coherent basis. This statement would need to be constantly promulgated until all parties to the budget process accept it. The absence of a medium-term framework, or if there was one it was not widely known of, in recent years has meant ridiculous pressure being placed on governments to adjust spending and taxation decisions on the basis of the latest "surprising" outcomes for growth and tax revenues.

Our first recommendation therefore is:

that Government should set out a medium-term macroeconomic framework within which annual policy decisions can be appraised.

The *Stability Pact* provides the context but it needs to be supplemented by the implications and political decisions that flow therefrom in terms of spending increases, tax "givebacks" and debt reductions.

This framework would need to be tweaked only when information emerges which would require adjusting the trend growth assumptions. We wouldn't go as far as suggesting the interesting institutional reform of von Hagen and Harden who recommend the establishment of a *National Debt Board*, entirely independent of Government which would decide on medium term and consistent annual debt targets. While the creation of a medium-term framework involves technical actions it is fundamentally in our view an exercise in political economy. By removing responsibility for a key aspect of the framework to an outside agency, the principle of democratic accountability is weakened and an important opportunity is thereby missed to ingrain a culture of process control into our system of national budgeting.

How does our recommendation sit with the inauguration of multi-annual budgeting (MAB) in last January's Budget? The difference is subtle and one of degree. Our view is that the medium-term framework must drive the process and not simply be a technical exercise that sets out in a limited way the consequences of current decisions. We say limited because our perspective of the medium-term framework would involve the presentation of a full set of macroeconomic projections together with assumptions. This framework should ideally show the governments intention's for the medium term and not simply the medium-term consequences of current decisions. This essentially is what the MAB exercise does. This exercise would be more appropriate to assessing the consequences of given expenditure and budget proposals in the preparatory phase of the Budget's construction. Unless we are to take the MAB projections as a reflection of the Government's medium-term fiscal intentions then it loses its potency as a control mechanism.

Implementing the expenditure "envelope"

The medium-term framework advocated above implies targets for spending, taxation and debt. Of the three factors it is clear that the spending component is the most difficult to control. Taxation and debt targets and the strategies to implement them are largely left within the compass of the Minister of Finance[1]. No other Minister has a direct interest in the outcomes of these targets as far as his own Ministry is concerned and hence is unlikely to present a stubborn resistance to the Finance Minister's preferences. The exact opposite happens with expenditure[2]. The role of the Minister and of the Department generally is brought into conflict with the line ministries and especially the large spending ones.

Effective control requires a highly centralised system with the Minister of Finance and the Taoiseach as key players. In such a system an enunciated spending target may help control but it might eventually prove to be unnecessary. In a more decentralised system

[1] In recent years the Minister's influence has been lessened by the operation of national wage agreements.
[2] We include tax expenditures here.

like ours[3] a spending target would seem to be a necessary element of control but experience has told us it certainly isn't a sufficient condition.

While the previous Government broke new ground in having an explicit spending target there was no process innovation to facilitate its attainment. This to us was the primary source of the failure to achieve control. It was almost as if the mere existence of the target was expected through an “invisible hand” process to deliver a consistent outcome. On this premise the current Government is no more likely to attain its target[4]**,** although its control aggregate (*Central Fund plus Net Supply Services spending*) is more susceptible to successful targeting (and manipulation) than that of its predecessor (*Gross Supply Services Spending*). In this regard it is worth noting that the current government has already taken steps to exploit the pliability of its control aggregate by boosting the 1997 base from which the 1998 ceiling will be derived to the tune of £250m, through the payment in September of £150m to the pensions funds of An Post and Telecom and £100m to the Small Savings Reserve Fund, neither of which was provided for in the Budget.

Nigel Lawson (1992) described the traditional British system, which determined the annual supply of services, as the “brick by brick” system. In this highly decentralised system the Chancellor of the Exchequer for much of this process could only watch from the sideline. The infamous bilaterals between the Treasury and the departments doubtlessly placed the Chancellor in a position where he was fighting a losing battle. The Conservative Governments of the eighties significantly reformed the system by instituting what Lawson describes as the “envelope” system. In this arrangement the Chancellor and the Prime Minister become the key players. A spending envelope is proposed which line departments are compelled to adhere except for exceptional reasons. Exceptional reasons for breaches of the envelope fell to be resolved by the so-called *Star Chamber*. Generally the *Star Chamber* system worked well. According to Lawson it was most successful when it was chaired by a strong personality like Willie

[3] von Hagen and Harden (1994) place Ireland among the most decentralised of control systems.
[4] Given the balance of political parties within the Government von Hagen’s and Harden’s (1994) finding that single-party Government's are more likely to achieve control provides some grounds for hope!.

Whitelaw. More generally von Hagen and Harden suggest that the key to the successful operation of such a Cabinet sub-committee is that its members must not have a vested interest in the expenditure outcomes. Ideally they should be powerful ministers without portfolio. A well-functioning *Chamber* would rarely have to meet. Its mere existence should act as a credible threat to errant ministers.

Clearly such a system is not perfect. A crude “envelope” system of itself cannot promote greater economic efficiency or effectiveness in public expenditure programmes. Its most obvious shortcoming is its adoption of the previous year’s outcome as the base for the current year’s spending. Another important shortcoming is that it imposes a uniform ceiling on spending growth across all departments and ignores pertinent differences (such as different rates of cost inflation, changing policy priorities that have implications for departmental shares in the total, or legitimate demands caused by once-off exigencies). We address these issues below. Moreover its value as a control mechanism depends very much on the degree of authority which is centred in the finance ministry buttressed perhaps by a strongly independent *Star Chamber*-type committee.

Our system of determining supply services spending can be characterised as the “brick by brick” system. The previous Government grafted an overall-spending limit onto this system. Our view is that the “brick by brick” system is fundamentally at odds with the “envelope” approach and the two systems cannot meaningfully coexist. Recognition of this point was not apparent over the last two years.

Once the 2% limit was adopted by the last Government it seems to us it should have led to two significant changes in the procedures governing the generation of the spending estimates.

First, the traditional “brick by brick” system should have largely fallen into abeyance. In its place each department ought to have been obliged to prepare their estimates strictly within the envelope. A simple way of focusing departments might be to only permit them to prepare their estimates in terms of an overall share of spending (Milesi-

Feretti (1997)). Departures from the envelope would be countenanced only in exceptional circumstances.

Care has to be employed in devising the “envelope” quantum. The medium-term macroeconomic framework will assist the political determination of the tradeoff between spending, tax “givebacks” and reductions in debt. It would clearly not be sensible to apply the determined spending cap (say x%) from this exercise to each government department. For one, a prudent allowance should be made for precautionary expenditures that could arise in the year ahead. Secondly, differential-spending requirements may arise across departments for a number of reasons, for example, predictable divergences in price deflators. Moreover it would be absurd to permit a department’s expenditure to rise in line with the overall cap when, in the absence of the cap, spending growth might in fact be lower!

A feasible means of coping with these considerations would be as follows. A fraction (say y%) of the overall-spending cap should be first set aside for precautionary expenditures. A fraction (say z%) of the remainder (x%-y%) would become the envelope for individual departments. The residual (x%-y%-z%) would then become available for exceptional spending requirements arising in individual departments. No individual department should of course have a prior claim on this residual.
Second, we believe that a *Star Chamber*-type arrangement would seem to be a necessary supporting element of the “envelope” system. It would exist in the first instance to resolve the hopefully small set of issues that could not be resolved within the “envelope” arrangement in bilaterals between the departments and Finance. Its main task, however, would be to decide on the allocation of the spending residual.

During the Rainbow's term of office neither of these two crucial steps were implemented, although a number of innovative budgetary procedures were put in place[5]. Clearly the 2% limit existed as an external lever to be used by Finance every

[5] Among these was the move to an autumn budget hence the transparent unification of the spending and tax sides of the Budget process and the inauguration of multi-annual budgeting (MAB). Mention should also be mentioned of the Tax Strategy Group (TSG) which was an inter-departmental committee of civil advisers and civil servants charged with the task of advising on budgetary strategy.

now and again in an attempt to focus ministers on the need for restraint. But it did not systematically inform the estimates' process. Of far greater significance, as an external lever, was the need to adhere to the Maastricht criteria and the medium-term strictures likely to be imposed by the *Stability Pact* and the scaling back of *Structural Funds*.

Nor was there any structure such as the *Star Chamber* put in place. There did of course exist a Cabinet Budget sub-committee chaired by the Taoiseach[6]. However, it resembled the *Star Chamber* neither in terms of its composition or remit, perhaps because of the nature of the three-party government. It was composed of line ministers with big spending budgets. Its focus was also diffuse. Unlike how the *Star Chamber* appeared to function, the sub-Committee deliberated on the general progress of the budget process and addressed issues as they arose. It did not have the direct remit to essentially tidy up the loose ends from the Finance bilaterals.

In effect the Cabinet on the recommendation of the Minister of Finance fashions the shape of the Budget parameters. As von Hagen and Harden sagely observe one cannot expect effective spending control to emerge from such a system. The process of determining consensus is biased towards more spending rather than less because of the operation of reciprocity in the spending positions of most ministers. Put in other words, a series of "you scratch my back and I'll scratch yours" horse trades is unlikely to favour a modest outcome in the overall spending aggregate. Arguably, this sort of horse-trading is more likely to prevail in a coalition government than a single-party administration. Given that coalitions are likely to be the rule rather than the exception in years to come, this is all the more reason to carry out some radical process re-engineering.

These thoughts lead us to our second recommendation:

Those of us involved in this Committee can testify to its usefulness in airing broader tax policy issues and in confronting the political tradeoffs with perhaps more considered deliberation than might have been the case in the past. It also helped the proceedings that the TSG's deliberations were in the context of buoyant growth and revenues.

[6] We have written this in the past tense because we don't know whether the Committee is still in existence.

an expenditure target implies the need to abandon the traditional "brick by brick" approach to the estimates' process and its replacement by the "envelope" system. A Star Chamber type sub-committee of the Cabinet would appear to be a necessary integral part of such a control process.

Value for money (VFM) assessment of public expenditure

Even if an “envelope” system were to be instituted along the lines we've outlined it does not of itself deal with the fundamental issue of the economic efficiency and effectiveness of public spending. As noted above, one obvious shortcoming is that it adopts the previous year as the base for the current year's spending. Most economists would favour a zero-based approach to determining the spending outcome in any given year. A first objection to such a proposal might be that it doesn’t take account of predetermined expenditures. No item of spending should be automatically accepted as being predetermined. This also applies to demand-led programmes since the issue of cost-minimising delivery and fraud minimisation ought to be a constant aspect of the review of such programmes[7]. A second objection to zero-based budgeting is that it would be impractical to institute such a system for every expenditure programme every year. This is a valid criticism but what might work is a requirement that, for instance, each major programme be reviewed on a zero-based approach every five years.

The Department of Finance may respond to this suggestion and say that this is already being implemented in the context of the *Strategic Management Initiative (SMI)*. Our counter is that while this may well be and it's early days to adjudicate on its impact, the system being put in pace lacks the fundamental requirement of transparency which appears to us to be a prerequisite for any evaluation system which stands a chance of being effective. Moreover it’s not clear to us whether Finance's zero-based approach is to become an integral arm of the annual estimates’ process.

[7] Witness the actual savings yielded by the review procedures put in place in the wake of last year's comparative analysis of the Live Register and Labour Force Surveys.

Transparency in what passes for VFM evaluation is necessary in order to appraise the quality of evaluation and more importantly to generate parliamentary debate on the explicit and implicit choices involved in public expenditure allocations. If such evaluations are seen to be no more than a new fad management technique, they will fail to infuse a culture of evaluation into our political system. The procedures and principles of evaluation need to be publicly known and debated and above all, the outcomes should be published and subject to public scrutiny.

There is, ironically, a ready-made evaluation system in place within the public service that could be readily adapted to all public spending programmes. We are referring of course to the evaluation system in place for the *Structural Funds*. This system has a number of elements. First, all Structural Fund expenditure is classified on a programme basis that facilitates evaluation. While the programme classifications do not always permit a ready economic evaluation, as the ESRI's recent study demonstrates (see Honohan *et al*,1997), it's a good starting point. (In this regard there is surely a strong case for resurrecting *A Better Way To Plan The Nation's Finances.)* Second, each programme has an associated set of quantifiable objectives, input, output and impact indicators which in principle facilitate effective monitoring. Third, a more thorough evaluation system is in place which allows for full-scale mid-term and end-term reviews of each programme and the entire CSF (see Honohan *et al*, 1997). Most of these reviews are conducted by consultants that are external to the public service. In addition a number of evaluation units have been created within the civil service. There is a central CSF Unit in the Department of Finance with a complement of three evaluators. Within Enterprise and Employment there are two evaluation units: the ESF Unit and the Industry Unit. The ESF Unit has a staff of 8 evaluators and the Industry Unit has four evaluators. The Department of Agriculture has recently set up its own CSF unit with a staff of three. In addition to these units, a number of external evaluators are retained on a daily contract basis in Transport, Industry, Local Development, Fisheries and Economic Infrastructure Programmes.

While the system is as yet relatively untried it nonetheless appears to us capable of acting as a VFM template for the totality of public expenditure. As of yet, however, it would appear that the Department of Finance views the system as only being relevant to the *Structural Funds*. The system may be viewed as a necessary hurdle to be surmounted in order to secure EU funding. Finance presumably would argue that it is constantly engaged in VFM evaluation and there is no need to institute a new institutional structure. The crucial difference, however, with the CSF evaluation system is its relative transparency. The basis of evaluation is fairly explicit and in many cases the evaluations are published and hence available for public scrutiny.

In effect we now have a dual approach to the evaluation of public-spending programmes. We have the fairly transparent CSF system and the much less transparent non-CSF system. This appears at the very least to be somewhat lopsided. Some indication of the lopsided nature of our approach to VFM evaluation can be got from examining the importance of EU receipts relative to total government expenditure as in Table 2. These data highlight the ironic situation that, whereas EU receipts account for 8% of total voted capital and non-capital spending and are thereby subject to a highly transparent and, on the face of it, serious and thorough regular evaluation, the greater bulk of public expenditure escapes a similar scrutiny. About 60% of the Agriculture vote; around 70% of the Education, Environment and Tourism votes and nearly 80% of the Enterprise and Employment vote escape equally transparent evaluation. Noting that the entire Social Welfare and Health votes evade similar appraisal perhaps better makes the point.

Another indication of our schizophrenic approach to public expenditure evaluation is to examine the actual number of *Community Support Framework (CSF)* evaluations that have been carried out to date (Table 2). There has been an impressive output of evaluations especially for Industry, Tourism, Transport and Human Resources. Yet this output begs the question as to why similar evaluations are not available for non-CSF spending?

While there is much to commend in the *Structural Fund* evaluation system, there are still some initiatives that could be undertaken to improve both the quality and transparency of the evaluation process[8]. It is disappointing that many of the analyses are not published and subject to academic scrutiny. The recent ESRI study draws

Table 2

EU Receipts Relative to Voted capital and Non-Capital Expenditure and CSF Evaluation Output

Vote Category	Total Vote Expenditure as % of Overall Expenditure 1997-95	EU Receipts as % of Total Vote Expenditure 1997-95	Number of CSF Evaluation Reports 1993 To date
Trans. Energy & Comm.	1	3	28[a]
Environment	8	28	4
Education	18	27	32[b]
Agr., Food & Forestry	6	39	12
Enterprise and Employment	5	22	33[c]
Tourism and Trade	1	32	15
Total	100	8	7[d]

a includes economic infrastructure.
b all human resources (some of these reports could be attached to the E&E vote).
c includes local development (the latter category is not included in the expenditure figure).
d refers to overall CSF evaluations.

attention to deficiencies in some of the CSF-related Cost-Benefit studies which have been undertaken and there is a strong undercurrent in their Report that many of the individual evaluations of the Operational Programmes were less than satisfactory from a methodological point of view.

Apart from the reasonable appeal that all publicly-funded evaluations should be published there is also a compelling case for an audit of evaluations by some competent body. This would provide a check on the possibility of "departmental capture" of individual programme evaluations. Afterall an external consultant is being paid by the

[8] The CSF Evaluation Unit within the Department of Finance is preparing a directory of evaluations carried out under the *Structural Funds.*

department commissioning the evaluation and no doubt will be anxious to secure additional commissions. The temptation for consultants to be less than frank in their criticism of programmes is all too possible. Secondly, the existence of a random audit on a periodic basis should provide a mechanism for introducing quality control at a methodological level.

The agency which would appear in the best position to execute such VFM audits would appear to be the *Comptroller and Auditor General (C&AG)*. This office has in recent years acquired the remit for VFM assessment and has also enhanced its staff resources to carry out this function. It has also carried out and published a small number of evaluations of evaluations.

This leads to our recommendation that:

the Structural Fund evaluation system should be extended to all public expenditure programmes and supplemented with a VFM auditing role of these evaluations by the C&AG.

Control incentives and disincentives

The recommendations set out above are designed over a period of time to institute a system which is more likely to counteract the tendencies towards fiscal illusion which exist in our current arrangements for the management of public expenditure. However, we believe that simple rules can also play a useful role in combating fiscal illusion. For instance, suppose it were ordained that no spending proposal (including tax expenditures), and certainly no proposal for new spending, were not to be entertained by the Minister for Finance unless associated with it were detailed proposals as to how the resources to pay for the additional spending were to be secured. These costs should be identified on a full-year basis together with their intertemporal profile following the MAB procedure. The necessary resources, whether they involve cuts in measures within the sponsoring department's remit or in other departments or additional taxation or borrowing, should receive equal due consideration in appraising the new spending proposals. There is no reason why such a requirement should not also extend to the representations of lobbies.

We have argued above so far for a systematic approach to VFM evaluation of public expenditure programmes. But given that the pay and pensions' bill accounts for over 50% of total current expenditure, a system of expenditure control, which left pay out of the reckoning, would be severely deficient. There has to be some mechanism that ensures productivity and real cost savings in the delivery of public services. The SMI sets itself the admirable goal of delivering such quality improvement but we would suggest a more radical surgery is needed.

The opportunity to effect real productivity improvements in pay seems to be only presented to Government in the context of the national pay agreements. But even in this context the scope for delivering real savings looks to be quite limited. In the negotiation of *Partnership 2000* it would appear that the focus really wasn't on the bill itself, except only indirectly through the negotiation of public-sector pay rates. The productivity clause is modest with a potential 2% saving over 39 months. And while the agreement indicates that payment of the productivity bonus must follow verifiable productivity improvements, past experience would lead one to be sceptical about this prospect being realised.

Our view is that there is no good reason why the State sector should not on an annual basis yield a productivity improvement equal to the economy-wide norm. Suppose such a stricture were factored into the estimates, by for example adjusting the expenditure base each year by say a productivity factor of at least 1%-2%, would this not be a mechanism for effecting savings?

We would go further and suggest that decentralised pay and non-pay departmental budgets would be a powerful mechanism for delivering productivity improvements. In addition the department Secretary General would have hiring and firing privileges.

These suggestions are put forward as stick mechanisms and they should be balanced by incentives. One obvious incentive mechanism might to permit departments to earmark a fraction of their productivity and other savings, from for instance the abandonment or scaling back of existing programmes, for the introduction of new programmes or the extension of existing ones. For instance, departments could be permitted to earmark 50%+ of savings for this purpose. All such additional spending proposals would of course be subject to the rigorous VFM assessment that we advocate.

It has to be of course recognised that it is easy to suggest methodologies for promoting productivity improvement when one doesn't have to implement them in an industrial relations environment. This consideration notwithstanding, we put forward our next recommendation:

agencies providing public expenditure programmes should be required to yield productivity improvements of 1%-2% per annum and departments would be permitted to retain 70% of programme savings for new spending initiatives which satisfied adequate VFM appraisal.

A Legislative Foundation

Many of our recommendations, designed to enhance the prospects for reining-in spending growth, could be viewed as essentially of a procedural nature and thus could be seen as necessary components of a public expenditure management information system. If this is all that would be necessary to address the problem of fiscal illusion, the issue would not so interesting to political economists. What we believe is required is an institutional change that will alter the entire culture of public expenditure deliberations. In particular, we champion a system which confronts the tendency for fiscal illusion head on and which promotes VFM and effectiveness' appraisals of public expenditure on a routine basis.

The SMI has the potential to transform the provision of public services but without an engagement of the political actors (including the lobbies) in the process of expenditure control expenditure, successful control is likely to remain an elusive goal. This is why we believe the recommendations we set out should form the spine of a legislative reform initiative. Legislation governing the procedures for the preparation of budgets has the potential to force the political system to confront the real constraints that are involved in expenditure choices. In addition to the procedures set out above we would obviously place a great store on the importance of transparency at every stage of the process. Transparency implies much greater facility for parliamentary debate at designated stages during the process as well as publication of evaluations reports etc.

Our thinking regarding the type of legislation needed is very much influenced by New Zealand's *Fiscal Responsibility Act, 1994* (New Zealand Treasury, 1997). It's worth quoting the NZ treasury on the objectives of the Act because it conforms so closely to our own thinking. According to the Treasury:

"The Act sets outs to do five things:

- increase the transparency of policy intentions and the economic and fiscal consequences of policy;
- bring a long-term (as well as an annual) focus to budgeting;
- disclose the aggregate impact of a Budget in advance of the detailed budget allocation allocations;
- ensure independent assessment and reporting of fiscal policy; and
- facilitate parliamentary and public scrutiny of economic and fiscal information and plans."

The legislation is as far from the balanced-budget-type amendment championed by some US legislators (see Electronic Policy Network) as you could get. It doesn't set out rigid deficit, spending or tax parameters which governments must adhere to but instead sets out a series of principles that should inform the formulation and execution of fiscal policy. The Act lays especial stress on promoting a strategic approach to policy development that gives due emphasis to the long-term economic and financial consequences of current fiscal policy decisions. Stringent reporting of key steps in the budget cycle is also stipulated in the legislation with the explicit objective of ensuring that "… the Government of the day has to be transparent about both its intentions and the short- and long-term impact of its spending and taxation decisions".

A most interesting feature of the Act is the requirement on Government to produce a series of publications in relation to its conduct of fiscal policy throughout the Budget cycle[9]. Of particular note is the obligation to produce a *Budget Policy Statement* a couple of months before the Budget. According to the Treasury the thinking behind this requirement is to:

"… separate[s] debate on the overall fiscal strategy from questions of detailed budget allocations … This ensures some debate on the aggregate impact of the proposed Budget and helps make the trade-offs between debt, taxes and expenses more explicit."

At the time of the Budget the Government is required to publish a *Fiscal Strategy Statement* which is designed to ensure consistency between actual Budget decisions and the intentions set out in the earlier *Budget Policy Statement*. Any departures from this *Statement* are required to be explained by Government. There is also an obligation to produce the equivalent of our own MABs, except that the future time horizon is mandated to be for a period of at least 10 years.

Regular *Economic and Fiscal Updates* are also to be produced throughout the year. In addition an innovation, which we could surely with benefit adopt here, is the mandatory publication of a pre-election economic and fiscal update for a three-year time horizon between 42 and 14 days before the date of a general election.

The legislation also enshrines the principle that the relative responsibilities of the Minister of Finance and the Secretary to the Treasury be explicitly acknowledged so that there can be no ambiguity as to where accountability resides.

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[9] Other requirements in the Act include the stipulation that Government accounts must be presented on both a cash and accruals basis.

The final element of the legislation which merits noting is the requirement that every report mentioned under the Act must be laid before a parliamentary committee. The Committee may call the Minister of Finance to defend any of his reports and it may also call expert witness and seek expert opinion.

Our final recommendation therefore is that:

legislation along the lines of the New Zealand Fiscal Responsibility Act should be enacted to underpin control of public expenditure to ensure conformity with financial sustainability, effectiveness and efficiency.

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