OECD Journal on Budgeting

GOVERNANCE

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Volume 1, No. 1

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OECD JOURNAL ON BUDGETING

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Publié en français sous le titre :
REVUE DE L'OCDE SUR LA GESTION BUDGÉTAIRE
Volume 1 – N° 1

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Foreword

T*he* OECD J*ournal on* B*udgeting* is a new and unique resource for policy-makers, officials and researchers in public sector budgeting. Drawing on the best of the recent work of the OECD Working Party of Senior Budget Officials, as well as special contributions from finance ministries of Member countries and others, the Journal provides insights on leading-edge institutional arrangements, systems and instruments for the effective and efficient allocation and management of resources in the public sector.

We regret that we are unable to take unsolicited contributions to the Journal. We are, however, anxious to receive feedback from our readers. Your views on how to improve the Journal are welcome and can be sent to: The Editors, T*he* OECD J*ournal on* B*udgeting*, OECD, 2 rue André-Pascal, 75775 Paris Cedex 16, France. Fax: (33 1) 45 24 17 06; e-mail: pum.contact@oecd.org.

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Introduction

By
Geert van Maanen*
Chairman, OECD Working Party of Senior Budget Officials

It is my great pleasure to launch the inaugural edition of the OECD *Journal on Budgeting*.

T*he* OECD J*ournal on* B*udgeting* is a new and unique resource for policy-makers, officials and researchers in public sector budgeting. Drawing on the best of the recent work of the OECD Working Party of Senior Budget Officials, as well as special contributions from finance ministries of Member countries and others, the J*ournal* provides insight on leading-edge institutional arrangements, systems and instruments for the effective and efficient allocation and management of resources in the public sector.

The Journal will be published four times per year and will be the flagship vehicle for disseminating the work of the OECD Working Party of Senior Budget Officials.

This Working Party brings together budget directors and other senior officials from finance ministries of the 30 Member countries of the OECD, as well as representatives of a number of non-member countries and other international organisations. The Working Party is a forum for the highest level officials to discuss major budgetary issues with their colleagues on the basis of specialised reports prepared ahead of each meeting.

The high-quality and innovative work carried out by the Working Party has been of immense value in modernising budgetary practices in Member countries. The Journal is designed to make this work available to a wider community in an accessible format.

I am confident that the Journal will become a standard reference work in this field.

* Geert van Maanen is Secretary-General, Ministry of Finance, the Netherlands.

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The Changing Role of the Central Budget Office

By
Allen Schick*

1. Introduction

The traditional role of the central budget office is incompatible with the management reforms enfolding in various OECD Member countries. These reforms are grounded on the principle that managers must be permitted to run their operations without undue outside interference. The logic of reform is that only when managers are free to use money and other organisational resources within agreed budgets can they be responsible for the organisation's successes or failures. In countries where a culture of reform has taken hold, there is consensus that halfway measures do not suffice, that managers either are free to act or are not. It is not a matter of relaxing one or another restriction, but of reshaping the operations of public institutions and the behaviour of those who work in them. The budget process is one of the main arenas in which the machinery of government is undergoing fundamental transformation.

The traditional role of the budget office has been to function as a central command and control post, specifying the items of expenditure, monitoring compliance with regulations, ensuring that the inputs are those agreed in the budget, and intervening as deemed appropriate. This role cannot coexist with the discretion accorded managers in the new public administration. Either managers decide on the items of expenditure (personnel costs, supplies, rental fees, and so on) or others do it for them. If the latter, managers do not have genuine freedom to operate according to their best judgement.

Defining a new role for the central budget office that is compatible with contemporary managerial concepts is a difficult task, for it entails balancing the critical need of the government for financial discipline against the need of managers for freedom to act. Simple divestiture of control is not a viable option, for doing so would destroy the discipline on which all budgeting rests. This paper explores the

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role and behaviour of the central budget office in a devolved environment that shifts decision making authority with respect to the particulars of public expenditure from central institutions to line agencies, and from headquarters in these agencies to subordinate units and field offices. It discusses the changes that three basic roles of the budget office – controlling the totals, establishing priorities, and seeking efficiency – might be conducted in the new environment of devolved management.

Not all OECD Member countries have embraced a culture of reform. By "culture of reform" we have in mind innovations that uproot established practices of public administration and radiate through the public sector. Where this culture thrives, reform is comprehensive rather than piecemeal, at the core of government rather than at the periphery, institutionalised rather than pilot tested. This culture does not pertain only to budgeting, but to other managerial actions as well. In countries animated by a culture of reform, managerial discretion is not an alternative form of public administration; it is the way the government operates. The countries in the vanguard of this movement include Australia, New Zealand, Sweden, and the United Kingdom.

What about the many OECD Member countries that have not reformed public management or have taken only halting steps in this direction? Is the managerial revolution of such limited scope that it should interest only those countries that have already introduced major reforms or are contemplating doing so? I think not. Most OECD Member countries are affected by the conditions that have impelled the transformation of public institutions.

Regardless of their posture on managerial reform, central budget offices cannot ignore the powerful tensions stressing contemporary government: pressure to curtail or eliminate chronic deficits, but not by raising taxes or taking away benefits that citizens have come to expect; consensus that the era of expanding government is over, but demographic trends that harbinger major spending increases in the decades ahead; demands for devolution and decentralisation, coupled with the spreading internationalisation of economic policy; a loss of confidence in the capacity of democratic governments to perform what is expected of them, but pressure to entrust government with even more responsibility for the public welfare; a rising portion of the budget allocated by statutory formula amid efforts by governments to achieve greater flexibility in allocating resources.

Governments facing these tensions cannot effectively control the budget by operating the detailed controls that served them so well in the past. Trying to do so may weaken their control of the totals, hobble efforts to reprioritise the budget, and degrade the efficiency of public expenditure. This is the paradox of contemporary budgeting: central control of the items of expenditure may not give the centre effective control of the budget.

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Contemporary pressures on public finance have weakened the efficacy of two of the traditional tools used by the central budget office to control expenditures: *ex ante* specification of the items of expenditure and allocation of the increment. In the past, itemised budgeting protected the totals, while decisions on the increments secured the government's priorities. Itemised control has been attenuated by the growth in total spending, especially in entitlements, incremental priority-setting by the inadequacy of increments to finance the built-in growth in expenditures. Controlling the items of expenditure no longer secures control of the totals because *a*) the totals are so large and the individual items are so small; and *b*) most spending is for entitlements that are not subject to itemised control. All *ex ante* control accomplishes is to take away from managers their discretion over running costs. In fact, over the years, most OECD Member countries have relaxed *ex ante* controls by consolidating the line items into broader frames, increasing the threshold for expenditures that agencies may make without prior approval, and giving managers more flexibility in implementing the budget.

The inadequacy of spending increments also has eroded central budget control. During much of the post-war era, central budget offices influenced government priorities by concentrating on the increment – the additional amounts to be spent in the next or subsequent budgets. Although the increment may have been small relative to the totals, it was the portion that politicians and spending agencies cared about the most. By allocating the increment, the budget office determined which programmes would grow and which initiatives would be undertaken. But incremental budgeting requires increments to allocate. Whether because of weaker economic growth, the built-in rise in entitlement spending, or the reluctance of politicians to raise taxes, spending increments are not presently available in some countries and are not as robust as they once were in others.

If its old role no longer suffices, a budget office has to reconsider what it does and how it fits into the machinery of government. In the course of examining itself, the budget office may have to assess the efficacy of the controls it operates. What levers does it pull to assure compliance with government policy? How does it assure that the bits and pieces of public expenditure do not add up to more than the government wants to spend? How does it make room in constrained budgets for new priorities? How does its voice for fiscal discipline get heard above the din of multiple, often conflicting, demands on government? The countries that have embraced reform have been compelled to address these questions; others are likely to follow suit.

In countries that have decided to transform public administration, the incompatibility of central control of operations and managerial freedom has forced the budget office to revamp its operations. In the typical case, the budget office has divested most (or all) *ex ante* control of running costs and now leads the effort for management improvement. It has a major role in devising new institutional

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arrangements, integrating budgeting with other management processes, prodding departments and other public entities to measure performance and evaluate results, developing new guidelines and methods for holding managers accountable, and installing new information and reporting systems. As they have withdrawn from the old roles, reformed budget offices have been busy with the new ones.

The full extent of this behavioural revolution often is not recognised by the newly freed managers. Despite the transformation, one still encounters the view that control is as centralised and the budget office is as interventionist as before. Managers in spending departments frequently complain that the budget office substitutes its judgement for theirs and is unwilling to entrust them with full discretion to manage their own operations. These perceptions are reinforced by instances in which spending agencies are constrained or overruled by the budget office on particular issues. For example, when the budget office imposes across-the-board cuts on running costs (as has happened in Australia, New Zealand, and Sweden) managers take that action as evidence that nothing has changed and that the budget office's grip is as tight as ever. There appears to be a naive view among some line managers that reform means *carte blanche* to spend as they want, as if they were not part of a larger government. Evidently, some managers do not understand that devolution of operations must be accompanied by centralisation of policy making. Reform cannot mean that spending agencies get their way regardless of the budgetary consequences of their actions. If it did, budget offices would soon reimpose the old controls.

In withdrawing from operational control and focusing on strategic policy issues, some central budget offices have gone through an institutional identity crisis. They know what they are no longer to do, but are much less certain as to what they should do. Adjustment has been especially difficult for budget offices embedded in large, powerful finance ministries; in these cases, restructuring the budget function cannot be divorced from consideration of the ministry's overall role. In the United Kingdom, for example, Treasury control has been a bulwark of government for generations. Some of the initiatives impacting on its operations were launched outside Treasury. Once the reforms were implemented, Treasury conducted a fundamental review of its operations and reorganised its budget (and other) work. Other countries, however, have refocused the budget office as part of the process of giving managers operational discretion.

It was noted above that some reformed budget offices have become the central outposts for managerial innovation, to the extent that this is now seen as one of the organisation's most salient roles. In my view, this may be a transitional phenomenon. During the early reform period, there is need for central guidance and for a clearing-house on new ideas and practices. The budget office can advance the cause of reform by producing handbooks and other materials that explain the new processes and advise managers on best (or improved) practices. It also can busy itself

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revising budgetary forms and procedures and evaluating the progress of reform. The transitional period is likely to be quite extended, for every country that has made the effort has found it necessary to adjust the reforms on the basis of early experience. The Australian, Swedish and UK reforms have stretched well over a decade.

Once the reform processes stabilise, efforts to direct managerial improvement from the centre will coexist uneasily with the commitment to managerial discretion. There is a limit to how much the budget office can do in prodding agencies to upgrade their operations, and there is substantial risk that if it pushes too hard, managerial initiative will dry up and a compliance mentality will return. In the long run, managerial innovation must be entrusted to the managers, not to central policy makers.

There is another reason why managerial reform is not likely to be a permanent niche. Managerial leadership is an inadequate basis for budgetary power. What has made the central budget office the powerhouse of government is not that it advises agencies on good practices, but that it allocates resources.

Managerial advice can be ignored; budget decisions cannot. Budget offices often leverage their power over resources to induce agencies to change management practices. But a budget office whose budgetary role is enfeebled will be weak in other matters as well. After reform, no less than before, the core role of the budget office must revolve around the allocation of resources and the routines of preparing and reviewing budgets.

Although budgeting must be the core budget office responsibility, this work may be conducted differently in the future than it was in the past. The basic routines of requesting and making appropriations continue, though they may require somewhat different skills, techniques, and information than once were common in budgeting. For example, reformed budget offices are likely to spend less time on implementing the budget than once was the case, but more time monitoring what agencies accomplish with available funds. This change follows from the principle that managers should have broad latitude in spending appropriated funds, but should be closely held to performance objectives.

All budget systems – reformed and traditional – have three basic budget tasks: to maintain aggregate fiscal discipline, to allocate resources in accord with government priorities, and to promote the efficient delivery of services. Fiscal discipline pertains to effective control of the budget totals. An effective budget system is one that has disciplined (in contrast to accommodating) totals. Allocative efficiency is the capacity to establish priorities within the budget, including the capacity to shift resources from old priorities to new ones, or from less to more productive uses, in correspondence with the government's objectives. Operational efficiency is the capacity to progressively reduce the cost of producing the goods and services for which resources are provided. Although the terminology may

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be unfamiliar, every central budget office is involved with maintaining aggregate fiscal discipline, striving for allocative efficiency, and promoting technical efficiency. How they go about these tasks distinguishes traditional and reformed budget offices.

Budgetary capacity can be assessed in terms of performance on each of the three dimensions. Strong fiscal discipline means that the totals do not merely rise to meet demands. Aggregate fiscal discipline refers not only to the decisions taken in formulating the budget, but also to pressures that arise during the year when the budget is being implemented. Allocative efficiency means not only that the government channels incremental resources to new priorities, but that it has the will and the procedures to transfer funds from lower to higher valued uses. Operational efficiency implies that the budget impels agencies to raise productivity and thereby reduce the cost of goods and services purchased by government.

These essential functions of budgeting are examined in the sections that follow in terms of the role of the central budget office, sanctions and incentives, and informational requirements. In the course of discussing each of these functions, I will explain how a reformed budget system differs from a traditional process.

2. Aggregate Fiscal Discipline

Control of the totals is the first purpose of every budget system. There would be no need for budgeting if the totals were permitted to float upward to satisfy all demands. Spenders would spend what they wanted without central review or constraint. But if aggregate control is fundamental to budgeting, the form it has taken has changed over the years, and along with it the role of the budget office. In most OECD Member countries each budget development was guided by a balanced budget norm. The operative rule was that in any fiscal period spending should not exceed current revenue. Countries differed in their application of this rule; some applied it only to current expenditures, others to capital investments as well. Some included funds carried over from previous periods in calculating current revenue, others did not. Inasmuch as this was a time of relatively limited government, the burden for assuring balance generally fell on expenditures. Balance was enforced through strict constraints on spending, the logic that if the parts of the budget were effectively controlled, so, too, would the total.

Strict budgetary balance was superseded after World War II by a more flexible rule that allowed the totals to accommodate cyclical changes in economic conditions and secular changes in budgetary demand. The impact of the new norm on aggregate fiscal discipline was remarkable. Government outlays in OECD Member countries averaged 28% of GDP in 1960 and about 40% two decades later, a growth rate in excess of 0.5% a year. These spending trends indicate laxity in fiscal discipline that was justified in terms of the economic and social gains achieved through

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higher government expenditures. The weakening of fiscal discipline also was reflected in the rise of budget deficits, especially after the first oil shock in 1974.

The persistence of high deficits and political resistance to tax increases induced many OECD Member countries to reassert fiscal discipline by stabilising the share of public expenditure in GDP. Some countries moved in this direction in the late 1970s, others in the 1980s; most introduced global fiscal norms that targeted medium-term reductions in deficits, spending, or taxes. In most cases, these norms were political statements of intent that were loosely related to the budget and lacked strong enforcement mechanisms. As a result, many of the norms were ineffective. Even countries which achieved temporary success in disciplining the totals when the economy was robust were compelled to relax aggregate fiscal discipline when the economy weakened. According to a report by the US General Accounting Office, four countries (Australia, Germany, Japan, and Mexico) that had extraordinary success in restoring fiscal balance during the 1980s experienced a new bout of surging deficits during the early 1990s, demonstrating that although "significant structural improvement in fiscal policy is possible in modern democracies... such progress is difficult to sustain".

This difficulty has led some countries to experiment with new forms of fiscal control that lessen cyclical gyrations and make it easier to restore fiscal discipline when the economy recovers. The main difference between this and the earlier stage is that countries are linking the aggregate controls more closely to the process of budgeting. This does not ensure, however, that they will be any more successful than in the past in avoiding cyclical shocks to the budget.

The central budget office cannot impose or enforce a fiscal norm by fiat; a fiscal rule that truly constrains government spending or the deficit must be accepted by the government and strong enforcement mechanisms must be in place. But the budget office does have the lead role in maintaining aggregate discipline, and it must be strong enough to withstand pressures to evade the norm by removing some transactions from the budget and to override the rule when politicians or sectoral interests regard it as too constrictive. Several comparative studies of democratic regimes have found that success in maintaining fiscal discipline depends on the strength of the Finance Ministry and cohesion of the government. In most OECD Member countries, the position of the budget office is enhanced when it is housed in a large Finance Ministry that has broad governmental powers. But even when this occurs, economic or political circumstances may weaken the ministry's resolve to maintain fiscal discipline. Germany and Japan, for example, have powerful, encompassing Finance Ministries. The German Finance Minister may be overruled by Cabinet only when the chancellor sides against him; Japan's Finance Ministry has had extensive regulatory powers extending to banking, securities, and other sectors, in addition to a powerful role in revenue and spending policy. But even in these countries, fiscal discipline was undermined: in Germany,

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by spending pressures following unification; in Japan, by the deepest recession since World War II.

Various studies have shown a strong correlation between the stability and cohesiveness of the government and the size of the deficit and the debt to GDP ratio. The key finding is that the more fragmented the government, the less able it is to assemble a majority in support of the tough measures required to maintain fiscal discipline. The most cohesive governments are majoritarian systems in which a single party constitutes the government (in the case of parliamentary regimes) or controls both the executive and legislative branches (in the case of presidential regimes); the weakest are those in which the governing party or coalition lacks a majority in parliament. In general, the more parties comprising the coalition, the less capacitated the government will be to establish and enforce fiscal rules. Fiscal discipline may be problematic when (as often happens in coalition governments) one party controls the Finance Ministry and another controls the social welfare portfolio.

The changed composition of public expenditure – much more spent on entitlements and relatively less on consumption and investment – has affected the manner in which the budget office maintains fiscal discipline. In the past, the budget office reviewed the items of expenditure and recommended the amount that should be made available for each. It also policed implementation of the budget to ensure that money was spent only for approved items and that the amounts spent did not exceed authorised levels. It took the position that total spending could not be controlled unless the individual items were. Contemporary fiscal control is moving in the opposite direction, however. In some countries, the budget office has disengaged from the items of expenditure and has taken the position that it can control total spending only by constraining the sub-aggregates, such as the total running costs allowed each department or the total programme spending resources allocated to each portfolio. It is willing to concede discretion over the items of expenditure to spending agencies in exchange for firm agreement as to the amounts they will have. For example, as a *quid pro quo* for gaining flexibility with respect to running costs, agencies must operate within firm limits. Often, as will be explained in the section below on operational efficiency, these limits are tightly constrained by across-the-board cuts and other rules that impel agencies to make choices among spending items.

Several versions of these limits have been tried in OECD Member countries. Since the 1991 fiscal year, the United States has imposed a statutory limit on total discretionary appropriations, along with procedures for allocating this total among the various parts of the budget. It has not, however, made much progress in divesting *ex ante* control of spending items. Australia, New Zealand, and the United Kingdom limit running costs and give managers considerable discretion in operating within these limits. Sweden curtailed central surveillance of spending items while imposing steep across-the-board cuts on operating expenditures.

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In a few countries, there has been a parallel development with respect to programme expenditure. Australia has given ministers considerable leeway in reallocating resources within portfolios, though it also assigns a major role to the budget office in operating the portfolio budgeting system. But it is much more difficult to apply the new form of budget control – central withdrawal from the items, but tougher constraints on the subtotals – to entitlements. These typically are open-ended; spending is driven by exogenous factors such as demographic trends and changes in economic or social conditions rather than by explicit budget choices. Budget decisions may play an important role when an entitlement is established, as well as when marginal adjustments are made in an existing programme, but most year-to-year change in entitlement spending is automatic. The budget records the amount sent, it does not decide the amount. Not only are entitlements open-ended, but spending on them is likely to deviate from budget projections during periods of economic weakness, when other changes (such as a fall in revenues) may unbalance the budget. The problem, many governments have learned, is that fiscal balance is not easily or quickly restored when the economy recovers. The structural impact on the budget lingers for as many as five to ten years after a bout of economic weakness.

Establishing fiscal discipline in the entitlement budget may require limiting or disabling the built-in stabilisers by placing global limits on all entitlements or on particular categories, or by capping some programmes. A few countries have had some success in capping particular entitlements, such as health care, and others are likely to experiment with new controls in the years ahead. These controls are controversial and can be introduced only with a high degree of political support. Health is the sector where efforts have been most pronounced, because this has been among the most volatile and fastest growing parts of the budget. The typical limits on health spending constrain payments to providers to raise fees on beneficiaries, but they usually avoid curtailing services. It is highly probable that in the very near future, a substantial number of budget offices will be involved in efforts to restrain the growth in transfer payments and other mandated expenditures through rules that are triggered if these programmes exceed budgeted thresholds. These efforts will be highly political; they will require legislative actions that go beyond normal budget decisions.

Central budget offices have had few enduring success stories in maintaining aggregate fiscal discipline when spending has been driven by entitlements. Nevertheless, the elements of a control system have been introduced in various countries. The main elements include the following:

a) A medium-term framework for stabilising the budget aggregates. The medium-term is essential because it is easy to evade budget controls when they pertain only to the current or the next fiscal year. The typical framework includes projections of future budget aggregates, budget norms

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(see next paragraph), and means of enforcing the norms. Developing and operating this framework is likely to be a major preoccupation of the budget office in the twenty-first century, perhaps superseding work on the annual budget. In the future, annual budgets will be even more driven by multi-year constraints than they have heretofore.

b) Medium-term norms must be realistic, that is, they must be achievable through politically acceptable actions. Yet they also must be constrictive, for if they merely accommodate prospective demands on the budgets, there would be no gain in having them. Developing the norms must engage key political actors – Cabinet, the head of government, perhaps the political parties, and, in the case of coalition governments, a formal agreement among the governing parties. They must also have some built-in enforcement – that is, some budgetary change occurs if the norms have been breached.

c) Aggregate norms are not likely to be effective if they pertain only to the totals; there must be a means as well of controlling the main subtotals. These may include limits on operating costs and other discretionary spending. These limits constrain the portion of the budget that is most amenable to cutbacks; they demonstrate that the government is willing to retrench its own operations in the quest for fiscal discipline. If the government cannot constrain the growth in discretionary spending, it is not likely to have much success in controlling other, more politically sensitive expenditures.

d) As noted previously, limits on mandatory spending are likely to be part of the toolkit of future budget offices. It is unlikely that democratic governments will go so far as to disable built-in stabilisers – doing so would disadvantage dependent persons at times of economic adversity – but they may be willing to take steps that slow the growth of these expenditures and reduce their volatility.

To enforce fiscal discipline, the budget office may need an enriched supply of information. Most central budget offices are skilled in macroeconomic analysis; most also work with models that relate demographic trends and economic changes (such as changes in prices and employment rates) to demands on the budget. Many have experience in constructing baselines and estimating the impacts of policy changes on projected revenues and spending. Some already use these data in medium-term frameworks; more will do so in the future.

Budget offices are evolving into entities that deal more with assumptions than with hard data. In the future, the actualisation of the revenue and spending levels set in the budget will depend on whether the underlying assumptions are realised. Accordingly, budget offices will have to even more closely monitor the economy and society to detect changes that may have major budgetary impacts.

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In other words, the budget office of the future will devote more of its resources to looking at what is happening outside government and less to what is happening inside. In looking outward, some budget organisations may investigate the feasibility of developing leading indicators of budgetary change to assist their early identification and assessment of cyclical changes in the economy and in other conditions affecting revenues and expenditures.

Fiscal norms are not self-enforcing; the government must have the capability to enforce fiscal norms and to correct any breaches that have occurred. Absolute prohibition against violating the norms may be too rigid to withstand political pressure for spending initiatives or tax cuts, or the *force majeure* of economic circumstances, but governments may have more success with flexible norms that permit trade-offs within budget constraints – for example, rules that require any additional spending that causes the deficit to rise to be offset by cuts in other expenditures or by revenue increases. A version of this rule has been applied by the United States since 1991 to revenue and spending legislation. The rule only covers deficit increases resulting from legislative action; it does not apply to automatic spending or deficit increases resulting from changes in economic conditions.

Flexible rules have two main advantages: they provide a safety valve for political pressures to expand programmes or provide tax relief, and they enable government to change budget priorities. But flexible rules require a vigilant and powerful budget office that can estimate the impact of proposed policy changes on future budgets and can intervene when the changes breach fiscal norms. Whether rigid (like the Treaty of Maastricht) or flexible (like those currently applied in the United States), fiscal norms set the stage for an ongoing battle between claimants on public resources and guardians of the purse. The central budget office will not win every battle against wily and politically potent claimants whose arsenal of tricks include proposals that hide the full cost of policy initiatives, efforts to take programmes off budget, and bookkeeping arrangements that underestimate budgetary impacts. In the future, no less than in the past, the budget office will be engaged in a struggle to guard the budget against these and other gimmicks. The irony is that the more effective fiscal norms are, the more claimants will seek to evade them. Over the long run, one cannot be certain that central budget offices will be able to uphold fiscal discipline unless they have steadfast political support.

3. Allocative Efficiency

Aggregate fiscal discipline can be a mixed blessing. While it stabilises the totals and makes them congruent with government policy, a fiscal norm that constrains spending below the total that would otherwise occur tends to freeze old programmes and priorities into the budget and new ones out. The more austere the norms and

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the longer they are maintained, the greater the risk that budget priorities will be rigidified. The risk is greatest when fiscal increments are lacking and the only way for the government to accommodate programme initiatives is to take resources away from current budget holders. How does the budget remain fresh and supple when there is little or no money for emerging priorities? How can the government think strategically and allocate resources to fulfil its vision? These and similar questions point to the importance of allocative efficiency in formulating the budget.

Allocative efficiency refers to the capacity of the budget system to distribute resources on the basis of the government's priorities and the programme's effectiveness. Allocating resources is the stock in trade of the central budget office; this is what the office does when it reviews agency bids for resources and recommends how much each should receive. In traditional budget arrangements, the process is open ended; agencies can ask for as much as they want. Invariably, the total demanded is in excess of available resources, thereby giving the central budget office the lead role in deciding where increments should be allocated and whether any reallocations should be made. In fact, the greater the excess of bids over resources, the greater the role of the central budget office in operationalizing the government's priorities.

There are a number of strong reasons for centralising reallocations in the budget office: 1) the budget office can reallocate more broadly among sectors than can a line department or ministry; 2) the budget office has a more comprehensive and possibly more objective view of the government's strategic interests and programme priorities than a single department that is likely to be beholden to sectoral interests; 3) the budget office can promote reallocations based on evidence of programme effectiveness rather than subjective criteria; 4) the budget office can establish rules and procedures to guard against evasion of fiscal discipline by underestimating the future cost of programmes to which resources are to be reallocated; 5) without strong pressure from the centre, departments may protect existing programmes rather than reallocate resources to new ones; 6) departments have incentives to launch programmes at low cost while building in spending increases in future budgets. If permitted, this behaviour would undermine both aggregate control and the government's capacity to establish programme priorities.

Despite these justifications of centralised resource allocation, the current condition of budgeting – fiscal constraints, inadequate increments, and pressure to make room in the budget for new priorities – may argue for a new approach in which spending departments are encouraged to generate policy changes. This would entail a fundamental re-orientation of the central budget office; it would act more as the referee of the reallocation system than as the reviewer of departmental budgets. The reasons for re-orienting the budget office in this direction need to be carefully considered. A useful starting point is the observation made above that traditional budget formulation was organised around allocation of incremental

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resources. Incremental budgeting enabled the government to respond to fresh demands while maintaining a relatively low level of intra-governmental conflict. Conflict was low because explicit trade-offs generally were avoided: winners gained by claiming incremental resources, not by taking from those who already had shares in the budget. Priorities were rearranged by awarding different growth rates to the various parts of the budget. As noted above, the budget office was at the hub of this incremental process; by allocating the increments, it influenced the future direction of the budget.

Although policy makers concentrated on the additional resources to be allocated, the budget process was structured to facilitate comprehensive review of expenditures. Spending departments submitted detailed justifications of all items of expenditure, not just of the increment. The budget office had a licence to review and challenge the items and to seek the cutback or elimination of those it considered unproductive or of lesser value. Formally, the process was highly adversarial; in outcome, however, the process was relatively calm. Conflict was mitigated by the availability of incremental resources and by the tendency to continue almost all ongoing programmes. Although all of the budget was nominally reviewed, almost all escaped serious review. Few changes were made, except for those financed by additional resources.

Incremental budgeting suited the times, but it was a flawed means of allocating scarce public resources. It tolerated allocative inefficiency and it contributed to the creeping enlargement in the relative size of the public sector. It weakened aggregate fiscal discipline by making the totals accommodate the parts. Aggregate spending was the sum of approved demands on the budget; it was not fixed independently of those demands. Spending agencies proposed numerous programme initiatives, but these generally were means of bidding for more money, not means of trading off within fixed budgets.

The perceived need for fiscal discipline may tempt the central budget office to tighten its grip by forcing reallocations from old to new programmes. This would seem to be a logical response to the contemporary budget predicament, for if the spenders won't make the trade-offs, the budget office can do the job for them. Nevertheless, the end result may be much conflict and little reallocation. The threat of losing resources and coveted programmes may impel spending departments to resist the trade-offs and savings demanded of them. These departments have formidable weapons at their disposal. They can withhold the information needed to make rational trade-offs; they can enter into logrolling coalitions with other claimants to protect their respective budgets against cutbacks and reallocations; they can mobilise support among affected interests and within government. Judging from the past, it is by no means certain that the budget office will win the battle for reallocation. It may end up instead with status quo budgets.

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The budget office operates at a disadvantage *vis-à-vis* the spending departments when it aggressively seeks to reallocate resources. It may lack sufficient programme information and political support to do the job. Departments know a lot more about their programmes – what works and what doesn't – than does the budget office. They also know a lot more about the political risks of changing programmes and policies. This asymmetry is due to the high cost of obtaining programme and political information, as well as to the understandable reluctance of departments to cast their preferred programmes in an unfavourable light. In other words, the budget office is beholden to the spending departments for much of the information it needed on how well programmes are working. It can ease this dependency by establishing its own evaluation capacity or by installing a performance measurement system, but if it wants reliable performance data to inform budget choice, it will have to give departments a prominent voice in the process. If it does not, the budget office may face a familiar predicament. Although many evaluations are completed, few are used in allocating resources.

How does the budget office give spending departments a prominent voice in the reallocation process without jeopardising the government's fiscal and programme priorities? Australia provides an interesting example in this regard. In Australia, reallocation is promoted by shifting the initiative for proposing policy changes from the centre of governments to the spending departments and by encouraging these departments to initiate trade-offs among their programmes within prescribed budget constraints. In this model, the focus of budgeting shifts from the items of expenditure to policy changes, and from nominal review of the entire budget to concentration on proposed additions and subtractions. The trade-off becomes the main unit of decision in budgeting. Trades are made explicitly, that is, by having departments nominate the programmes to be cut or expanded and by having the government decide which of the proposed savings and additions are to be incorporated into the budget. Departments are free to propose trade-offs within their area of responsibility; the broader their portfolio, the more robust the programme changes can be. It probably would be a good idea to allow departments to implement minor changes unilaterally so that the government can focus on those policy initiatives that have major programme and financial impacts.

In such a reallocation scheme, the role of the central budget office is different, but still quite important. It has a lead role in operating the trade-off system and in ensuring that the policy changes are consistent with the government's fiscal norms and programme objectives. The budget office establishes guidelines and procedures for proposing and reviewing policy changes, maintains baselines and data bases for measuring the budgetary impacts of policy changes, advises ministers and the cabinet on policy proposals, and either operates or promotes the ongoing evaluation of programmes and measurement of performance. As it undertakes these vital tasks, the budget office reduces its involvement in (or withdraws from)

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some traditional budgetary activities. It no longer reviews detailed items of expenditure; rather the items (those pertaining to running costs as well as those concerning programme operations) are handled by the affected departments within guidelines set by the government or the budget office. This devolution of traditional budgetary tasks promotes managerial efficiency (discussed in the next section) and frees the budget process for programme decisions and policy changes.

A budget system oriented to reallocation is likely to have most of the following elements:

a) The government establishes medium-term fiscal objectives and, assisted by the budget office, determines the margin (if any) available for programme initiatives or the net savings required to meet its fiscal target. The margin is calculated on a net basis: new spending minus savings from programme cutbacks.

b) The margin is allocated among ministries, in accord with the government's strategic priorities. Within its target, a ministry can increase the resources available for programme enhancements by proposing cutbacks in other parts of its portfolio.

c) The budget office maintains a baseline for projecting future budget conditions if current policies are continued and for measuring the budgetary impact of policy changes. The baseline is projected for three or more years beyond the year for which budget decisions are being made, so that the medium-term impacts of policy changes can be assessed.

d) The budget office demands that policy changes be advanced in terms of their expected programme effectiveness. Ministries should propose changes in the light of evaluation findings, and they should specify in advance how programme initiatives are to be assessed. Ministries also should systematically relate data on programme outcomes and effectiveness to their budget proposals.

e) Cabinet actions on the budget concentrate on policy changes, not on the items of expenditure. Policy changes (subtractions and additions) are incorporated into the baseline, which is then rolled forward one year and becomes the starting point for the next annual budget cycle.

These elements have been the central features of the Australian budget system since the mid-1980s. Annual budget decisions are made in reference to forward estimates, the baseline of authorised spending for the budget year and the three following years. The forward estimates are not just projections of future spending; they are the spending levels that will be approved in future budgets unless revisions are made as a result of policy changes or changes in underlying economic or programme conditions (such as changes in price levels or in programme participation rates). By definition, therefore, a policy change is a revision to the

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forward estimates. Proposed policy changes are considered in a prescribed sequence that includes identification of policy options, the costing of policy changes in discussions between the affected department and the Department of Finance and Administration, trilateral negotiations between the Treasurer, the Minister for Finance and the Portfolio Minister, consideration of policy proposals by a Cabinet Committee, and final Cabinet decision. As noted, the budgetary impacts of these decisions are entered into the forward estimates.

It would be beyond the scope of this paper to provide a full description or assessment of Australia's reformed budget system. A recent evaluation concluded that the reforms greatly increased the likelihood of savings options being adopted by ministers. Moreover, savings measures in a particular ministry are much more likely to be adopted when the ministry itself is arguing for them rather than when they are presented by the central budget office, with the knowledge and skills of the programme agency being devoted to criticism and obfuscation.

4. Operational Efficiency

The distinction between programme costs and operating costs is often made in budgeting for government programmes, with different decision rules applied to each of these expenditure categories. During periods of budgetary constraint, for example, the government may approve modest increases in programme expenditures while freezing or imposing across-the-board cuts on operating expenditures. This "double standard" may ease the budgetary predicament of cross-pressured politicians, who often face voter demands for reduced government spending (or taxes) and for enriched programme benefits. But what makes sense for harried politicians may complicate the work of programme managers who must maintain a high level of programme output while making do with less resources.

Tight operating budgets have become the norm in OECD Member countries. Retrenchment in this portion of the budget has become a recurring phenomenon as financially stressed governments have sought savings in their most controllable and least politically sensitive expenditures. Cutbacks in operating expenses rarely suffice to close the budget gap, but they convey the appearance that the government is doing something to correct is fiscal imbalances. In budgeting, there are two easy ways for the government to obtain these savings. One is for it (via the central budget office) to closely control the items of expenditure and to restrict the authority of departments to spend on personnel, supplies, and other operating inputs; the other is for the government to give departments greater operating discretion within fixed budgets. The two approaches point in opposite directions. The first gives the budget office greater involvement in the details of expenditure; the second requires it to withdraw from most of the details. The first approach

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emphasises legality and propriety in public expenditure; the second seeks efficiency in the use of public resources.

Over the years, central budget offices have differed in the extent to which they have intervened in operating decisions. Some have required that operating expenditures be approved in advance by central controllers; others have given substantial discretion to operating managers. In many countries, the squeeze on operating expenses has spurred the budget office to relax the controls and to seek means of improving managerial efficiency. Where this has occurred, the budget office has been compelled to re-examine its role and operations. It is no exaggeration to say that in the past, involvement with operating details was the main preoccupation of the budget office, especially during implementation of the budget. In a growing number of OECD Member countries, most operating matters are now in the hands of departmental managers. What is the appropriate role of the budget office in this new environment? How does it translate managerial discretion into managerial efficiency? Where does it fit in now that it no longer dictates the terms of expenditure?

The new role of the central budget office revolves around maintaining a system of accountability for the government. This entails prescribing information systems and reports, sharpening the capacity of spending departments to measure productivity and output, comparing results against expectations, and (as previously discussed) managing the process of change. This is a different role than the one budget offices became accustomed to play during the century-long evolution of government budgeting, but it is an important role, and one that can keep them both busy and in the thick of resource allocation.

The problem with the role is that accountability for results may be difficult to enforce in public institutions, and trying to do so may impel the budget office to recapture some of the controls it surrendered in the name of managerial freedom. In every country that has moved in this direction, devolution of managerial control has advanced much further than has the assimilation of new accountability methods. The *quid pro quo* of giving managers more freedom in exchange for making them accountable for results is asymmetrical: the former is much easier to accomplish than the latter. Even in New Zealand, where extraordinary progress has been made in installing new accountability measures, the budget office is in a relatively weak position to demand improvement when results fall short of the mark.

If the main purpose of managerial freedom is to improve efficiency in the delivery of public services, it is essential that productivity gains be measured and not just assumed. Governments need objective, systematic, and reliable means of measuring the volume and cost of output across a range of public services. It does not suffice that just a handful of selected performance targets be measured. What

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will be required is sufficient information that the government can report with confidence on trends in public sector productivity.

One can expect, therefore, that reformed budget offices will devote considerable resources in the years ahead to strengthening the accountability of spending entities. This may entail overhaul of the accounting and information systems, stronger sanctions and incentives to perform, tougher demands on managers to act as change agents in their organisations, new contractual means of specifying and monitoring outputs, greater use of net appropriations and market-type mechanisms to drive productivity improvement, more extensive application of the logic and techniques of managerial and cost accounting to the public sector, ongoing redesign of the budget documents and appropriations measures, and more. This is a full agenda, more than many budget offices will be able to handle.

Although it is possible that some reformed budget offices will reverse course and recapture previously surrendered controls, the greater likelihood is that additional budget offices will join the bandwagon for reform. Unless there is widespread discrediting of the managerial revolution, today's reforms will become tomorrow's norms. There may be a few holdouts – countries which for cultural or political reasons retain command and control management – but these will be outnumbered by the countries which embrace devolution. Some will do so wholeheartedly, others with a degree of reluctance; some will decentralise as little as they can get away with, others will drive devolution as far as it can go.

5. Conclusion

Aggregate fiscal discipline, allocative efficiency, and operational efficiency are complementary tasks in budgeting. A well-developed budget process should serve all three objectives. Moreover, accomplishing one of these tasks advances the others as well. Nevertheless, in the practice of budgeting, the three roles may get in one another's way. They require different types of information, work orientations, and skills. Getting all three to work in tandem may entail enormous transaction costs, more than a government may be willing to bear. The more typical approach may be to emphasise aggregate fiscal discipline because it is vital to the political interests and financial stability of the government, operational efficiency because it comports with the contemporary value orientation of private and public management, but to go slow on change in the allocation system because it entails a fundamental reconsideration of the role of the central budget office. As appealing as this approach may be, it should be recognised that over the long run the greatest payoff of reform is likely to be in improved programme allocations.

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Budgeting in Sweden

By
Jón R. Blöndal*

1. Introduction

From enjoying the largest budget surpluses of any OECD Member country in the late 1980s, Sweden went into having the largest budget deficits of any OECD Member country in the early 1990s, which were accompanied by a massive increase in government debt. In a span of just five years, the level of debt had nearly doubled. However, by the late 1990s, the budget had been brought back to balance and Sweden is now enjoying significant surpluses again.

The government believed that the budget process itself had contributed significantly to the deterioration of the public finances. The purpose of this paper is to describe in detail the reforms introduced in this area in Sweden. The discussion is divided into four parts. Section 2 discusses the budget formulation process. Section 3 discusses the role of Parliament in the budget process. Sections 4 and 5 focus on the implementation of the budget. Section 4 discusses the flexibility enjoyed by budget-holders in implementing the budget whereas Section 5 discusses the new accountability for results regime in place as a *quid pro quo* for this increased flexibility. As the paper covers the entire budgeting cycle, it offers a general overview of public management in Sweden.

In reading this paper it should be borne in mind that Sweden has generally been at the forefront of developments in budgeting and public management. The reforms introduced in Sweden following the fiscal crisis built on an already modern framework in most respects and the reforms themselves had been under discussion in Sweden prior to the crisis. The fiscal crisis simply offered a window of opportunity to implement them in a comprehensive manner over a very short timespan.

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2. Budget Formulation Process

2.1. *Introduction*

As noted, Sweden's budget formulation process underwent fundamental change during the late 1990s in response to the Swedish authorities' belief that the budget process itself had contributed significantly to the deteriorating state of the budget balance in Sweden.

The key elements of the reforms included the adoption of a multi-year budget framework and a top-down budget process. A Spring Fiscal Policy Bill was introduced whereby Parliament discusses and approves the key aggregate figures in the budget framework. The budget process was made more comprehensive by the inclusion of entities that had previously operated off-budget, primarily in the social security field. The principle of gross budgeting (separating revenues and expenditures) was adopted to increase transparency for certain transactions, again primarily in the social security field. This principle was, however, not applied to user charging for government service where its application was seen as a disincentive for levying user charging. All open-ended permanent appropriations were abolished and became subject to annual scrutiny and authorisation. This applied primarily to various entitlement programmes. Furthermore, the fiscal year was changed to the calendar year (which started previously in July) and the legal basis for budgeting was strengthened. This involved the enactment of a State Budget Act and additional measures in Parliament's standing orders in relation to the budget process. In practice, this often meant codifying practices that had previously been subject to administrative decision or simply tradition.

The discussion in this section is organised around the three phases of the new budget formulation process in Sweden:

- Phase I: The Multi-Year Budget Framework.
- Phase II: The Cabinet Budget Meeting.
- Phase III: "Each minister is his own Finance Minister".

Phase I centres around updating the Multi-Year Budget Framework which then forms the basis for the subsequent phases of the budget formulation process. This is the responsibility of the Ministry of Finance based on the critical review of information submitted by the spending ministries.

Phase II is the Cabinet Budget Meeting where resource allocation takes place on a macro level, *i.e.* the total level of funding for each of 27 Expenditure Areas is decided (see Box 2). This is a collective Cabinet decision based on recommendations presented by the Minister of Finance. The decisions reached in this meeting are incorporated into the Spring Fiscal Policy Bill presented to Parliament.

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Box 1. **The Budget Formulation Timetable**

January-March

Ministry of Finance updates the Multi-Year Budget Framework based on budget submissions from spending ministries.

Mid-March

Minister of Finance presents to Cabinet his budget recommendations for the coming year and the following two years.

End March

Cabinet Budget Meeting takes place where the total level of expenditure for the coming year and the following two years is approved as well as indicative funding levels for each of 27 Expenditure Areas.

15 April

Minister of Finance presents the Government's Spring Fiscal Policy Bill to Parliament.

April-May

Spending ministries finalise allocations among individual appropriations within their respective Expenditure Areas.

15 June

Parliament approves the Government's Spring Fiscal Policy Bill with any amendments.

June-August

Budget documentation prepared.

Early September

Cabinet agrees on the final budget proposal to be presented to Parliament.

20 September

Budget bill is presented to Parliament.

Phase III is where the Ministry of Finance largely withdraws from the details of the budget formulation process and "Each Minister is His Own Finance Minister", *i.e.* each minister is responsible for allocating the total level of funding in his respective Expenditure Area among individual appropriations. (There are 13 ministries so a minister can have responsibility for more than one Expenditure Area.) Phase III culminates with a final review by the Ministry of Finance and Cabinet of the allocations proposed by the spending ministers for each Expenditure Area.

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2.2. *Multi-year* Budget Framework

Sweden employs a multi-year budget framework as the basis for the annual budget process. It has a three-year time horizon, *i.e.* the upcoming budget and the two following years.

The multi-year budget framework provides the link between the government's fiscal policy objectives in a macroeconomic context and their application in an operational context. It operates on three cascading levels. The first level constitutes the articulation of the government's fiscal policy objectives in macroeconomic terms, *i.e.* level of surplus or deficit as a percentage of GDP. At the second level, these objectives are translated into a maximum level of total expenditure based on certain economic assumptions. At the third level, the limit for total expenditure is further operationalised by giving indicative funding levels for each of 27 Expenditure Areas (see Box 2).

The multi-year budget framework is legally binding. Parliament approves the maximum level of total expenditure for the government (L*evel* 2) and the indicative level of funding for each of the 27 Expenditure Areas (L*evel* 3). The limits are stated in nominal terms. The total for the indicative level of funding for the 27 Expenditure Areas is less than the maximum level of total expenditure. This difference

Box 2. **The 27 Expenditure Areas**

There are about 500 appropriations in the Swedish budget. There are separate appropriations for operating costs, transfer programmes and capital outlays. A majority of the appropriations are for operating costs, mainly for the operations of agencies.

An innovation in the recent budget reforms was to group all government appropriations into 27 Expenditure Areas. These are listed in Appendix 1. This is the basis on which the Spring Fiscal Policy Bill and the Budget Bill is presented to Parliament. Previously, the appropriations were divided by the ministries responsible for the appropriations. The 27 Expenditure Areas were proposed by Parliament, which wanted a clearer presentation of expenditures on individual policy areas than was afforded by the division by ministry. It was also designed to reflect the committee structure in Parliament.

As there are 13 ministries in Sweden, a minister can be responsible for more than one Expenditure Area. There are also instances of two or more ministers being responsible for a single Expenditure Area. In such cases, the responsibility for each appropriation within the Expenditure Area is assigned to the respective minister. Despite this apparent complexity, Swedish officials emphasised that this presentation is working very well.

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constitutes the "budget margin". For example, the budget margin would be 1.5% in Year 1; 2% in Year 2; and 2.5% in Year 3. The purpose of the budget margin is to provide a buffer against any forecasting errors so that the maximum level of total expenditure approved by Parliament will not have to be amended.

As a multi-year budget framework is in place, the starting point in the annual budget exercise is to update the information for Year 2 in the framework. The multi-year budget framework therefore provides an "anchor" for the annual budget process and thereby fosters discipline. Sweden had employed multi-year forecasts prior to the latest reforms but they were in no way binding and they were not formulated on a rolling basis. Rather, each year started with new multi-year forecasts being prepared with no reconciliations with prior forecasts.

The Ministry of Finance starts by re-examining the macroeconomic outlook for the coming year to see if the economic assumptions applied in the multi-year budget framework remain valid. The updated macroeconomic outlook plays a key role in determining the stance of budget policy. For example, higher than assumed economic growth would make additional resources available for the coming year. Recent experience has shown that the economic assumptions have been biased downwards. The funds that have been "made available" due to this have been applied to reducing debt at a more accelerated rate. They have not been used to fund new spending measures.

The Ministry of Finance emphasises, however, that they use their best professional judgement in formulating the economic assumptions for the multi-year budget framework and that they do not systematically employ overly prudent economic assumptions in this regard. The Ministry of Finance does examine economic forecasts prepared by financial institutions and other leading organisations in arriving at their own economic forecasts. The economic assumptions used by the Ministry of Finance are, however, not subject to review by any outside body. It should be noted that previously, the economic assumptions employed by the Ministry of Finance had tended to be overly optimistic. Two institutional reasons are cited for the improved quality of the economic assumptions. First, the change of the fiscal year to the calendar year has made the time-series of economic data match with the budget, thus eliminating the adjustments that had to be made in each case. Second, a re-organisation within the Ministry of Finance brought the economic forecasting work closer to the budgeting area than had been the case previously. The corrective impact of the economic crisis can, however, not be underestimated in this regard either.

At the same time as the Ministry of Finance re-examines the economic assumptions contained in the budget framework, each spending ministry re-examines the assumptions underlying the indicative funding levels provided to them in the multi-year budget framework. In early February, each spending ministry submits to the

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Ministry of Finance their budget proposal for the coming year plus forecasts for the following four years (although only the first two forecast years will be applied for the updated multi-year budget framework).

The budget submissions are to be divided into funds necessary for "maintaining current policy" and funds for "new policy initiatives". The former category therefore involves updating previously forecasted funding levels. The role and contents of the budget submissions are discussed in more detail later in this section.

The Ministry of Finance critically reviews the budget submission supplied by the spending ministries as they have a tendency to overestimate the necessary funding required. At this stage, technical discussions take place between officials of the Ministry of Finance and their counterparts in spending ministries to clarify any differences they may have concerning the underlying assumptions for selected budget submissions.

The Ministry of Finance maintains a competency to "second guess" ministries in this respect. The Ministry of Finance focuses its efforts especially on transfer programmes. The Ministry of Finance has, for example, established its own independent models for projecting expenditure trends for major transfer programmes. The focus on transfer programmes is in recognition of the fact that the updated funding levels for operating cost and capital appropriations tends to deviate little whereas significant deviations can take place in the area of transfer programmes.

Based on their critical review of the budget submissions from spending ministries, the Ministry of Finance prepares its budget recommendations for the Cabinet. The Ministry of Finance recommends the total level of expenditure and indicative funding levels for the 27 Expenditure Areas for the coming budget and the following two years. The total level of expenditure for the coming budget year and the following year must be in accordance with the maximum specified in the multi-year budget framework already in place. No information is released on individual aspects of the recommendations until they are presented in their entirety to the Cabinet. The Ministry of Finance only consults spending ministries to clarify technical details as stated above. The Ministry of Finance also presents to the Cabinet the entire set of budget submissions from spending ministries for information. The Ministry of Finance does not comment on individual budget submissions for specific appropriations but rather uses them as "building blocks" for the aggregate numbers. If, however, the Ministry of Finance recommends a lower level of funding for an Expenditure Area, it will have specific recommendations in this regard if the responsible minister objects to them. This is especially the case for transfer programmes.

2.3. *The Cabinet* Budget Meeting

The recommendations of the Ministry of Finance are presented to members of the Cabinet several days prior to the Cabinet Budget Meeting at the end of March.

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The Cabinet Budget Meeting takes place at the Prime Minister's Retreat which is located outside of Stockholm. The meeting generally lasts two days. It is attended by all ministers; and deputy ministers also attend from the Ministry of Finance and the Prime Minister's Office. Senior officials from the Ministry of Finance and the Prime Minister's Office are also present to provide additional information as requested.

It should be emphasised that there have not been any Cabinet Meetings related to the budget prior to this and that no Cabinet committees exist on budget matters. The Minister of Finance would only consult the Prime Minister on his recommendations prior to submitting them to the Cabinet. Specifically, the Finance Minister's recommendations for the indicative funding levels for each Expenditure Area would not have been discussed with the responsible ministers on a bilateral basis prior to the Cabinet Budget Meeting. This is also the first time that ministers will have the opportunity to see the original budget submissions of their colleagues.

The discussions at the Cabinet Budget Meeting generally centre on ministers seeking additional resources for initiatives within their respective Expenditure Areas. They do this by seeking to reallocate resources from other Expenditure Areas. Otherwise, they will have to finance these initiatives by reallocations within their respective Expenditure Areas. The Ministry of Finance establishes an explicit monetary threshold for initiatives to be considered at the Cabinet Budget Meeting, or they have to be judged so politically important as to justify them being discussed at this stage. This threshold serves to ensure that marginal increases are financed from cuts elsewhere within an Expenditure Area rather than adding up to a large total. This also serves to limit discussion to major transfer programmes at these meetings.

Ministers have to "digest" a tremendous amount of information during the Cabinet Budget Meeting. They have relatively little time available to prepare for this meeting. This would appear to be designed to avoid "leap-frogging", whereby one minister's proposal are agreed in isolation which may then form a justification for the agreement of other proposals and thereby undermining budget discipline. By making all the decisions in one meeting, there is a clearer focus on the bottom line and increased recognition of the fact that agreeing to one proposal will require corresponding cuts in other areas. It can be argued that this limited time frame hinders efficient resource allocation between the 27 Expenditure Areas. It does, however, serve to foster aggregate fiscal discipline.

At the end of the meeting, the Cabinet will have agreed to a level of total expenditure for the coming year and the following two years, in addition to indicative funding levels for each of the 27 Expenditure Areas. The budget decisions reached at this meeting are then formalised in the confirmed minutes of the Cabinet

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Meeting and in the Spring Fiscal Policy Bill. This serves to make the decisions reached at the meeting more binding as it is more difficult for ministers to seek any changes to the decisions. This serves a very important function in the subsequent phase of the budget process. The Spring Fiscal Policy Bill is discussed further in Section 3.

2.4. "*Each minister is his own* Finance Minister"

It must be emphasised that all the above decisions are made at the level of the Expenditure Areas, not at the level of each appropriation. It is only in the third phase of the budget formulation process that decisions on each appropriation are made. These decisions are made by the ministers responsible for each Expenditure Area. "Each minister is his own Finance Minister" within the limits set for his Expenditure Area. The Ministry of Finance largely withdraws from the budget formulation process during this phase. This has given the spending ministers greater ownership over their respective budget proposals and made them more likely to identify lower priority programmes within their Expenditure Areas to finance higher priority initiatives.

The spending ministries have two months following the Cabinet Budget Meeting to prepare their initial allocations for individual appropriations. They must submit these to the Ministry of Finance by mid-May. The Ministry of Finance may question specific allocations made by spending ministries although this rarely occurs. This is one indication of the responsibility that individual ministers have assumed over their respective budget proposals. It is only in the most exceptional circumstances that the level of funding for an Expenditure Area would be increased in this phase and it would have to be accompanied by corresponding cuts in another Expenditure Area. The final budget proposal is agreed by the Cabinet in early September. The Budget Bill is presented to Parliament on 20 September.

It is during this phase that performance information enters the budget formulation process. The original budget submissions to the Ministry of Finance that are used for updating the multi-year budget framework tend to average only two to three pages in length per appropriation. They contain only financial information. The Ministry of Finance views performance information as having an *indirect* influence on appropriations in most cases. The incremental impact of performance information is of such a magnitude that it can be accommodated for by reallocations within a given Expenditure Area. Furthermore, the spending ministries are in the best position to judge the merit of performance information and it would be inappropriate to have such detailed information accompany each budget submission to the Ministry of Finance.

The performance information is contained in the annual reports of each agency. These reports are published by March of each year. The annual reports are

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discussed in further detail in Section 5. Agencies tend to comment on the limited use that is made of performance information in the budget process. This may be partly explained by the fact that agencies overestimate the role that performance information can play in the budget process and that they do not fully recognise (or accept) that performance information is now to be considered only in this phase of the budget formulation process and not in the original budget submissions submitted to the Ministry of Finance or in the Cabinet Budget Meeting. It may also be explained by the limited capacity of spending ministries to apply performance information during this phase of the budget process. The spending ministries tend to be organised in such a way that budget and management functions are the responsibility of the same officials who have responsibility for each policy function. This model has its disadvantages. The top officials of each spending ministry, however, focus more on political and legal matters rather than management issues. As a result, the use of performance information as an aid in allocating appropriations may suffer. It has been recommended that the management function in the spending ministries be strengthened, as is discussed further in Section 5.

A key element of this last phase of the budget process is also the drafting of the budget documentation itself. It consists of 12 volumes: an overview plus 11 documents where discussion of each of the 27 Expenditure Areas takes place. The budget documentation has been modernised in recent years and does not have a "legal document" feel to it. It is more comparable to corporate annual reports.

Box 3. **Previous Experience with Performance Information**

It should be noted that Sweden experimented in the early 1990s with very detailed budget submissions to the Ministry of Finance, which placed strong emphasis on performance information. This experiment did not yield great success and a reaction against the use of performance information by ministries may have been the result. Essentially, all agencies were to prepare in-depth assessments of their activities every three years. The assessments that were prepared by the agencies were universally positive about every single aspect of their activities. This had the effect that many considered the agencies themselves incapable of reporting on their own operations and this may account for the limited use that some ministries make of the annual reports prepared by the agencies. This experiment also resulted in agency budget submissions that were "the size of telephone books". It was simply unfeasible to process this information in the budget formulation process and this may account for the very short budget submissions that the Ministry of Finance now requests. It should be noted that the agencies did not believe they had received sufficient guidance from their ministries in order to conduct the in-depth assessments.

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Box 4. **Supplementary Budgets**

Supplementary budgets are presented to Parliament twice a year – in April coinciding with the Spring Fiscal Policy Bill and in September coinciding with the Budget Bill. Increased funding for transfer programmes, notably unemployment benefits and specific transfers to municipal and county governments have been the major components of the supplementary budgets. Increased funding for these areas has been financed by reductions in other Expenditure Areas and by increases in revenue (consistent with the budget margin).

Each ministry is responsible for preparing the initial discussion of its respective Expenditure Area. These are then forwarded to the Ministry of Finance for review and editing to ensure that the budget has a consistent message in line with the policy decisions adopted by the Cabinet. The overview document is prepared by the Ministry of Finance and, *inter alia*, contains a wealth of economic data to relate the budget to the macroeconomic situation.

As is noted in Section 3, Parliament has voiced concern about the quality of the performance information that is presented in the budget documentation. It is considered too dispersed and overly focused on outputs rather than policy relevant outcomes. Action is being taken by the government in this area. It would seem appropriate for ministries to place increased emphasis on bringing together the various output information that it receives from their agencies and highlighting how specific outputs are contributing to the policy relevant outcomes. This is further discussed in Section 5.

2.5. *Conclusions*

The Swedish budget formulation process has been transformed in recent years. It is now a top-down exercise based on a multi-year budget framework encompassing all of the government's activities. This transformation has taken place over a relatively short period of time and appears to be based on solid foundations. No officials interviewed for this study expressed a desire to return to the old system. It is also noteworthy how successfully the Ministry of Finance has been able to delegate responsibility to spending ministries in this new top-down budget environment.

The budget process has shown itself to be quite effective in maintaining aggregate fiscal discipline. The challenge is to maintain fiscal discipline in the current surplus environment. Allocative efficiency in the budget process is fostered

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by the decentralised nature of the final allocation of funds to appropriations within each Expenditure Areas. It would, however, appear to be hampered by the very limited time frame that Cabinet has to agree to allocations among the 27 Expenditure Areas, as previously discussed.

It should be noted that the budget proposal is presented on a cash-basis to Parliament. The annual reports of agencies and the government's consolidated financial statements are, however, presented on an accrual-basis. It is currently under study to present the budget to Parliament on an accrual-basis as well but no definite decisions have been taken in this regard. Parliament has voiced hesitations about the desirability of this move.

Finally, the role of performance information in the budget process needs to be clarified as it appears to be viewed quite differently by the Ministry of Finance, the line ministries and the agencies.

3. The Role of Parliament

3.1. *Introduction*

Sweden has a history of minority governments. This has required successive governments to seek the support of opposition members of Parliament in order to approve the budget. As a result, the Swedish Parliament has a more significant role in the budget process than in many other countries with a Parliamentary system of government.

The process whereby Parliament discussed the government's budget proposal could, however, until recently only be described as undisciplined. The level of government expenditures would invariably increase during Parliament's discussion of the budget. It was a long process lasting five months from the time of the presentation of the government's budget proposal. The government's budget was incomplete when first presented to Parliament with the government later proposing various and substantial changes to its original proposal. Initial debate about the budget was therefore difficult as many key proposals had not been presented at that time. The focus of debate was also on individual appropriations with little co-ordination or respect for aggregates. The exact amount of the budget was only certain at the end of the process.

It had been recognised by the authorities for some time that a more effective and efficient process was required. Formal work was initiated in the early 1990s when Parliament established a Commission of Inquiry to formulate a proposal for making the budgetary work of the Parliament "faster, more effective, and easier to understand". The fiscal crisis in the early 1990s added urgency to the need for reform. During 1996 and 1997, fundamental changes were made to the manner in which Parliament approves the budget.

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Box 5. **The *Riksdag***

The Swedish Parliament, the *Riksdag*, is a unicameral legislature with 349 seats. There are 29 constituencies for elections to Parliament. A total of 310 of the seats in Parliament are "fixed seats", *i.e.* divided on a permanent basis among the 29 constituencies. The remaining 39 seats are "equalising seats", *i.e.* divided after each election among the political parties in each constituency to reflect the national popular vote and achieve proportional representation. Elections are now held every four years (previously every three years).

A number of the reforms described in the previous section originated from the work of the Commission of Inquiry. A new and binding timetable, with the calendar year as the fiscal year, was established. The government may now not amend its initial budget proposal except in exceptional circumstances. The development of the 27 Expenditure Areas originated from this work as well. As these reforms have been described previously, this section focuses on the new approval process for the budget that has been adopted by the Parliament.

3.2. *The Approval Process*

The key reform implemented was the introduction of a top-down approach for discussing and approving the government's budget proposal. The approval process can be divided into three phases. Prior to the presentation of the budget, Parliament approves the level of *aggregate government expenditures* (and aggregate government revenues) in a Spring Fiscal Policy Bill. The government's budget proposal must conform to this limit unless the government separately proposes a higher limit. Parliament's deliberation of the actual budget proposal is then divided into two distinct phases. First, Parliament approves the level of *expenditures for each of the* 27 *Expenditure Areas*. Only then does Parliament approve the level of *individual appropriations* within each of the 27 Expenditure Areas. Each of the three phases is discussed below.

3.2.1. *Spring Fiscal Policy Bill*

The government presents the Spring Fiscal Policy Bill to Parliament no later than 15 April each year. This is five months prior to the budget proposal being presented to Parliament.

The Spring Fiscal Policy Bill presents proposed limits on aggregate government expenditures (and aggregate government revenues) for the coming budget

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Box 6. **The Parliamentary Budget Timetable**

15 April

Government presents Spring Fiscal Policy Bill to Parliament.

Early June

Parliament approves Fiscal Policy Bill.

20 September

Government presents Budget Bill to Parliament. Expenditures are divided into 27 Expenditure Areas which are in turn divided into about 500 individual appropriations.

End November

Parliament approves in one vote the total expenditures for each of the 27 Expenditure Areas.

End December

Parliament approves individual appropriations within each of the 27 Areas with one vote for each Expenditure Area.

1 January

Start of fiscal year.

and the following two years. Parliament debates these aggregate limits and enacts them into law in early June. There are no restrictions on Parliament's ability to amend the government's proposal.

A key aim of the Spring Fiscal Policy Bill is to cast budget policy in a macroeconomic setting. There is a very strong macroeconomic orientation to the commentary that accompanies the Spring Fiscal Policy Bill; much of it is devoted to an assessment of the current economic situation and medium-term economic prospects. The Minister of Finance and other government members focus their remarks in Parliament on the macroeconomic situation and how budget policy relates to it. The Bill is referred to the Finance Committee and is then debated in Parliament.

The Spring Fiscal Policy Bill has created a vehicle whereby debate in Parliament can focus on the appropriate size of the public sector and the economic impact of various combinations of aggregate revenues and aggregate expenditures. As such, it can help prepare the ground for any difficult decisions that the budget proposal may contain.

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The government has chosen to include in the Spring Fiscal Policy Bill indicative information on the division of aggregate expenditure into the 27 Expenditure Areas. This division is not binding as Parliament only approves the level of aggregate expenditure at this stage. Opposition parties have also chosen to present their alternatives to the government's Spring Fiscal Policy Bill at this stage and the different choices they would make in funding the 27 Expenditure Areas. It can be argued that this debate is taking place too early in the budget process and that it pre-empts the subsequent phases of the approval process. However, one must recognise that presenting this information at this stage to Parliament strengthens the hand of the Ministry of Finance in the budget formulation phase.

3.2.2. *The Budget Bill*

The government's budget proposal is presented to Parliament no later than 20 September. The aggregate level of expenditure must be in line with the amount approved by Parliament in the Spring Fiscal Policy Bill unless the government separately proposes a higher limit. As mentioned above, the budget proposal is divided into the 27 Expenditure Areas which are in turn divided into about 500 individual appropriations.

The Budget Bill is for general consideration in Parliament in September and October. In fact, the entire fall session of Parliament is devoted largely to the budget proposal and related legislation. Members of Parliament have until 7 October to present any motions to amend the budget proposal. There are no restrictions on the amendments that can be made to the budget proposal as long as the limit on aggregate expenditures established in the Spring Fiscal Policy Bill is respected.

Parliament must approve the division of aggregate expenditure into each of the 27 Expenditure Areas by the end of November. Following this, Parliament approves individual appropriations within each of the 27 Expenditure Areas in late December. This is designed to facilitate the reallocation of resources from one Expenditure Area to another and to counter the tendency to focus on individual appropriations rather than the overall direction and trends in government expenditure.

The committees of Parliament play a key role in budget deliberations and much of the fundamental work in reviewing the budget proposal takes place in committees. In this respect, there is a strong division of labour between the Finance Committee and the sectoral committees. The Finance Committee is responsible for the overall budget proposal and for recommending to Parliament the level of aggregate expenditures and the division of aggregate expenditures into each of the 27 Expenditure Areas. The sectoral committees are responsible for allocating individual appropriations within their respective Expenditure Areas. For example, the Finance Committee will recommend the total level of expenditure in the agriculture Expenditure Area whereas the Agriculture Committee will

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recommend how that total should be allocated to individual appropriations within the agriculture Expenditure Area.

In early October, the budget proposal is referred to the Finance Committee. As noted above, it is responsible for proposing to Parliament any changes to the total level of expenditures in each of the 27 Expenditure Areas. It may increase funding for one area and lower funding for another area. The Finance Committee seeks the views of the sectoral committees on the level of funding for their relevant Areas. Each sectoral committee formally reports to the Committee on Finance by the end of October. The Finance Committee then reviews these reports and other relevant information. The Finance Committee also reviews the economic assumptions of the budget and the revenue side of the budget at this time. In mid-November, the Finance Committee presents its recommendations to Parliament on the division of aggregate expenditures into each of the 27 Expenditure Areas. Parliament discusses these and votes on them at the end of November.

Following the approval of the funding levels for each of the 27 Expenditure Areas, the Finance Committee withdraws from direct participation in the budget approval process while the sectoral committees allocate funding to individual appropriations within their relevant Expenditure Areas. Although the level of funding for their Expenditure Areas is only agreed at the end of November, the sectoral committees will have commenced the review of their individual appropriations prior to the end of November. The heads of the relevant government organisations will be called on by the sectoral committees to provide further information on their funding request although these practices do vary in individual committees. The focus of the reviews, however, is more and more on the performance of the relevant organisation or programme. As is described in a following section, Parliament does not exercise control of the inputs that government organisations and programmes use in their operations. Most government organisations rece ive one single appropriation for their operating costs. The *quid pro quo* for granting this flexibility was that information would be supplied to Parliament on the outcomes and outputs of government organisations and programmes. There appears to be dissatisfaction in Parliament with the quality of the information supplied by the government in this regard. Parliament would prefer to receive more policy relevant outcome information rather than disaggregated output information. The government has, in fact, announced that it views improving the performance information supplied to Parliament as a priority.

Following their reviews of individual appropriations, the sectoral committees present their proposals. The sectoral committees are permitted to change the composition of appropriations in their relevant Expenditure Area but must remain within the agreed total for their Expenditure Area. Otherwise, their proposal will be invalidated and will not be permitted to be discussed by Parliament. The sectoral committees must agree on a single set of recommendations for the Expenditure

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Area as a whole. There will therefore be 27 sets of majority recommendations. If a proposal does not have majority backing in the committee it will therefore not be reported out of committee. This is a new voting procedure and has been criticised for being overly restrictive, *i.e.* that proposed amendments can be "killed" in committee. The Parliament discusses the budget proposal and decides on the appropriations within each Expenditure Area. The budget for the next year is approved immediately before the Christmas recess.

Finally, the resources available to Parliament when discussing the budget has increasingly become an issue. The committees rely largely on cost calculations submitted by the Ministry of Finance or the respective line ministries when discussing the budgetary impact of various amendments under consideration. Although there appears to be confidence in the cost calculations prepared by the ministries, there have been calls to set up an independent budget office for the Parliament in order not to be dependent on the Executive branch on such matters. There have also been calls to increase the resources available to opposition political parties so that they can better prepare credible alternatives to the government's Spring Fiscal Policy Bill.

3.3. *Conclusion*

The budget process that Parliament has adopted is comprehensive and disciplined. It is marked by an acceptance of Parliament to heed to a set of binding budgetary constraints when discussing the budget. The number of amendments approved in Parliament to the government's budget proposal has decreased significantly following the adoption of the new budget process. This is not necessarily a function of the new budget process, but rather of the fact that the present government enjoys a stronger position in Parliament than many previous governments. In fact, the true test of the new budget process is how well it will operate under alternative electoral circumstances.

Concerns have been voiced that presenting the division of total expenditures into the 27 Expenditure Areas at the time of the Spring Fiscal Policy Bill has preempted subsequent stages of the approval process and that the new voting procedures in Parliament whereby all amendments can be "killed" in committees is too restrictive. These concerns are being actively discussed in Parliament.

It is clear, as the government has recognised, that the performance information presented to Parliament needs to be improved. This would serve to both increase the quality of discussion in Parliament and to sustain the abolition of input controls and the vast managerial flexibility now enjoyed by government organisations.

Finally, it would appear likely that the resources available to Parliament when discussing the budget will increase in future, either in the form of increased

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resources for the political parties themselves or for increased non-partisan resources, such as expanded staffing levels at committees or the creation of an independent budget office responsible to Parliament.

4. Managerial Flexibility

In implementing the budget, managers enjoy great flexibility in the use of appropriations. This is partly due to the institutional organisation of public administration in Sweden: small policy ministries and a large number of agencies responsible for executing policies. All restrictions on operating cost inputs have been systematically removed in recent years, including those for personnel management and accommodation. There is also an elaborate system in place to promote effective financial management practices in this devolved environment, including the use of interest-bearing accounts and the carry-forward of unused appropriations and a facility to borrow against next year's appropriation. This section discusses each of these areas in turn.

4.1. *Ministries and Agencies*

No restructuring of government organisation was required as a pre-requisite for management reforms in Sweden. The separation of policy and operational functions into ministries and agencies has been a hallmark of Swedish Government organisation for over 200 years. The structure of government reforms that a number of OECD Member countries were implementing in the 1980s and 1990s were well established in Sweden in the late-1700s.

Today, there are 13 ministries and about 300 agencies in Sweden. The ministries are very small in size with between 100 and 350 staff each. The agencies vary greatly in size; the smallest ones have fewer than 10 staff while the largest ones employ tens of thousands of staff. Approximately 99% of government employees are employed by the agencies; the remaining 1% are employed by the ministries. The mismatch of staff resources does not appear to impede the work of the ministries. They view their small size as a great asset, allowing for easier and faster communication and co-ordination among ministries. There were no complaints of agencies "withholding" information from their ministries; there was "constant" dialogue between the two. The relationship between ministries and agencies has evolved over a long time in Sweden and appears to work quite well.

The demarcation between policy and operational functions can, of course, be a grey area. What emerged clearly from discussions is that ministries do not get involved in the management of agencies. In fact, some agencies complained of the "total" disinterest of ministries in their management. The ministries focus on managing the policy interface with decision-makers – co-ordination with other ministries, preparing proposals for cabinet, seeing legislation through Parliament and,

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most recently, dealing with matters arising from Sweden's accession to the European Union. This has great advantages in terms of facilitating managerial flexibility as is discussed in this section. It does, however, create problems for holding agencies accountable for their performance as is discussed in the next section.

The management of agencies is vested in the director-general of each agency. Directors-general are appointed on a fixed-term basis. The average tenure of directors-general is seven years and the government has a policy of actively promoting renewal at the directors-general level. Directors-general are appointed by Cabinet decision. The responsible minister and the Prime Minister, however, play the primary role in selecting directors-general. These are, however, considered non-political appointments and directors-general do not resign at the change of government.

There are no restrictions on whom the Cabinet may appoint. There is no formal "career system" or "senior executive service" in Sweden. The great majority of directors-general have a public sector background, although there are examples of directors-general being recruited from the private sector. The position of director-general is, however, not advertised. Rather, ministers "identify" suitable candidates. This has been criticised and there would appear to be room for increased transparency in the recruitment of directors-general, for example by advertising vacancies and by explicitly stating the criteria upon which directors-general will be selected. Notwithstanding this, the persons selected as directors-general are generally recognised as very capable individuals.

Most agencies have boards associated with them. Most do not function as governing boards but rather as advisory boards. Board members are often politicians, either members of Parliament or municipal politicians, or representatives of special interest groups affected by the agency's operations. The boards have been heavily criticised with many officials describing them as irrelevant at best. The government has adopted a flexible approach with regards to the boards. Some agencies will have no boards; other agencies will have advisory boards; and a number of agencies will have "boards of full responsibility" which are to act in a similar fashion as boards of directors for private sector enterprises. In this case, the director-general would be responsible to the board, which in turn would be responsible to the ministry.

A number of serious concerns can be raised about the concept of "boards of full responsibility". First, it would blur the role of director-general and the accountability of agencies to ministries. Second, board members would lack in the necessary professional skills to effectively guide the work of the agencies. Third, the special interest group background of board members would be inappropriate if they are to function as governing boards. The last two concerns are based primarily on the persons previously selected by the government as board members.

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There would appear to be ample justification for these concerns; directors-general as the clear heads of agencies has been quite effective as the model for governing agencies in Sweden.

4.2. *Removal of Input Controls*

As a general rule, agencies now receive one single appropriation to fund all of their operating costs with no restrictions on the choice of inputs. The last two centrally determined inputs, collective pay bargaining and accommodation were abolished in the mid-1990s. The objective was to give directors-general total responsibility for all of their operations. As noted earlier, there are separate appropriations for transfer programmes and capital outlays.

4.2.1. *Collective Bargaining*

Personnel management in Sweden has historically been decentralised with the outstanding exception of collective bargaining arrangements. Directors-general of agencies are, and have been, responsible for the recruitment, grading and dismissal of their staff. There are no restrictions on whom they may hire. There is no "civil service" encompassing the government as a whole. Vacancies are generally advertised in the press with all qualified applicants being treated equally. Staff are not tenured in Sweden. They can typically be dismissed at two to 12 months notice depending on how long they have been employed by the agency. In fact, there are essentially no differences between the employment legislation governing the public sector and the private sector in Sweden.

Collective bargaining arrangements have historically been very centralised. A National Collective Bargaining Office concluded central pay agreements with the unions representing the staff of agencies. The agreements were then approved in Cabinet and received consent from the Finance Committee of Parliament. Agencies had no flexibility to offer different pay than what was concluded in the central pay agreements.

Prior to the current reforms, Sweden had embarked on a course away from this very centralised regime by introducing a two-tier collective bargaining system. This meant that a central agreement was reached with the unions that called for a pay rise that consisted of a minimum fixed amount to be distributed to all staff and a "pay kitty" whose distribution was then negotiated between each agency and the unions at each agency. The unions are divided into separate bargaining units for each agency. Over the years, a rising proportion of the total wage settlement took place at the agency level.

Nonetheless, these were "central" agreements in character and agency appropriations were fully adjusted to reflect the settlement. It had been recognised for some time that this centralised system was at odds with the general philosophy

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that directors-general should be responsible for the operations of their agencies. Central collective bargaining made an outside force responsible for a significant portion of an agency's resources. Full devolution would also serve to depoliticize the pay negotiations.

In 1994, collective bargaining was totally devolved to the agencies and is now the responsibility of the director-general of each agency. The cost of personnel is now one of the many items of expenditure that directors-general must manage within the limits of their single appropriation. There is no longer any automatic adjustments to their budgets to compensate for pay agreements that are concluded. The Ministry of Finance and the Parliament no longer have any direct influence on the contents of the collective agreements establishing the salaries and other conditions of employment for government staff. The agreements are negotiated entirely on the instructions of the agencies.

Although collective bargaining is totally devolved to the agencies, the two-tier structure of the negotiations has remained largely in tact. The agencies now form a Confederation of Government Employers for negotiating purposes. Concurrently, the share of the total settlement that is negotiated at each agency has increased significantly. It is estimated that about three-fifths of the total wage settlement is now negotiated at each agency. The negotiations at each agency are very much based on the performance of each individual staff member. It is common for staff holding the same job titles to be paid differently based on their performance. The individualisation of pay would appear to be generally accepted in the public sector in Sweden. It is estimated that over 90% of government employees now have individualised pay. The unions have demonstrated a co-operative attitude in developing and implementing the new collective bargaining arrangements.

There is only limited experience with this new framework, but it is predominantly positive. The agencies have welcomed their increased responsibility for wage formation, and employer policies in general. The agreements that have been reached have been within the cash limits of agency appropriations. This is not attributed directly to the institutional framework of the Confederation of Government Employers, but rather to the "immense" peer pressure that directors-general exert on each other for responsible settlements. In fact, it remains to be seen whether the Confederation is simply a transitional institution that will be dissolved as more experience is gained with the totally devolved collective bargaining system. This would apply especially to some of the larger agencies.

4.2.2. *Accommodation*

A single government organisation enjoyed a monopoly over supplying all government organisations with offices and other accommodations. It charged rent for its services but agencies were automatically compensated for any increase in

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the charges. This central control was abolished in 1993. Government agencies now have the freedom to choose their accommodation. They can simply give notice and get their accommodations supplied by the private sector.

The government agency responsible for supplying accommodation was abolished and its assets split among three organisations. Heritage assets, such as the royal palaces, were grouped in one organisation. All remaining assets were grouped into two state-owned enterprises. Universities and other academic buildings were placed in one company while all other assets were grouped in a second company. The companies are to charge market rent for their accommodations.

This reform coincided with a sharp downturn in the property market. As a result, some agencies found it advantageous to move to less expensive accommodation, or to get superior quality accommodation at the same cost. This created a potential conflict of interest between the agencies when viewed in isolation and the government as a whole which was left with surplus accommodations. This, however, never became a public issue in Sweden and within the government it was viewed simply as a transitional cost on the way to a more efficient system in the long-term.

The freedom to choose accommodations, however, could not be enjoyed equally by all agencies. Some agencies occupied very special accommodations, prisons and museums being outstanding examples. This does not appear to have caused tensions as such. These agencies complain, however, that there is no such thing as market rent for their specialised accommodation and want to renegotiate their lease agreements as they feel they are being made to pay unreasonable and excessive rent for their accommodation. This is currently the subject of government investigation.

4.3. *Financial Management Instruments*

Efficient financial management has been a key feature of management reforms in Sweden.

Accrual accounting has been introduced in agencies. This reform was considered essential as managers now enjoy total flexibility in their choice of inputs and therefore require information on the full cost of each input to be able to manage effectively. The introduction of accrual accounting would appear to have proceeded relatively smoothly as the quality of the previous accounting system was very high. For example, complete and up-to-date registers of assets had always been maintained. Although some officials viewed the introduction of accrual accounting as essentially a technical exercise, most do recognise the increased quality of the cost information. The budget and all appropriations are, however, on a cash-basis (or a modified cash-basis) as noted earlier.

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Appropriations for operating costs are now deposited into the agency's interest-bearing account, normally at the rate of one-twelfth each month. If an agency spends its appropriations at a slower rate, it is paid interest on the balance in the account. Similarly, if an agency spends its appropriations at a faster rate, then it must pay interest to reflect the government's cost of borrowing. Agencies, of course, vary greatly in their ability to time individual transactions but this system has served to increase consciousness of cash management in agencies.

Another reform designed to improve the management of cash was allowing agencies to carry-forward their unused appropriations, currently up to 3% of the annual appropriation for operating costs may be automatically carried over; larger amounts must be approved by the Ministry of Finance on a case-by-case basis. This was designed to avoid end-of-year spending binges which are an inherent problem of the annual budget process. Another objective was to increase discipline on managers as any overspending in the year gets carried over as well. It was also intended to foster efficiency gains in agencies beyond those assumed in the budget as any gains would be retained by the agency. Without the carry-forward option, it was considered that managers would not have sufficient incentives for seeking efficiency gains in their operations.

There were two concerns raised about the carry-forward system. First, some believed that "time bombs" were being built up as the level of unused appropriations carried-forward is quite substantial. Second, the Ministry of Finance was accused of taking the level of funds available for carry-forward excessively into account in the annual budget negotiations. This, however, would not appear to be the case as the Ministry of Finance explicitly rejected a proposal to "confiscate" the carry-forward funds during the fiscal crisis. The Ministry believed that this would undermine the objectives of the reforms. The Ministry of Finance now has a policy of investigating cases only where agencies continue year on year to accumulate surplus funds.

The government also introduced a facility for borrowing against future appropriations, normally up to the level of 3%. The borrowing facility is hardly used at all. In cases where it is used, it is primarily for agencies that have overspent their appropriations, overspending which they must "repay" from future appropriations. This is very rare in Sweden.

A special type of mandatory borrowing facility was also introduced. These are loans to finance investment in computers and other administrative equipment. The primary motivation for creating this borrowing facility was, however, to rationalise investment decisions and foster better management of administrative equipment by being able to even out their cost over their useful life. The borrowing facility can also be seen as working hand in hand with the new accrual accounting

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regime as the length of the loans is equal to the useful life of the equipment being purchased. The loans bear market-rates of interest.

4.4. *Conclusion*

In no OECD Member country do managers enjoy greater flexibility in the management of their organisations than in Sweden. It is testimony to the quality of management in Swedish Government organisations that they have been able to use this flexibility successfully.

Annual surveys of customer perception of service quality levels in both private sector and public sector organisation in Sweden reveal an improving general satisfaction with the level of service in public sector organisations. Sweden has also conducted extensive surveys of public sector productivity trends. These reveal that productivity has shown a sharp upturn in recent years. Causality links are, of course, hard to establish, but hard budget constraints and increased managerial flexibility is, at the very least, consistent with increased service quality levels and increased productivity.

Two main concerns were voiced in this area. The first centres around the boards associated with agencies. The present boards are viewed very negatively in Sweden and there would appear to be ample reasons to question the option of having "boards of full responsibility". The second major concern centred around the recruitment process for new directors-general. There would appear to be significant room to increase the transparency in this area. Both of these concerns have been described earlier in this section.

5. Accountability for Results

5.1. *Introduction*

The previous section outlined the great flexibility that managers enjoy. The *quid pro quo* for this increased flexibility is that managers be held accountable for results. This is a fundamental change: holding managers responsible for what they do, not how they do it. Instead of controlling inputs, the focus is now on outcomes and outputs.

This accountability regime is based on ministries specifying the results they expect of their agencies and the agencies then reporting to the ministries on the results that they have achieved. The application of this accountability regime has, however, encountered problems. This is widely acknowledged in Sweden. Some of the problems are to be expected when any new system is being introduced and will be overcome as more experience is gained. Many of the problems, however, have an institutional aspect to them which relate primarily to the management capacity of ministries. The previous section noted that ministries had very little

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Box 7. **Financial Management Ratings for Agencies**

Agencies are required to report monthly on their use of appropriations which is monitored by the respective ministries. Information on the use of appropriations for the current year is reported to Parliament in the Spring Fiscal Policy Bill and in the Budget Bill. The agencies prepare half-yearly financial statements on accrual-basis which are audited.

In addition, the National Audit Office has recently implemented a system of financial management ratings for agencies. Their objective is to assess the financial management standards in agencies on a systematic basis. Each agency is assigned a rating of A (fully satisfactory), B (satisfactory), or C (not satisfactory) for each of two elements of their financial management practices. The first one can be described as a "consolidated" rating. One of the key bases for this rating is whether the agency exceeded its appropriations. The second rating can be described as an "internal" rating. This rating is based on an evaluation of the internal management controls in place at each agency to ensure the accuracy and completeness of all financial reporting.

The ratings for each agency are made public. This high visibility makes the ratings a powerful vehicle for exerting discipline on the financial management practices of agencies. It was clear that the agencies viewed their ratings very seriously. From the perspective of the National Audit Office, the ratings system also assists in systematically identifying areas where agencies may require more guidance and information in order to perform their financial management operations effectively.

interest in the management of agencies and that this had facilitated the increased managerial flexibility enjoyed by agencies. The flip side of this, however, is that the ministries have limited capacity for specifying the results expected of agencies and monitoring their performance – both of which are essential elements of the new accountability regime.

The information in this section focuses on *substantive* results and not *financial* results. The system of assigning financial management ratings for agencies is, however, discussed in Box 7.

5.2. S*pecifying* R*esults*

The budget document is not the primary vehicle for conveying information on the expected results of agencies. As noted previously, appropriations are not based on specific outcomes or outputs but are rather a single lump sum to cover the entire operating costs of the agency.

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The vehicle for specifying results is the Letters of Instruction (*Regleringsbrev*) which the ministries issue to each agency immediately following Parliament's approval of the budget. The Letters of Instruction symbolise the changes that have occurred in public management in Sweden. Its original purpose was to communicate to agencies specific input controls. Following the abolition of the input controls, the Letters of Instruction were "relaunched" as a vehicle to communicate to agencies the expected results of their operations in terms of outcomes and outputs.

The new accountability regime therefore calls for ministries to specify the desired results of their agencies in the Letters of Instruction. According to Ministry of Finance guidelines, their contents must include a review of how the agency's work contributes to the government's desired outcomes; a specification of objectives and targets at an operational level and how the agency is to report back on the results achieved; and specification of any special assignment that the agency is commissioned to carry out.

The new style Letters of Instruction have, however, not lived up to this expectation. The Letters of Instruction reviewed for this study revealed a great diversity in their contents. At one extreme, some Letters of Instruction were designed with a contract-like level of detail whereby specific outputs were listed in great detail and targets established for measuring the agency's performance in producing those outputs. At the other extreme, there were examples of Letters of Instruction that indicated practically no results information. They simply referred to the general objectives of the agency as stated in the legislation establishing the agency and contained no specific definitions of outputs or performance measures. In between these extremes, there were examples of Letters of Instructions whereby the ministry indicated that an agency should place special emphasis on performing a certain activity, but did not give any comprehensive directions to the agency.

Several observations can be made about the Letters of Instruction.

First, there is a belief by some that the new-style Letters of Instruction are attempting to impose a contractual approach to Swedish public management which they believe to be at odds with the traditional interchange between ministries and agencies. This relationship has up to now been characterised by dialogue, informality and flexibility; a more contractual approach, it is presumed, would have a significant and negative impact on this relationship. Although this argument was not voiced directly by many, it would appear that a number of officials have hesitations about the new system based on its implied contractual nature.

Second, some officials view the detailed output specification that is to be contained in the Letters of Instruction as an intrusion on their managerial autonomy. A number of officials voiced this concern in terms of outputs being *overspecified* and thus becoming an unreasonable interference on the management of agencies

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(which may be a valid argument); some officials, however, viewed *any* output specification as an intrusion on the management prerogatives of agencies (which cannot be considered a valid argument).

There is always a danger that one can take output specification too far and that such output controls could erode managerial flexibility in agencies no less so than the traditional input controls did. Sweden, however, would appear to be far from even approaching this problem at present. The fact that most officials are cognisant of this danger is also a source of confidence in Sweden not encountering this problem in future years. This should not be confused with the rather naïve view expressed by some that any attempts at output specification should be resisted. The current situation was described by one agency official as a "golden age" for public management; the input controls had been removed while no effective output controls had been established. This may not be a widely held view but it is dangerous nonetheless because it undermines the foundation on which today's managerial flexibility is based and will make this flexibility unsustainable in the long-term.

Third, and rather contradictory to the first two observations, the variety of detail in the Letters of Instruction described above may not in fact represent any real differences in the level of instruction provided by the ministries to their agencies. The detailed specification of outputs would appear to originate from the agencies themselves as the ministries simply would not have had the capacity to prepare them to such levels of detail. This is commented on further in the next section. The detailed Letters of Instruction therefore probably give an impression of more guidance from ministries to agencies than is really the case. The danger in the new system is that representations are being made of an accountability regime that may not necessarily hold true. This has serious implications for the long-term sustainability of the reforms.

As noted above, the relationship between ministries and agencies in Sweden has traditionally been based on informal dialogue. The relationship implied by the new style Letters of Instruction would alter that system; in fact, they would represent a culture shock if applied as thoroughly as originally envisaged. They would also involve substantial transaction costs as ministries would have to upgrade their resources significantly if they were to be able to issue detailed Letters of Instruction without relying on the agencies. The value of such an investment can be seriously questioned.

An alternative approach may be for the ministries and agencies to continue their informal dialogue but for the agencies to then submit draft Letters of Instruction to the ministries detailing what outputs they intend to produce in support of the agency's objectives as they understand those objectives to be based on the dialogue with the ministry. The ministry would review the draft Letters of Instruction

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and make any amendments before formally approving them. Formal approval by the ministry serves the purpose of providing reference marks for the review of the agency's operations. This approach would appear to only make transparent what is current practice in many cases. It would also clarify the roles of the ministries and the agencies in specifying outputs and recognise the key roles that agencies will inevitably play in such an exercise. Nonetheless, a stronger role is required for ministries in this area and this is discussed in a subsequent subsection.

5.3. *Reporting* Results

The primary vehicle for agencies to report the results of their operations is the agency's annual report. Since 1993, all agencies have been required to issue an annual report that consists not only of a financial report but also of a performance report.

According to Ministry of Finance guidelines, "the agency shall keep accounts and comment on its work performance in relation to the objectives, and in accordance with the reporting-back requirements, specified ... in the [Letters of Instruction]." Furthermore, the agency "shall comment on the performance reported and give an account of essential external and internal circumstances, such as factors in the surrounding world, organisational changes, etc., that have affected this performance. The information in the performance accounts shall cover the past three financial years and be comparable over time. In the event that it is not feasible to compile comparable three-year performance information, the agency shall comment on and justify this fact. The agency shall, in particular, comment on the performance reported in relation to the objectives of its work that the government has specified in the [Letter of Instruction] or some other decision. The particulars in the performance accounts shall be based on documented data and measuring methods."

A review of a selection of agency annual reports reveals a great diversity in their format and contents. It is obvious that agencies place significant resources into the preparation of these reports. They vary in size from small reports produced on word processors to large and glossy reports adorned with pictures and elaborate graphs. A number of agencies translate their annual reports into English. The agencies appear to take great pride in their annual reports and use them as a means of introducing their agencies to an external audience.

The structure of the annual reports generally follows a common line. The agency's director-general highlights the operations of the agency during the year in very general terms and raises the key issues faced by the agency during the year. This is then followed by a detailed review of the agency's operations which is generally segmented by work areas (outputs). Although there is a specific statement of outputs in the annual reports, the performance information is for the most part intertwined with this narrative discussion of the agencies activities. Following

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the narrative discussion, the agency's statements are then presented. They consist of an accrual-basis income statement, balance sheet, a statement of appropriations, a statement of cash-flow analysis and a statement of outputs – together with the accompanying explanatory notes.

There are two critical observations that can be made concerning the annual reports. The fundamental problem with the role of the annual report in the accountability chain is, of course, that the expected results of the agencies have not been effectively specified by the ministries. This means that there are often no, or only vague, reference marks for the accountability of agencies to be measured against. This is not really a problem of the annual reports themselves but rather of the Letters of Instruction as discussed above. Another problem, and related to there often being no clear reference marks in the Letters of Instruction, is the fact that the annual reports tend to be very voluminous. There are extreme examples of agencies presenting more than 100-page narrative review of their operations in the annual reports. In such cases, it is difficult to identify what is truly relevant and pertinent information. However, the information "overload" problem appears to be improving with time as more experience is gained by agencies in producing them. Most agree that the quality of the annual reports has shown marked improvement in each successive year.

An important factor in improving the quality of the annual reports is the fact that they are audited by the National Audit Office – both the financial report and the performance report. The auditors have issued qualified opinions on annual reports due to the poor performance information contained in them, albeit rarely. The auditors have acknowledged that the agencies are on a learning curve in preparing the performance information and as a result have been more tolerant than otherwise in auditing them. This, however, is a transitory stage and the threat of a qualified opinion should in future exert a powerful discipline on agencies in producing the reports.

On the whole, the annual reports are an effective vehicle for presenting information on the operations of the agencies. If reference marks for the expected results of the agencies are improved in the Letters of Instruction, then the annual reports are well suited to serve their function in the accountability chain.

The limited impact that the annual reports appear to have in the budget formulation phase was criticised by some agency officials. This issue was discussed in an earlier section.

5.4. *The Management Capacity of Ministries*

The capacity of ministries *vis-à-vis* their agencies has been commented on several times in this paper. This lack of management capacity has been a source of problems in the new accountability for results regime as the ministries have not

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been in a position to effectively specify the results expected of agencies, or to effectively monitor the performance of agencies, as the new accountability regime calls for. This is clearly an area where reforms are needed.

This can be achieved by either modifying the current accountability for results regime, or by fundamentally changing the respective roles of the ministries and agencies. It was suggested previously that the former approach would be more desirable. Agencies should submit draft Letters of Instruction to their ministries outlining the outputs they intend to produce, based on their previous dialogue with the ministry. The ministry would then review these outputs and amend them before formally approving them. The approved document would then serve as the reference mark for the agencies in the accountability chain. This approach builds on the current nature of the relationship between ministries and agencies, while clarifying and making more transparent the roles of each. The informal and co-operative relationship that exists between ministries and agencies is a great asset to public management in Sweden and should not be readily altered in any fundamental aspects.

Nonetheless, the role of the ministries needs to be strengthened in this area. This has been recognised in a recent directive from the Prime Minister's Office requiring ministries to meet with directors-general at least once a year to discuss management issues. The organisational structure of the ministries would appear to involve a bias against the management aspect of their work. The ministries generally have three "chief officers" working with the minister. The U*nder-secretary of* S*tate* is the highest ranking official in the ministry and is responsible for the overall operations of the ministry. This is a political position and he serves at the pleasure of the minister; the other two "chief officers" are career employees of the ministry. The P*ermanent* U*nder-secretary* is responsible for scrutinising all ministerial decisions to ensure their legal conformity. The U*nder-secretary for* L*egal* A*ffairs* is primarily concerned with the development of the ministry's legislative agenda. There is no senior position devoted to management issues. All the top functions are primarily political or legal in nature.

An official commission in Sweden has previously recommended that this anomaly be remedied by the establishment of the position of U*nder-secretary for* M*anagement*. Concurrently, the positions of P*ermanent* U*nder-secretary* and U*nder-secretary for* L*egal* A*ffairs* would be amalgamated. The creation of the position of U*nder-secretary for management* would serve to ensure that agencies submit their draft Letters of Instruction and that they be reviewed and amended as necessary by the ministry before being approved; and that agencies report on their performance in an effective and efficient manner and that this information be analysed appropriately. For example, more policy-relevant outcome information could be derived from the disparate output information supplied by agencies. This could then be used to improve the performance information presented to Parliament in the budget

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documentation. The creation of this position would also serve to ensure communication between ministries and agencies on management issues, rather than this dialogue being limited to questions of political policy and legal affairs as would appear to be the case at present. The recommendation to establish this position has not been implemented. In fact, it has met with stiff resistance from the present chief officers of ministries, presumably because they view their powers as being diluted by this new position. There would, however, appear to be clear and compelling reasons to institute this recommendation. Management issues need a stronger voice in the ministries than at present and the position of Under-secretary for Management would provide that voice at the highest levels of the ministries.

5.5. *Conclusion*

Sweden has comprehensively removed input controls but the development of an effective accountability regime based on results has been lagging. It should be noted that these problems are by no means unique to Sweden; specifying and monitoring results is a difficulty for all OECD Member countries adopting results-based accountability approaches.

The challenge facing Sweden is to establish an effective accountability regime while respecting the traditional roles of the ministries and agencies. It was suggested that this could be achieved by having agencies submit draft Letters of Instruction to their ministries while at the same time upgrading the capacity of ministries in dealing with management issues.

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Appendix I

List of Expenditure Areas

- The Swedish Political System.
- Economy and Fiscal Administration.
- Tax Administration and Collection.
- Justice.
- Foreign Policy Administration and International Co-operation.
- Defense.
- International Development Assistance.
- Immigration and Refugees.
- Health Care, Medical Care, Social Services.
- Sickness and Disability Benefits.
- Old-Age Benefits.
- Family and Children's Benefits.
- Unemployment Benefits.
- Labour Market.
- Study Support.
- Education and University Research.
- Culture, the Media, Religious Organisations, Leisure.
- Planning, Housing Supply, Construction.
- Regional Development.
- General Environment and Development.
- Energy.
- Communications.
- Agriculture, Forestry, Fisheries.
- Business Sector.
- General Grants to Municipalities.
- Interest on Debt.
- Contribution to European Union Budget.

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Voucher Programmes and their Role in Distributing Public Services

By
Martin Cave*

This paper is concerned with a number of conceptual and practical issues associated with the use of vouchers to distribute public services. Section 1 proposes a definition of vouchers and considers the position which voucher distribution occupies in the spectrum of possible mechanisms for the production and distribution of public services; this leads into a discussion of the objectives which voucher distribution might promote. Section 2 classifies the contexts in which vouchers might be applied and types of voucher systems. This permits a preliminary mapping of combinations of policy objectives and characteristics of the public service in question onto alternative forms of voucher distribution. Section 3 provides an illustrative review of the use of vouchers in the distribution of public services. Many of the examples discussed are in the field of education, where discussion of or use of vouchers is most developed, but experience of other public services is included where it is available. Section 4 contains conclusions.

1. What are Vouchers? What are they Intended to Achieve?

1.1. *Definition*

Voucher systems of distribution are defined as regimes in which individuals receive (pay for or are allocated) entitlements to a good or service which they may "cash in" at some specified set of suppliers, which then redeem them for cash or the equivalent from a funding body. Vouchers are used in the distribution of private goods and services as well as in public services. Consider, for example, arrangements whereby employers give their staffs luncheon vouchers which can be used in a variety of eating places affiliated to the scheme in question. The

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vouchers are an element in a multi-dimensional labour contract between employer and employee, and they affect other elements in the contract, notably the wage rate. In this case vouchers are given in return for some implicit consideration, such as a reduction in the wage rate: since there is no free lunch. This naturally raises the question of why that most flexible means of exchange of all – cash – is not used. The answer lies in terms of some special advantage inherent in the voucher form of distribution, which might be a tax break in some jurisdictions, or the opportunity for the distributor of the voucher to benefit from some price discount in purchasing services from the establishments where the vouchers can be cashed.

In public services, on the other hand, vouchers are usually distributed for nothing and paid for out of tax revenue. In other words, the goal is not to facilitate market exchange but to redistribute income or guide consumption. The inflexibility of the voucher compared with cash – deriving from the fact that it can only be cashed in certain places, and in return for certain services – is part of its *raison d'être*. The distribution of vouchers can be to everybody in a particular population or age group (universal), or confined to a sub-set ("categoric").

Vouchers traditionally have taken the form of pieces of paper authorising a named person to receive a specified service from a list of designated providers, subject to capacity constraints on the part of the provider. Designation of the recipient ensures that they are not tradable across consumers and designation of the service ensures that they are not equivalent to more fungible means of exchange such as cash. Vouchers can also, of course, take on the more modern guise of smart cards, in which entitlements and cumulative use are recorded electronically.

Vouchers operating through these media are explicit. However, implicit voucher systems are also common, as is shown by the following illustration. Suppose that the parents of a child are entitled – or required – to procure free primary or secondary education for that child, from one of a number of schools. Access to a school is gained by registering the child as a pupil. Subject to capacity constraints, schools must accept any child who registers. In a case like this, the child is a walking voucher.

There is no reason for treating such implicit cases of voucher distribution differently from explicit cases. The illustration does, however, point to a limit in the definition of voucher distribution, that there must be a margin of choice on the part of some or all consumers. This can best be understood in the context of a more general discussion of methods for the production and distribution of goods and services.

1.2. *Alternative* Resource Allocation Systems *and the* Place *of* Vouchers *in them*

The two polar opposites of mechanisms for the production and distribution of goods and services are the pure market system based upon private ownership and a totally directive system with public ownership in which all resources, inputs

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and outputs, are centrally allocated – in the case of consumption by assignment of a particular good or service to a particular individual. (It is worth mentioning that a pure market system – "market socialism" – could operate with public ownership of the means of production, to make the useful point that the decision about ownership is quite different from the choice of mechanism – market or otherwise – through which resources are distributed.)

Except for brief periods of crisis – war economies or short-lived radical experiments – no economy has sought to operate as a whole on the directive basis. Despite this, the production and distribution of non-marketed public services has been an enclave of centralised activity in economies characterised elsewhere by market mechanisms. Because it has been an enclave, the sector has been forced to purchase inputs by ordinary market methods. But the production and distribution of the services have traditionally been achieved in a directive way, in the sense that a public authority uses publicly owned capital to produce services which are then allocated to individual consumers either on a "take it or leave it' basis (medical treatment, for example) or through a system of compulsory consumption (primary and secondary education, for example). This system has often co-existed with a separate private sector where consumers buy services for cash from private suppliers or, more rarely, from public producers.

In recent decades, significant inroads have been made into this centralised system of production and distribution, and it is useful to describe them in ascending order of radicalism.

The first major change is to introduce a purchaser/provider split. This involves creating a public fund-holding agency, which purchases services from producers. Those services may still be allocated to consumers in ways which give them no element of choice: for example, each child may still be assigned to a particular school, but after the purchaser/provider split, that school (or its level of activity) is chosen by the purchaser through a competitive process. The pay-off to this separation is that an element of competition can be introduced on the production side, even if it is not accompanied by an element of choice on the consumption side. For example, the purchaser may introduce a system of competitive tendering for the production of services. If several purchasing agencies are created (in different regions, for example), they may compete in signing up providers, thus introducing competition onto both sides of the market.

This process has the potential to identify low cost providers, as high cost providers will either not get business, or – if they bid below cost – their accounts will disclose financial losses, possibly leading to restructuring or exit from the sector. Depending upon the regulatory arrangements, new providers may be allowed to come into the market, possibly relying upon private sector capital.

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Arrangements of this kind are one particular form of what is referred to as a quasi-market (le Grand and Bartlett, 1993). Competition in production is achieved, even though there is no margin of choice for consumers. A distinguishing characteristic of the voucher system is that it introduces that element of consumer choice.

The next step up the ladder of reform is thus to give consumers of the service a choice in the identity of the producer and in the nature of the service delivered. The margin of choice will define the power of the voucher system. If there were no choice – the "voucher" could only be redeemed with one supplier for the provision of a predetermined service – it would not be an authentic voucher system. Allowing a consumer to take his or her voucher to one of a range of alternative suppliers (medical practices or schools, for example) introduces an element of choice even if the range of alternatives is quite small. Producers now have not only to control their costs to maintain commercial viability, but also provide services which consumers want in order to attract their business. Beyond this fairly restrictive voucher scheme there lie a number of alternative methods of development. The range of suppliers can be extended, as noted earlier. More radically, consumers wanting a more expensive service than can be funded by the voucher may be allowed to top it up with cash. These and other alternatives are discussed further in the next section.

Table 1. **Financing and Production Mechanisms**

	Financing		
	Private	Mixed	Public
Production			
Single supplier			
Private	Monopoly privatised utilities		
Public	Monopoly public enterprises		Traditional public services
Many suppliers			
Private	Ordinary goods and services	Voucher 1	Voucher 4
Mixed		Voucher 2	Voucher 5
Public		Voucher 3	Voucher 6

Notes: Examples of voucher schemes:
Voucher 1 – Food stamps
Voucher 2 – Nursery education
Voucher 3 – Higher education
Voucher 4 – Free bus travel for concessionary groups
Voucher 5 – Youth training
Voucher 6 – School choice in public school system

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In the end, a voucher system might come to be almost indistinguishable from a system of monetary transfers. This would arise if vouchers became tradable. (A rich person could then buy, presumably, at less than face value, the education vouchers distributed to a number of poorer households, and use them to send a child to a premium school.) More plausibly, as the range of services against which any voucher could be redeemed is extended (health vouchers to cover an especially nutritious food etc.), the system gets closer and closer to a form of redistribution. Even with a system like this, there may be an element of regulation, by establishing an approved list of suppliers or a licensing regime. But this system of regulation would be little different from that which operates in the market for a number of private services, such as private schools or restaurants.

These various arrangements are illustrated in Table 1, which also identifies a number of voucher schemes discussed in Section 3 below. The table does not cover some major and relevant dimensions of allocation mechanism, such as how much pricing freedom is allowed and what are the technological and cost conditions governing production.

1.3. *Vouchers and the Objectives of Policy*

This discussion of alternative systems of distribution usefully leads on to a consideration of the goals of policy and the ways in which vouchers may help or hinder their achievement.

One goal likely to be omnipresent is *productive efficiency*. It has been argued that the traditional centralised system for the production and distribution of public services is inimical to efficiency. Simple cost efficiency might therefore be promoted by a tendering process among alternative suppliers. The evidence on this question is not unambiguous, but it tends strongly to support the notion that competition in supply reduces costs, although often at the expense of wage levels.

The second objective is *allocative efficiency*. This means ensuring that the overall structure of output and the matching of individual consumers to particular services are in the public interest. In the standard situation of well informed consumers exercising individual preferences, this objective is best achieved by allowing consumers to exercise a full degree of choice over a large range of options – leaving them to decide not only which particular good or service to buy from a given range, but also to determine their overall allocation of spending across different types of service.

In the case of public services, two serious difficulties are encountered. The first arises from lack of information: consumers may lack the knowledge to make an optimal, or even a satisfactory choice. (This is discussed in more detail in the following section.) The second difficulty arises because many public services are "merit" goods – goods where by government policy, the preferences of individuals are overridden or adjusted in order to achieve some government-determined

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level of consumption. Compulsory education is an example. Society may also be prepared to cover the costs of medical treatment for a terminally ill individual, but would not give that person a similar sum to finance a final bout of hedonistic expenditure. Both of these difficulties create challenges for wide-ranging voucher systems which give consumers a considerable margin of choice over how to cash in their vouchers.

Note also that, for this better allocation to result, producers in high demand must be prepared to adjust their supply to meet demand. If the incentives to do so are absent (as may well be the case in public sector organisations), they may respond by "cream-skimming" and "shunting"; for example, a school may choose the best students from those who apply, shunting others into inferior schools where their prospects are poorer.

The third objective is *income redistribution*. As well as promoting certain forms of consumption, governments use public services to redistribute income. As some of the case studies discussed in Section III demonstrate (notably that on nursery school vouchers), the mechanism used to distribute public services, or – more narrowly – the details of a particular voucher scheme, may have a considerable impact upon the redistribution of income which is achieved.

Finally, there is the objective of *administrative convenience*, or the reduction of *transaction costs*.

We return to these four objectives throughout this paper.

2. Types of Distribution Schemes

This section reviews in greater detail the differences among alternative ways of formulating voucher schemes and the contexts in which they operate. We begin with a discussion of three key contextual variables. This is followed by a discussion of a range of policy variables.

2.1. *Contextual Variables*

The discussion in Section I has identified competition and information as two important considerations relevant to the attainment of cost minimisation and allocative efficiency. We examine these further, together with a third consideration – the flexibility of production.

If vouchers are to have any meaning, consumers must be able to exercise an element of choice, either from services provided by a single supplier or – more significantly – from services provided by a variety of suppliers. The feasibility of such choice depends in part upon the cost characteristics of the service concerned. The least favourable case would be one in which economies of scale were such that there was minimal scope for differentiating the service, or (more precisely) the cost

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of such differentiation in terms of higher unit costs outweighs the benefits of choice. In such a "one size fits all" world, vouchers have no place, although it would be theoretically possible for the purchaser to organise a competitive system for determining which firm would become the monopoly supplier in a particular area.

Even if service differentiation were possible, a monopoly supplier would have little incentive to produce a range of services adapted to the different needs or preferences of its consumers. Such indifference to customers' preferences can be widely observed in the area of marketed services, particularly those provided by monopoly utilities.

This implies that, for consumers to be able to use their vouchers in a way which creates incentives for suppliers to meet their needs, some degree of competition is necessary. The problem is that most public services have to be provided near to where consumers live. The risk of local monopoly is therefore very considerable, as can readily be seen from both the education and health sectors. And monopoly restricts consumer sovereignty.

The issue then becomes a classic one of industrial economics: how many competitors are enough? There is no general answer to this question, even though many economists might be prepared to say, under duress, that two is rarely enough, whilst five or six might normally be so.

The second contextual element concerns the degree of information available to the consumer. In the extreme case of a consumer with no information at all about the nature of the service provided by alternative providers, a voucher is of no value. Such consumers will simply cash in their vouchers randomly. At the opposite extreme, a consumer with full information would be able to make a rational choice. More complicated circumstances arise where a customer (say a child) has lots of information, whereas the voucher is spent by the customer's agent (say a parent).

In the case of most public services, the truth will lie somewhere in between. Part of the problem is that most public services are not so-called *search goods*, with the characteristic that an individual can find out everything about the service before making a choice. More realistically they are *experience goods*, where the consumer only finds out about the service in the course of experiencing it. They may even be *credence goods*, with the characteristic that, even after consumption, the consumer does not fully comprehend what benefits he or she has received. Where experience goods are consumed repeatedly, the problem of lack of information is unimportant. However, many public services are not consumed repeatedly (emergency operations), or it is costly to switch (schools).

In practice, consumers of public services are likely to find themselves in a position where they can readily seek out information about some of the attributes of the service (the visiting hours of a hospital, or the curriculum taught in a school,

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for example) but cannot acquire full information about others. Some of their problems can be mitigated by providing further and better information. For example, schools can be obliged to disclose their examination results, and comparative data can be supplied for similarly situated institutions. Hospitals can be obliged to furnish similar information. Nonetheless, to the extent that information about the attributes of a public service is incomplete, the choice provided by vouchers will fail to achieve an optimal matching between consumer and service. However, this is not the relevant yardstick for comparison. A more appropriate one is the allocation which would be achieved without the introduction of vouchers.

The third dimension concerns the flexibility with which suppliers can vary their output or (relatedly) the degree of excess capacity in the system. Ideally, consumers would be able to cash in their vouchers with their first choice supplier. In practice, however, this is not likely to be the case as the most favoured supplier will have, at least in the short term, capacity constraints. Where capacity constraints exist, a selection process is necessary, and the remark on cream-skimming above is relevant.

2.2. *Administrative Features of Voucher Systems*

Most of these have already been noted, but are discussed here more fully.

2.2.1. *Which Suppliers are Entitled to Redeem Received Vouchers from Consumers?*

This key issue determines the extent of competition among suppliers. Restrictions could take various forms based upon ownership (can private sector organisation provide the service?), location (is there a geographical restriction?), regulation (has the supplier been inspected and found to be satisfactory?), and so on. (On the first issue, see Hansmann, 1996.)

2.2.2. *Can the Voucher be Supplemented by Other Payments?*

Preventing vouchers from being topped up represents a serious restriction on choice, and has a major impact on the distributional consequences of the system, as Figure 1 demonstrates. It shows the expenditure options available to two households before and after the introduction of alternative voucher schemes. Before any scheme is introduced, household 1 can split its expenditure between purchases of a public service and other expenditure by choosing any point on A_1 B_1. The poor household 2 has options on line A_2 B_2. A voucher scheme is then introduced. Supposing that both households receive a voucher (financed from another source) entitling them to amount A_1 C_1 (or A_2 C_2) of the public service free of charge. They can then top up their consumption of the public service by using other income. The options available to each household are then, respectively, A_1 C_1 D_1 and A_2 C_2 D_2. If household 1, previously consuming at F_1 now chooses G_1, the voucher has simply enhanced its income and imposed a burden on the public finances.

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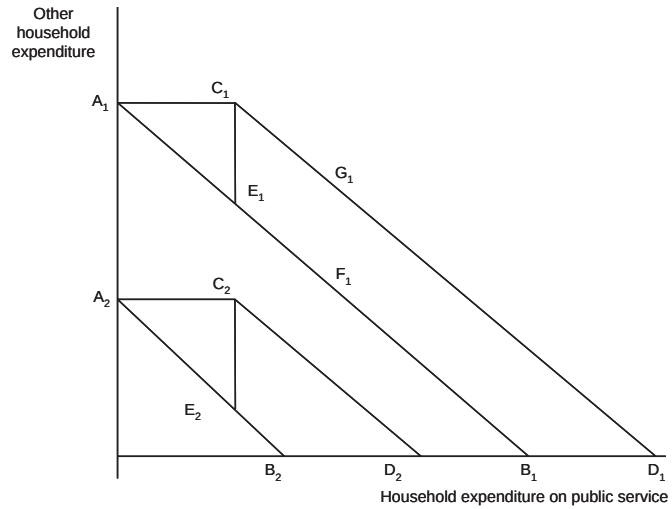
Figure 1. **Impact of vouchers, with and without top-ups, on income distribution**



Now suppose, alternatively, that the household wishing to consume more of the public service than is allocated under the voucher must pay out of its income for the whole amount consumed, and not just the excess. In that case, the expenditure option now available to the household are, respectively, A_1 C_1 E_1 B_1 and A_2 C_2 E_2 B_2. Thus, if household 1 chooses to opt out of the public provision financed by the voucher, it loses the benefit of public subsidy. Hence the redistributive effects of any voucher scheme depend crucially upon whether topping up is allowed.

To summarise this analysis, a voucher distribution system in which no top-ups are allowed redistributes income against those households which opt out of the basic provision. Secondly, introducing top-up vouchers where expenditure is correlated with income benefits rich households without necessarily changing their consumption patterns.

2.2.3. *Do All Consumers Receive a Voucher to the Same Value?*

To the extent that public services are funded out of taxation, they already embody an element of income redistribution, whether a voucher distribution system is used or not. That redistributive element can, however, be enhanced by further measures. For example, the monetary value of a voucher can be made subject to income taxation, which will work to the disadvantage of those with relatively high marginal tax

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rates. Or vouchers of higher value can be distributed to particular groups in society, for example those with low family incomes or suffering from a disability of some sort.

2.2.4. *How Are Shortages Coped With?*

If consumers' choices cannot be accommodated because of capacity constraints, an allocation process has to be employed. This could be "first come, first served", or a random allocation, or appeal can be made to some other criterion. This might simply be proximity to the point of supply, or the allocation could be on the basis of need, with, for example, patients with the most complex medical conditions being entitled to use their vouchers preferentially at the best equipped medical facility. But as rationing expands, the element of consumer choice diminishes and voucher distribution loses its force.

2.2.5. *Are There Tight Restrictions on What the Voucher Can be Spent on?*

Some voucher systems restrict the type of service on which the voucher can be cashed. For example, a primary education voucher might only be redeemable by an organisation providing a very tightly defined educational curriculum. Alternatively, individuals might receive vouchers which could be spent much more flexibly. For example, 18-year olds might receive a voucher entitling them to receive up to the equivalent of X months full-time training or tuition, which they could cash in at any time in their working lives with a variety of suppliers.

This discussion enables us to identify in a preliminary way circumstances which are likely to help and to hinder the attainment of the objectives noted in Section 1 by voucher distribution. Productive efficiency will, other things being equal, be promoted by a competitive framework with multiple suppliers. And, the form of voucher provision chosen can accentuate the redistributive impact of the system of financing public services.

The most interesting result, however, relate to the attainment of allocative efficiency. The discussion above enables us to identify factors which assist and factors which restrict an efficient allocation of public services to consumers (assuming their preferences count for something):

Factors which promote the exercise of choice:

- Many Suppliers.
- Service Differentiation.
- Absence of rationing/capacity constraints.
- Good information about services available.
- Each voucher can be cashed against a range of services.
- Top-up payments generate choice of quality.

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Factors impeding the exercise of consumer choice under a voucher system:

- Few Suppliers.
- Little variation in service type.
- Significant levels of rationing/capacity constraints.
- Poor information about service quality.
- Tight restrictions on the services which the voucher can fund.
- Prohibition of top-up payments.

3. Vouchers In Practice

This section gives an account of a number of experiences or proposals for the use of vouchers in the distribution of public services. Following the analysis of the previous two sections, it focuses upon:

- The objectives of the public service in question.
- Characteristics of production (economies of scale, etc.).
- The balance of public/private provision at the starting point of the voucher proposal.
- The extent of information problems restricting the application of consumer choice.
- The characteristics of the voucher system proposed.
- The effects, if the proposal were put into operation.

3.1. *Vouchers for* Nursery Education

The availability of pre-school child care places has been a major pre-condition for increases in female labour force participation. In the United Kingdom (as elsewhere) such care is provided in a variety of forms, either formally or informally (Duncan and Giles, 1996). Where child care is paid for, there is also a substantial variation in price. Nursery schools and local authority nurseries are either free at point of use or have very low fees, whereas other forms, such as child minding, have a substantial average cost per hour. (For a discussion of the US case, see Leibowitz, 1996.)

There are also considerable differences in the hours of care provided under the different modes. In the United Kingdom, local authority nurseries and playgroups typically provide 10 hours of child care a week and nursery schools 20 hours. The average for child minding is 30 hours. Together with the observation that hours of child minding are positively related with the hours worked weekly by mothers, this creates a relationship whereby the hourly child care price for providing up to 20 weekly hours is constant, while the hourly price then rises sharply as the number of weekly hours exceeds 20. Objectives for subsidised child care fall

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into two categories – market failure and redistribution (this section draws heavily on Duncan and Giles, 1996). The market failure arguments fall into three strands:

i) E*xternalities*. This involves the controversial argument that non-parental child care or nursery education provides children with a better start than solely parental care. It is thus part of an argument widely applied to education that some or all of the benefit is of a public rather than a private nature, in the sense that individuals who are better socialised and/or more competent can benefit the whole of society, in addition to the benefits which they derive themselves, either through higher wages in the labour market or through more satisfying personal lives.

ii) I*nformation failures*. The argument here is that families fail to perceive the financial losses which they incur as the result of career breaks, and hence underestimate the decline in national output of which those financial losses are a reflection.

iii) C*apital market imperfections*. If the above argument is correct, then families may have to borrow from the capital market in order to finance the child care which permits them to maintain continuity of employment. Yet the capital market may not be up to the challenge, partly because of the difficulty of providing security for the loan.

In the case of the second and third argument, there appear to be other ways of correcting the market failure than providing a subsidy. Information campaigns and guaranteed loans might deal directly with the information and capital market problems. The first argument based upon an externality does, however, provide a better foundation for a subsidy.

The argument based on redistribution can be made in various ways, relating to the parent, the child, or both. If child care does provide a head start for children, then there may be a distributional ground for subsidising it, to ensure that all children start off on level terms, with an equal chance of earning higher wages and achieving higher positions in the social hierarchy. A separate argument applies in relation to the parents. Since it is the mother who typically has a career break in order to look after a child, women are subject to a systematic disadvantage, which child care can redress. To the extent that many households are headed by a single mother, subsidies may also prevent the transmission of disadvantage from one generation to the next.

As far as the supply of nursery education is concerned, a variety of public and private sector providers are in place although households in rural areas may have limited choice (Sparkes and West, 1998). The kind of economies of scale observed in educational institutions where specialised teaching takes place are not present. Moreover, users are likely to place a high premium on locational convenience. The

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prospects for having a number of alternative suppliers seem good except in the most sparsely populated areas.

In 1996, the UK Parliament passed a Nursery Education and Grant Maintained Schools Act, which created the basis for phase I of a nursery education voucher scheme which started in four local authority areas in April 1996. The aims of the scheme were to:

i) Increase provision so that all four year olds whose parents wanted it could have three terms of pre-school education before compulsory school age.

ii) To ensure that all the places were of good quality.

- To improve parental choice by building on the present diversity of pre-school provision in the maintained, private and voluntary sectors. (Department for Education and Employment, DfEE, 1996*a*.)

Under Phase I of the scheme, parents could apply for vouchers worth £1 100 covering three terms of nursery school education with a registered provider. Possible providers included private schools, privately run play groups, and state schools or day nurseries.

Providers had to confirm that they would work towards desirable learning outcomes for four year olds recommended by the School Curriculum and Assessment Authority; private and voluntary providers had to agree to their educational provision being inspected by nursery education inspectors, appointed and trained by the Office for Standards in Education (OFSTED) and to agree to publish certain information about their educational provision (DfEE, 1997*a* and *b*).

Private or voluntary providers could require an additional monetary payment from parents, but there would be no user charges in the public sector. If a state school redeemed a voucher, the previous funding which it received would be reduced pound for pound up to the value of the voucher, so that it was no better off if pupil numbers remained unchanged. But it would benefit from new money to the extent that it attracted additional four year olds or extended the amount of pre-school provision received. There is evidence of such so-called "voucher maximising" behaviour by local authorities (Sparkes and West, 1998)

The scheme came into operation nation-wide in April 1997. However, following the accession to power of a new government in May 1997, it was abandoned with effect from March 1998. The strategic principles for early years school provision adopted by the new government include the target of providing a good quality place by April 1999 free of charge for all four year olds whose parents want it, and an intention to extend that entitlement to three year olds over time. Local provision would be planned through the establishment of an Early Years Forum representing a wide range of interests. Local education authorities would have responsibility for securing places in partnership with private and voluntary sector

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and with employers. Plans must take account of parental choice, and where places combine education and day care, parents can be asked to contribute to the cost of day care. Parents would not be required to pay additional fees for education, but can opt to do so.

It appears at this early stage that the new plans involve a considerably greater role on the part of local education authorities in shaping provision. But some features of the former arrangements are maintained – the continued availability of subsidies for public and private or voluntary provision, a continued opportunity for parents to exercise choice and the maintenance of opportunities to top up the subsidy. What seems to be at stake is not elimination of the voucher scheme but, in the terminology developed above, the replacement of an explicit voucher scheme involving considerable choice with an implicit scheme involving more co-ordination of provision.

Because the initial voucher scheme was quickly abandoned, there are limited opportunities to evaluate its effects. However, even before the scheme came into operation, it was possible to anticipate some of its distributional consequences. If we assume that, in the short-term, the supply of child care places and their prices are fixed, then the effects of the scheme are largely restricted to subsidising existing purchases of private child care services. Duncan and Giles (1996) show that the distribution of expenditure on child care is heavily skewed in favour of families with a four year old enjoying higher net incomes. The implied annual gain from the government voucher scheme for the highest quantile of such families is £350, while the gain for the lowest quantile is less than £25. Its redistributional effects were thus regressive – a result (as noted in Section II) which one would expect to see whenever vouchers are used to subsidise private provision which had previously been wholly unsubsidised and used predominantly by better-off households. In the medium term, we would expect some impact of the scheme on labour supply: this might be positive in some cases but (because of the income effect) negative in others. Private providers of child care might also raise their prices and capture some of the benefits of the subsidy.

Duncan and Giles also show that alternative measures involving the targeting of subsidies would be more effective in achieving redistributional objectives. This could be done through the tax regime, for example by allowing recipients of certain benefits to deduct a proportion of child care from their income before it was means tested, or by means-testing the vouchers.

3.2. *Primary and Secondary Schooling*

The use of vouchers for compulsory primary and secondary schooling has attracted more interest than any other illustration (see Johnes, 1993). There is general agreement on the necessity for some kind of publicly funded provision of this

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service, the justification being both on distributional grounds (to allow children of poorer households access to highly paid or high status occupations) and on efficiency grounds (in the light of the general recognition that basic education is both necessary for individuals to play a role in political and social life and a powerful engine of economic development). Most school systems are based predominantly on public schooling free at the point of use, often accompanied by a private sector in which differential fees are charged. Publicly funded schooling is typically supplied directly by the state sector (for example, a municipality or local authority), although funding is sometimes channelled through a third party, such as a voluntary organisation or religious group.

The matching of students to schools takes place through mechanisms which involve different degrees of parental or student choice. This can vary from a "no choice" assignment based usually on geography, through the expression of preferences for places which then feed into an allocation of students to a given supply of places, to a higher level of choice, in which demand is catered for through the appropriate expansion or contraction of providers. These last two cases are an implicit voucher system, with a limitation of providers to a specified set of institutions and no opportunity for top-up.

An early and very influential case in favour of education vouchers was made in 1955 by Milton Friedman (see Friedman, 1962). He introduced the then unfamiliar notion that publicly-funded education did not necessarily have to be publicly provided. He recognised that primary and secondary schooling have high "public benefit" components and that, because not all households are able to finance their children's education, there is a case for the selective issuance of vouchers to defray some or all of the costs, combined with compulsory attendance rules. Competitive provision would promote both efficiency and innovative schooling practices, and there was an independent merit in relying upon decentralised rather than collective decision-making because the latter tends to strain social cohesion.

He further argued that it was wrong to claim that vouchers would exacerbate class distinctions, because few households then lived in a small town environment with a single high school which virtually all students attended. He claimed that "... stratification of residential areas effectively restricts the intermingling of children from decidedly different backgrounds. In addition, parents are not now prevented from sending their children to private schools. Only a highly limited class can or does do so, parochial schools aside, thus producing further stratification". (*Ibid.*)

While Friedman's ideas were taken up by many conservative thinkers on both sides of the Atlantic, in the US support for vouchers also extended to the liberal tradition. Notably, Christopher Jencks (1966) argued that the excessive bureaucratisation and poor incentives of a unitary public school system bore with particular severity upon the quality of schooling achieved by children in low income areas,

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particularly in a city environment. He believed that these problems could be redressed by a voucher system for which private providers were eligible. Other contributors to this debate, on the other hand, argued that the public school system was redeemable and favoured an "internal" voucher which could only be used within the public school system (Fantani, 1973). More recent work by Chubb and Moe (1990) has reiterated the argument based upon the baleful effects of a centralised bureaucracy.

A combination of value judgements and empirical claims underpin these debates. Thus, there is debate about the extent to which fragmentation of students into groups receiving different forms of education in different locations has an adverse effect upon social cohesion. There are also debates about the extent to which a market system would reduce the cost of bureaucracy and the degree to which competition creates incentives to reduce wasteful expenditure, meet students needs and promote innovation.

As emphasised in Section 2 above, the extent of parents' information becomes a key issue in forming a judgement about the likely implication of greater school choice. An important point here is that it is not necessary for all parents to be well informed for schools to have an incentive to improve performance: a knowledgeable minority can confer benefits on others as well, by raising the average level of performance. However, each parent has to be well informed to match his or her child to the best alternative available.

To a greater extent than is the case in nursery education, economies of scale may limit competition in sparsely populated areas. But it is likely that most urban and suburban dwellers could have a significant element of choice, although the impact of the voucher scheme will depend to some extent upon what transport costs are considered acceptable.

In jurisdictions where decisions about school spending are made locally, and where like-minded households congregate in areas offering preferred combinations of tax levels and local public goods, the issue arises of how the level of voucher payments should be chosen when they can be redeemed outside the area where the child lives. The problem is to prevent households in low-cost school areas redeeming inexpensive vouchers at schools in high-cost areas and thus free-riding on the higher taxes paid there (Manski, 1992; Hoxby, 1996).

We now consider a number of case studies of school choice, dealing first with explicit voucher schemes and then with implicit schemes which extend parental choice without the introduction of a formal voucher. One key point (illustrated in Figure 1) is the introduction of a universal (not means-tested) voucher scheme in an environment where there is a significant element of private and unsubsidised education will involve a considerable dead weight cost to the public finances through the extension of subsidies to households which were already paying for

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private education. Because both the UK and the USA have significant private providers for primary and secondary education, the arrangements described below do not extend to private sector providers, with the exception of the Milwaukee scheme, in which participation is capped.

3.2.1. *An Explicit School Voucher Scheme*

A scheme of this type has operated in Milwaukee, Wisconsin, since 1990 (Lamdin and Mintram, 1997). Eligible students (those with a family income up to 175% of the poverty line) are entitled to opt out of the normal public schools system and attend private schools in the city, which must satisfy certain criteria relating to standards and the absence of religious members. If schools are over-subscribed, selection is made randomly. No more than 1% of the students in the school system may enrol in the choice programme in any one year, and such students may not account for more than 49% of those attending any school. In 1996/97 private schools received $4 373 from the state for each choice student, an amount equal to the state aid per student in the public school system. However, average spending per student in the public school system is much higher than that figure, because it incorporates revenues from other sources as well.

An evaluation carried out by the Witte (1996) examined five outcome measures. In achievement test results, Witte found no statistically significant difference between choice students and a matched sample of others. Attendance in choice school was better, the rate of parental contact with them higher, and levels of satisfaction reported by parents were also higher than within the Milwaukee public school system.

This study is of particular interest because it involves private schools, but its restriction to 1% of the school district population ensured that its fiscal impact was not substantial.

3.2.2. *Implicit School Choice Schemes*

Three experiments intended to enhance school choice within US public schools, and a major educational reform within the UK directed at widening school choice are dealt with here.

The first, inspired by Jencks and colleagues, operated in Alum Rock, California in the 1970s. Parents in voucher school attendance areas were allowed to choose among several "mini schools", or alternative educational programmes organised within schools. During the five years of the experiment the number of such programmes increased from 22 in six schools to 51 in 14 schools. Free transport was provided to non-neighbourhood schools, and a lottery was used to allocate places to oversubscribed programmes. Non-voucher school areas were treated as controls.

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The effects on student attainment were ambiguous. There is some evidence that reading scores for the voucher students declined, both compared with the projection of their previous performance and with the scores of students in non-voucher schools while another study concluded that maths scores improved (Rouse, 1997). Other facets of performance such as absence rates shows an improvement.

The second of the US experiments took place within District 4 of East Harlem in New York (Chubb and Moe, 1990). In 1972, the district contained 22 schools, but during the late 70's and 80's about thirty alternative schools were developed. After 1982, all families had to choose a school. The enhanced choice has been reported as being followed by higher scores in mathematics and reading and the schools concerned seem to have enjoyed greater levels of parental involvement than elsewhere.

A much larger experiment of choice within public schools was made by Minnesota, which in 1987 introduced a state-wide plan allowing students to attend any school district, subject to space limitations and other legal restrictions (Lamdin and Mintrom, 1997). Unfortunately, there has been no overall evaluation of the results. Some research concluded that minority students and their families use school choice at the same rate as white students and their families. Districts losing large numbers of students were more likely than districts that had few losses to take steps to attract new students and to discourage existing ones from leaving.

In the UK, a major series of educational reforms carried out from the late 70's to the late 80's brought major changes to the school system in England and Wales, including the creation of new types of secondary schools and new programmes (Bartlett, 1993; West and Pennell, 1997).

The 1988 Education Reform Act also introduced substantial financial delegation to schools. The key implication of this was that most of the funding followed the student according to a centrally determined formula. This was combined with measures to promote open enrolment. The Government decided that all maintained schools should accept students up to the level of their physical capacity. Popular schools would expand as a result of parental demand, and schools were put in direct competition with one another for students.

At the same time, the legislation required local education authorities (LEAs) and schools to publish information about their arrangements for admissions, including the criteria on which allocation decisions would be made if the school were oversubscribed. LEAs and schools are also required to publish examination results, and these are collated and published annually by the Department for Education and Employment, in the form of performance or league tables.

An evaluation of the reforms by West and Pannell (1997) notes that the simultaneous introduction of a National Curriculum for Primary and Secondary Education has limited the extent to which school choice has increased diversity. They also

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conclude that "the evidence does not support the view that there has been a significant increase in choice for parents. There is no clear evidence that parents are now more successful in obtaining a place for their child at their first choice school. Indeed, in areas where the quasi-market is most developed, parents may find it more difficult to obtain a place in their local school" (*Ibid.*). They do find, however, evidence of cream skimming and the development of school hierarchies. Because of a number of simultaneous changes in the system, it is not possible to establish the extent to which the enhanced school choice is responsible for the observed increase in overall educational standards.

This selective account of experience with voucher schemes and school choice programmes shows no clear trends. Enhanced choice in specially targeted schemes seems to lead to greater parental involvement, and some parents are prepared to put considerable effort into the process of selecting schools for their children. In universal schemes, there is evidence of cream-skimming and shunting. Even where trials have been conducted, difficulties with experimental design have made it difficult to draw any firm conclusions concerning the effect of the scheme on educational attainment.

One aspect of voucher and school choice schemes which has attracted attention is their cost implications. Levin and Driver (1997) have estimated the additional costs associated with record keeping and monitoring, transport and adjudication which might arise as a result of the introduction of hypothetical voucher plans. (They also consider the public funding costs of providing vouchers for students currently educated in private schools, but we neglect those here.) They estimate the cost of record keeping and monitoring as being equivalent to 1% of total public expenditure on schools, the cost of transport at 16% and the cost of information and adjudication as 1.3%. Clearly extra transport costs dwarf administration costs, which are small, and consideration of any voucher schemes will have to address this question.

3.3. *Vouchers for* Post-compulsory Education *and* Training

Because of its non-compulsory nature, education and training offered after the school leaving age creates an opportunity for a market allocation system to operate with less regulatory input. The variety of possible forms of provision also create a basis for the exercise of consumer choice. Such choice might have two effects (Coopers and Lybrand, 1995):

i) It would provide producers with an incentive to offer a better quality service, geared to customers' needs, in order to attract business.

ii) It would compel students to think more carefully about the kind of educational training they wanted; having thus been empowered, they may be more committed to whatever programme they undertake.

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The name given in the UK to a voucher system of this kind is Learning Credits (DfEE, 1996*b*). Its predecessor, Youth Credits, was introduced as a pilot scheme in ten areas in England and Wales in 1991, and an evaluation of that scheme (Croxford *et al.*, 1996) found no evidence that the availability of credits encouraged young people to leave full time education at 16. The pilots also demonstrated that credits increased the proportion combining training with employment, for example – employed-status trainees. This was consistent with the aim of making youth training more employment-based. Youth Credits also increased the proportion of young people in work who received government-supported training, although this was largely at the expense of other training. The tentative conclusion of the assessment was that the impact of the pilots in their first year of operation was more qualitative than quantitative. They did not increase overall participation in training, but steered trainees towards employment-based and government-supported training.

In 1996, the government announced its intention to introduce from September 1997 a new Learning Credit entitling all young people aged 14-21 to have access to learning opportunities at levels up to but excluding first degree or equivalent. In particular, all 16-year olds would be entitled to a Learning Credit which entitles them to embark up to the age of 21 upon post- compulsory education or training suitable to their needs (excluding higher education qualifications) and to impartial advice in making best use of their credits.

The form of the voucher is a simple plastic card issued to eligible students. Those students can then cash in their credits with a variety of local providers, including secondary schools, further education sector colleges, employers and other work-based training providers.

It is too early to say whether the Learning Credits programme will achieve its objectives. Of particular interest is the claim that the degree of empowerment which this scheme offers promotes a higher level of commitment to whatever programme of education or training is chosen.

3.4. *Vouchers for Higher Education*

The massive extension of higher education in most OECD Member countries has imposed severe strains on traditional European funding arrangements, which have often been based upon selective implicit voucher systems, with free tuition for students with specified qualifications or for all those selected by higher education institutions (HEIs). As a result, there is a tendency to move away from universal free or highly subsidised tuition in favour of arrangements whereby students, their families or employers make contributions to fees. This can be justified by the relatively high private rates of return which students earn on first degrees. The evidence that higher education generates an externality, and therefore should be

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regarded as a public good qualifying for public funding, is weaker than in the case of primary and secondary education.

At the same time, it is recognised that some students from poorer backgrounds may face capital constraints in borrowing money to finance higher education. Some governments have addressed this question by offering subsidised loans, which may be repaid on an income contingent basis: a graduate with lower earning will be allowed to repay more slowly, and hence benefit more from any interest rate subsidies. An alternative approach is to offer some kind of means-tested benefit, which might take the form of selective distribution of vouchers. Thus one dimension of the voucher debate in higher education concerns the way in which they can be utilised to achieve a government's distributional goals.

The second dimension of vouchers particularly relevant to higher education concerns the degree to which the supply of places is student driven (*i.e.* responsive to student demand) or determined by HEIs, funding bodies or the government. This major distinction can be elucidated by a schematic account of higher education reform in the United Kingdom.

Initially, HEIs received a block grant, in return for which they provided degree programmes, to a considerable extent at their own discretion. In the 1980's, the Government made the obligations on HEIs in receipt of a block grant more explicit, and also introduced elements of competitive tendering into the process of allocating the block grant. This generated a form of quasi-market in which the quantity of places provided by the funding bodies was subject to competitive tendering by universities, while students had to match themselves to the places available. As a result, some institutions and some subjects were oversubscribed, while some were undersubscribed (Cave, Dodsworth and Thompson, 1992).

A full voucher system, in which students could take their funding to any institution with the will and the capacity to accept them, would represent a major reform to this system. It would mean that the structure of places available would, with a lag for supply adjustments, be determined by student demand, rather than by decisions of the funder. Some programmes and some institutions would prosper, while others would wither.

A voucher system of this kind could be configured in various ways. It could be confined to public HEIs, or vouchers could also be cashed in at private institutions. The scheme could permit top-up fees to be paid in addition to the voucher, or such fees could be excluded and a uniform charge imposed. Vouchers could be extended to cover maintenance as well as tuition, and, as noted above, they could be means-tested.

So far, governments have not generally embraced pure student-demand driven voucher systems for higher education. Thus, although the UK government introduced a degree of supply-side competition in the 1980s, when public funding

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for higher education was stabilised in the early '90s, that element of competition was largely eliminated. The current UK Government's policies for reform of higher education include a continuation of the block grant, rather than a student-driven method for allocating funding, with a prohibition on HEIs charging top-up fees. The new student contribution to the tuition fee is, however, means-tested. If constraints on enrolment are relaxed, that will introduce greater incentives and prospects for particular institutions to expand with corresponding contraction on others.

A report of a committee of enquiry into higher education established by the UK Government (the Dearing report) contrasted the block grant and demand-led systems as follows:

- The main advantage of a block grant approach, at least in the short term, is the certainty it offers on the level of public expenditure on higher education which would be incurred in each year. As this approach gives the funding bodies the power of being monopoly purchasers – 'monopsonists' – it puts them in a powerful position to push down the cost of higher education, which they can do more effectively than individual student purchasers could. A block grant approach, depending on how it is operated, can offer institutions a degree of stability in their funding. It also gives the funding bodies a strong lever to ensure the maintenance of quality and standard. It empowers the funding bodies to promote particular types of study differentially.
- By contrast, in a model in which public funding follows students' choices, those choices determine the shape of the system and institutions are encouraged to respond in order to maintain or increase recruitment and income.
- The main potential disadvantages of [this] approach are that:
  - the government has no ready means of controlling public expenditure on higher education within a financial year;
  - the individual student will not be as powerful a purchaser as a central funding body, which may reduce the pressure on institutions to be as cost effective as possible;
  - the individual student may not be well informed enough to make good decisions, and in particular may be unable to avoid poor quality on a standard offering. (NCIHE, 1997.)

After noting that alternative methods exist to control public expenditure under the demand-led system, the Committee concluded that the best way forward is by a gradual but steady progress towards more public funding flowing with the students. It therefore recommended a target of distributing at least 60% of total public funding to institutions according to student choice by 2003.

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Higher education is a relatively fertile ground for the application of explicit or implicit voucher schemes. The sector is relatively competitive. The scope for informed choice is at least as great as in other sectors of education. The public element in the benefits of higher education is judged to be smaller than in education at earlier stages, and the capacity which selective distribution of vouchers has to achieve distributional objectives is a major advantage. Finally, if it is considered desirable to have a diverse system of higher education, permitting cost differences from one provider to another, then top up fees, combined with vouchers, can offer students a range of price and quality options, while continuing to maintain a uniform level of subsidy per eligible student.

3.5. *Further Areas for the Application of* Vouchers

3.5.1. *Food Stamps*

Food Stamps are a kind of voucher, as they entitle the recipient to spend the stamps on any of a range of permitted foodstuffs in any authorised outlet. Since all households purchase food, there is a greater risk of the development of a secondary market in food stamps, and measures are usually taken to outlaw trafficking in the stamps. This is considered particularly necessary, since one of the stated objectives of food stamp programmes is to ensure that the recipient households use their increased spending power on food rather than – as it is feared might occur if distribution were in cash – choose to purchase less favoured goods such as alcohol or narcotics.

A further refinement which food stamps programmes bring to the analysis of vouchers is that they can be, and are, made available for purchase at a subsidised price rather than distributed free. The degree of subsidy can be varied depending upon such factors as the household income, but, whatever the level of subsidy, the household is restricted to spending stamps on food, unless they break the rules concerning tradability.

Economists' analysis of food stamp programmes has generally been unfavourable. Part of this is due to the opposition to paternalism implicit in the schemes – the requirement that the subsidy be spent on food rather than on other uses. But this ignores the problem of persons with poor life or budget management skills. In addition, many analyses of food stamp programmes in the United States have explained the programmes as a manifestation of political power of the agricultural lobby, rather than as an attempt to redistribute income (Stiglitz, 1988).

3.5.2. *Social Housing*

In many countries, housing subsidies are channelled through publicly financed accommodation which is made available at subsidised rents to households

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qualifying on the basis of their individual circumstances. Both access to such public housing and, in some cases, the rents charged for it are means-tested. This system is clearly a possible candidate for replacement by a voucher distribution regime, in which individual or households receive a means-tested voucher which they can spend on a wider range of housing including public housing, housing owned and operated by not-for-profit organisations such as housing associations, private rented property or owner-occupied housing.

To the extent that information problems associated with housing are likely to be relatively small, a voucher system of this kind has the capacity to be both equitable and efficient. Subsidies are not confined to those in public housing, and individuals can exercise choice over where they live. Subject to planning constraints and other regulatory intervention such as rent control, housing is a fairly competitive market with free entry.

In practice, however, there are likely to be continuing advantages associated with particular forms of ownership. For historical reasons, rents charged for public housing may be lower than those in the free market and, for the reasons given above, there may be considerable inflexibility in increasing supply.

For this reason, housing benefit in the United Kingdom is currently based on the payment of actual costs to qualified persons, in the form either of rents or mortgage payments, rather than some means-tested standard amount (Bramley, 1993). This has a predictably adverse effect on incentives to keep costs down, and has to be accompanied by restrictions on the type of accommodation to which individuals or households are entitled. Public expenditure on housing benefit is also directly linked to prices in the housing market. (For a comparison of UK housing benefits with systems operating in Germany and France, see Evans, 1996.)

3.5.3. *Social Care*

Social care includes a range of services provided to individuals, such as the disabled or the elderly. It may be provided in the individual's home, or in a residential home. The qualification for the care may depend upon both means-testing and other criteria, such as disability (Garber, 1996; Glennerster, 1996*b*; Hoyes and Means, 1993).

The traditional way for providing social care is through direct allocation. Thus, a disabled person may receive regular visits from a carer who will assist in domestic activities, or an elderly person may be admitted to a publicly-owned residential home. To the extent that individuals or their family can select from a range of such homes in a particular area, this represents a "categoric" implicit voucher system.

It would, however, clearly be possible to introduce an explicit voucher system, at least for certain types of social care. This might be particularly suitable where the care service is provided from a number of possible sources, public and

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private. An arrangement of this kind was tried in the UK, where the Independent Living Fund was set up in 1988 to provide cash payments to severely disabled people to enable them to assemble their own package of care, subject to the restriction that the money had to be spent on certain categories of services.

4. Conclusions

This paper has focused upon three aspects of voucher distribution for public services: the objectives of the distribution system – notably allocative efficiency and redistribution (Section 1); types of voucher system and their appropriateness to public services with different characteristics (Section 2); and actual or possible areas for the application of vouchers (Section 3).

Table 2 brings these elements together, by examining the characteristics of seven public services and the probable or most frequently proposed system of voucher distribution for them, based to a large degree on UK experience. Some brief comments on each follow.

In the case of *pre-school nursery education*, customers are likely to be demanding a great variety of services, which are often provided on a small scale and open to fairly effective inspection by the purchaser. The aim is likely to be provision of a basic level of service for all who want it. Because of price variations and an inheritance of public and private providers, it is hard to prohibit top-up fees. High pre-existing levels of privately financed consumption are likely to cause a newly introduced voucher scheme to have considerable dead weight costs to public finances resulting from the replacement of private finance by public finance, unless they are means-tested.

P*rimary and secondary education* are universal and compulsory, and exhibit a significant externality. Except in sparsely populated areas, competition is practicable, but a centrally determined curriculum may limit the scope for product differentiation. Governments show an understandable reluctance to fund expensive and exclusive private schools. This makes implicit voucher schemes such as school choice a natural solution, but, to give more consumers a real choice, it is essential to ensure flexibility on the supply side; otherwise, "superior" schools will skim the cream, inequities will increase, and many households will be unable to exercise choice.

The variety of possible forms of *training* in the period after compulsory education make it a natural area for universal voucher distribution. Since much training of this kind is employer- provided, it is impossible to prevent top-up payments in the form of wages for trainees on certain courses. Top-up payments for non-employer-provided training can, however, be eliminated.

Vouchers in *higher education* can be run on the school choice model. There are, however, no obvious impediments to more flexible schemes involving possibly

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Table 2. **Probable characteristics of vouchers in a range of services**

	Nursery education	Primary/ Secondary schooling	Training/ Lifetime learning	Higher education	Food stamps	Social housing	Social/ Long-term care
Principal objectives	Merit good, redistribution	Merit good, redistribution	Merit good, redistribution	Merit good	Redistribution	Redistribution	Redistribution
Scope for competition	Good	Variable	Good	Good	Good	Good	Good
Extent of information problems	Low	Moderate	Moderate	Moderate	Low	Low	Moderate
Initial structure of provision	Public/Private	Predominantly public	Public/Private	Predominantly public	Private	Public/Private	Public/Private
Extent of differentiation	High	Moderate	High	Moderate	Low	High	High
Voucher likely to be universal (u) or categoric (c)	u or c	u	u	c	c	c	u or c
Voucher means-tested	Probably	Possibly	Unlikely	Possibly	Yes	Yes	Probably
Private suppliers can redeem vouchers	Probably	Probably not	Yes	Possibly	Yes	Yes	Yes
Top-up fees (or equivalent) chargeable	Yes	No	Probably	Possibly	Yes	Yes	Yes

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loan-financed top-up fees, with price differentiated by institution and by subject, and a mix of private and public providers.

F*ood stamps* are included to illustrate a voucher scheme with private sector providers only. In its US manifestation, it redistributes income flexibly by having the stamps available for sale to households at different prices, depending upon their means. The illustration also raises questions about the appropriateness of directing consumption in a paternalistic fashion in this way, rather than making cash payments.

Finally, *social housing and social care* have a variety of public and private sector providers and customers with heterogeneous tastes. In both cases, subsidies are likely to be selectively available, on the basis of income or needs.

This evaluation shows that vouchers have considerable flexibility as instruments for the allocation of public services. They can be universally available or be used for services which are means tested or restricted in other ways. Their redistributional implications can further be adjusted by permitting or prohibiting top-ups and their capacity to extend choice to the area of public services creates good opportunities for improvements in allocative efficiency, except in cases where the beneficiaries lack sufficient information to make a sensible choice. There is tentative evidence of vouchers promoting commitment on the part of the customer. At the same time, some governments are concerned that voucher systems tend to work against the objective of co-ordinating provision as they encourage suppliers to focus on their own, rather than service-wide issues. These characteristics make vouchers a powerful instrument in public service reforms with both positive and negative consequences.

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Greater Independence for Fiscal Institutions

By
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1. Introduction

This paper seeks to outline the thinking behind a proposal contained in a recently released discussion paper by the Business Council of Australia (BCA). The BCA is Australia's leading business body. It comprises the chief executive officers of most of Australia's largest companies. The BCA's paper was entitled *Avoiding boom/bust: macroeconomic reform for a globalised economy* (1999). A major section of the paper was devoted to exploring the idea of "re-engineering" fiscal policy.

The proposal was to re-engineer fiscal policy institutions to make them more like monetary policy institutions. To this end, it was proposed that there be legislated some capacity to adjust tax rates across-the-board at short notice and without further reference to the legislature. Further, it was proposed that there be an independent body with a degree of control or influence over the new instrument of tax adjustment which was analogous to the control which a central bank has over the conduct of monetary policy.

The current paper is structured as follows. The next section explores some of the central characteristics of economic reform, and the way in which they have been manifest in fiscal reform in the recent past. The following section explores the central problems of fiscal policy – implementation lags and the drift to deficits. Section 4 explores the attraction of monetary policy institutions for conducting macroeconomic policy. Section 5 explores the reforms which might address the existing problems with fiscal policy. They take us closer to the monetary policy model. Section 6 illustrates what a fully articulated model of fiscal policy in the image of monetary policy might look like and what issues would need to be addressed in establishing it. The final section offers some concluding speculations and observations.

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The paper is intended to broadly reflect an OECD perspective. Nevertheless, examples are taken particularly, though not exclusively, from the Australian experience.

2. Fiscal Policy and the Characteristics of Economic Reform

An important theme of economic reform in the last two decades has been ensuring that decisions are made by the appropriate actors in the economy.

Where official trade barriers once influenced the way in which the private sector allocated its resources, today such decisions are made within a much more competitive market framework with firms deciding where they can make the highest return from the deployment of their resources.

This approach, initially at the heart of the GATT (General Agreement on Tariffs and Trade) and trade liberalisation in the post-war era, has been generalised further in recent decades with considerable attention being given to improving the competitiveness of domestic markets with competition policy and the corporatisation and/or privatisation of agencies which previously enjoyed statutory monopolies.

Other decisions – for example, who to tax and how much, how much to spend and what to spend it on – remain, and will always remain, with government. Where government retains a role in macroeconomic decision-making processes, there is a constant need to ensure that the institutions making these decisions are best placed and structured to carry out their desired functions.

To this end, economic reform the world over has been about adapting government institutions and re-specifying their objectives. Like every other country, Australia's reform path has sometimes been frustrating. But in a comparative sense, Australia has been an exemplar of reform in the developed countries and the rewards of past efforts have been becoming progressively more apparent over the last five years.

Two of Australia's greatest successes have come about not through the establishment of new institutions, but rather through the evolution of existing institutions.

Thus, the Productivity Commission, which has a wide remit to provide objective advice to governments on microeconomic reform across the whole economy, began as a much more circumscribed body – the Tariff Board. This body has had its charter progressively expanded since the mid-1970s when it became the Industries Assistance Commission, and later the Industry Commission.

Likewise the Reserve Bank (central bank) has seen its objectives, functions and independence evolve over time. In the case of both the Tariff Board and the Bank, a degree of independence was provided for in Acts of Parliament which took many decades to mature into real independence.

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Australia's fiscal policy institutions have also evolved. Great strides have been made to promote fiscal transparency. Much more systematic use is now made of forward estimates of both revenue and outlays in the budget process. Reconciliation tables are published detailing where and why budget targets have not been met. And the budget reporting of the states has been harmonised and integrated into the National Fiscal Outlook.

Increased fiscal transparency has also now been embodied in Australia's Charter of Budget Honesty, which requires regular publication of information on the progress of fiscal policy and the fiscal outlook, including "generational" accounts to be published at least every five years. Australian Government accounts are now kept on an accruals rather than a cash-basis.

These have been considerable achievements, placing Australia at the forefront of developed countries in fiscal policy management (see *e.g.* OECD, 2001; IMF, 1999). Improved fiscal transparency has played its part in restoring Australia to more prudent fiscal policy in the last few years.

3. Modern Fiscal Management: Current Problems and Issues

Given current institutional arrangements, the normal play of democratic politics has several unfortunate effects on fiscal policy. An understanding of those problems can help us chart the short to medium-term reform priorities, and it can help us develop a vision of where we should be heading over the long-term. In this section, we explore the problems with the subsequent three sections exploring the reform agenda which the analysis suggests.

3.1. *The Problem of Fiscal Drift*

Fiscal policy changes can be unduly influenced by the electoral cycle. Thus, governments tend to feel more secure tightening policy early in a parliamentary term and loosening it towards the end of the term. Sometimes this will meet the needs of the economic cycle. But if this is the case, it will be by accident. Usually it will not.

In addition, there appears to be a bias towards fiscal expansion. This is borne out both by common-sense and by experience. As the Governor of Australia's Reserve Bank (then Deputy Governor) Ian Macfarlane commented in 1996:

> *It is easy, and usually popular, to introduce a new benefit or to make an existing one more widely available. But it is difficult to remove existing entitlements because it is always politically unpopular, and there may be large human costs as a result of dependency. This gives a bias towards increasing current expenditure and future levels of taxation, a bias that is readily apparent from the experience of all* OECD [*Member*] *countries over the past* 30 *years* (*Reserve Bank Bulletin, June* 1996).

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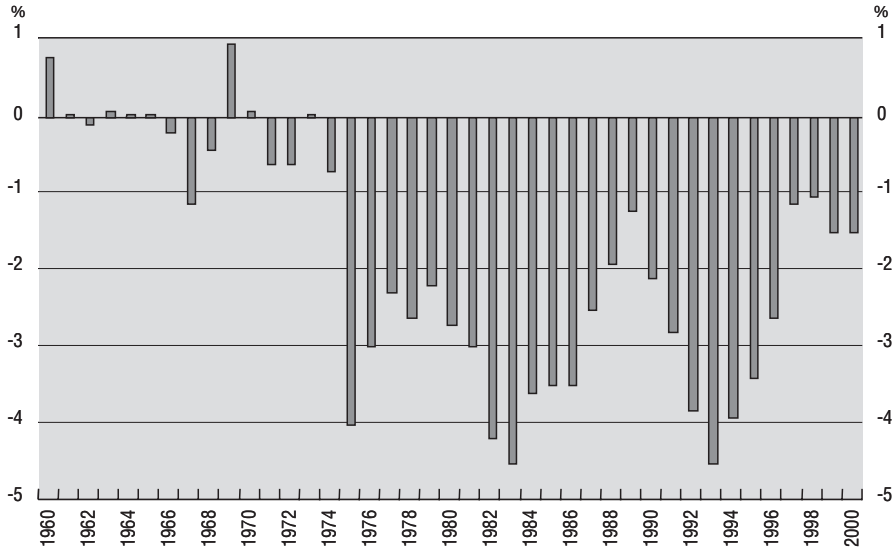
Figure 1. **OECD general government financial balance (% of GDP)**



Source: OECD.

Indeed, as the size of government has risen over the last generation, a "funding gap" has emerged. Governments have been keener to spend than to tax.

Only in the last few years has the Australian Government moved vigorously to bridge this funding gap. In the 1990s, there were more than six years of strong and steady growth before the budget was moved into surplus. While Australian business congratulated the government on the very substantial political achievement of restoring the budget to surplus, it is not being unkind to observe that with nine years of strong economic expansion under its belt, Australia should by now be doing better. One of the main reasons it has not done better has been the pressure exerted on the government by the Australian Senate where it does not enjoy a majority.

Even given the attention to fiscal consolidation in America, Europe and the antipodes, it seems likely that fiscal consolidation is unlikely to get much beyond balancing the budget (in years of good growth) before competition in the political marketplace drives any surplus back towards break even.

If this is right, fiscal policy is condemned, as Sisyphus was, to the constant frustration of trying to roll the stone to the top of the hill, from which it rolls back

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down to the bottom again. Whenever there is a recession or a degree of economic sluggishness, we will continue to run substantial deficits, with balanced budgets or small surpluses in the good years. But the balanced budgets and surpluses will be inadequate to "reload the fiscal cannon" fully for the next downturn to use the expression of Larry Summers, the US Secretary of the Treasury. This is certainly what happened in Australia and several other OECD Member countries in the 1980s.

As we have all discovered in the last two decades, a world like this is in some ways a world turned upside-down. Where markets have become accustomed to fiscal drift, fiscal expansion can drive monetary contraction. As deficits grow, governments make progressively greater demands on the market for debt, and any further fiscal expansion leads markets to expect growing demands to be made into the future.

As a consequence, fiscal expansion is balanced or even outweighed by the monetary contraction implicit in rising bond yields and falling currencies. And *vice versa*. As we have seen in Australia on several occasions, where governments which have consistently run deficits have shown the backbone to repair their fiscal affairs, the market confidence which such action engenders is sufficient to offset or indeed to substantially outweigh the contractionary effect on the fiscal side. This is exactly what we would expect if loose fiscal policy were not to be an eternal free lunch – or what Australians would call a "magic pudding".

But this is a perverse, second-best world. Proper management of fiscal affairs would see an escape from it. And the path of institutional evolution which is proposed in this paper would provide us not only with the tools to escape this world, but with the best possible tools to rehabilitate the role of fiscal policy in making a contribution to helping tame the economic cycle.

3.2. *Fiscal Transparency Legislation*

Best practice fiscal transparency legislation such as New Zealand's Fiscal Responsibility Act or Australia's Charter of Budget Honesty require regular reporting of the fiscal outlook, including at election time. This mobilises the power of transparency to reduce the scope for short-term political influences to derail fiscal policy. Clause 9(1)(*f*) of Australia's Charter of Budget Honesty also seeks to impose a discipline on temporary fiscal expansion to ensure that it is in fact temporary. It requires governments to "specify fiscal policy actions taken or to be taken… that are temporary in nature, adopted for the purpose of moderating cyclical fluctuations in economic activity, and indicate the process for their reversal."

Nevertheless, fiscal transparency has only limited appeal as a constraint on democratic politics. As Ruth Richardson, a former Minister of Finance in New Zealand, has conceded (1994), New Zealand's fiscal responsibility legislation "places an onus on the government to be explicit about its fiscal strategy, but is neutral as to what that fiscal stance might be".

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Most, if not all, of the most substantial fiscal blow-outs in recent history were not concealed from the public as they were occurring. The fiscal deterioration in OECD economies since the mid-1970s was widely reported at the time. Far from going unreported, the dramatic Reagan fiscal expansion in the United States was a major topic of policy debate and discussion throughout the years during which it occurred. In other words, fiscal transparency legislation may help, but there are likely to be times in the future when it is not sufficient.

3.3. *Lags in the Implementation of Fiscal Policy Changes*

There is another critical problem with fiscal policy institutions as they are currently constituted. Where economic developments suggest that the stance of fiscal policy should be changed, change is very difficult to bring about quickly.

This is even the case for fiscal expansion. Tax cuts, for instance, will generally take some months to pass through a legislature. Except on simple transfer programmes, spending changes also take time to organise. Indeed, of the discretionary fiscal expansions implemented as a response to recession in post-war United States, none were finally enacted before the recession they were intended to address had technically ended (Keech, 1995). This was also true of the fiscal stimulus applied in Australia in 1992.

But these problems of fiscal expansion – the implementation lag – pale into insignificance compared with what might be called the "consolidation lag". If a fiscal expansion is warranted, it can often be agreed upon and implemented within a few months. But if such an expansion was intended to be temporary, reversing it is usually not so easy because it is not so popular. Thus, the tendency to fiscal drift discussed above. Anticipation of such fiscal drift lies behind the market's usually quite rational anxiety about fiscal expansion, and also lies behind the opposition to fiscal pump priming by finance ministries in many countries.

4. Some Lessons From Monetary Policy

Before proceeding to explore some possible remedies to the problems of fiscal policy, it is worth considering how these problems appear to be much better dealt with by the institutions of monetary policy.

The differences in the policy environment are as follows. Firstly, monetary authorities – central banks – have a greater level of independence from governments of the day than departments of state that work to ministers. Once appointed, the governor of a central bank cannot easily be removed. There will often be a strong expectation and tradition of collaboration between the central bank and the government of the day. (This is at least the case in Australia). Nevertheless, the bank does not discharge its duty to the public interest through its service to the government of the day, but

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Box 1. **How Independent Should a Central Bank Be?**

It is a matter of some controversy as to how much independence is the right amount. Australia's Reserve Bank (RBA) sets the stance of monetary policy but can be overruled by the government providing this is done publicly. Certainly the Australian model of "independence with collaboration" has worked reasonably well in the recent past notwithstanding the inevitable tensions. While much policy discussion has tended to assume that "more independence is better than less", there are potential advantages in a half-way house.

What tension exists between the government of the day and the central bank can be a dynamic one with strong mutual benefits. In Australia, although there can be public differences of view between government and the Bank, the government's ability to overrule the Bank tends to ultimately have the effect of co-opting it into basic support for the Bank's monetary policy. And by the same token, it draws the Bank into attempting to manage monetary policy in a way which takes account of the political circumstances of the day. The power to publicly overrule the Bank has never been used.

In a very thoughtful contribution to the debate, the Secretary of the Australian Treasury, Mr. Ted Evans, offers this defence of an independence which is forged in collaboration.

> *While it would be expected that board members be apolitical – in the party-political sense – it would equally be expected that they have political abilities*: i.e. *that they be adept at assessing facts and taking policy decisions in the national interest. This, together with the requirement of integrity, is the basis of selecting board members.*
>
> *This latter point appears to have been lost on some who see it as a weakness that the* RBA *board is not comprised solely of experts in monetary matters. I think it is fair to say that, at least at this stage of Australia's economic development, monetary policy has become independent partly because the bank board is not so comprised.*

Source: Evans, 2000.

rather more directly as it were, through carrying out the functions and duties prescribed in its own act.

Secondly, the institution is not just independent to be itself and provide advice, but also to play an important role in implementing policy. Arrangements differ between countries, but all OECD central banks have a critical – sometimes essentially exclusive – role to play in managing the stance of monetary policy.

A third and critical difference between monetary and fiscal policy is the speed with which action can be taken. The normal lead time in the case of monetary policy is the month or so between board meetings, although of course there is nothing to stop

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boards from doing as they have sometimes done in the past and either holding extraordinary meetings or delegating the power to the governor between meetings. So, in principle, there is nothing to stop action within hours of forming the intent to act.

This combination of greater independence and timeliness has underscored the attractions of using monetary policy as the principle means of "leaning against the wind" of the economic cycle.

The contrast between the credibility of the Central Bank compared with that of the government is well illustrated by comparing examples of discretionary macroeconomic expansion in Australia in the 1990s. The fiscal expansion of early-1992 was accompanied by bond market nervousness with constant skittishness leading up to the government's announcement in February.

Market commentary suggested that, the fiscal stimulus was pushing up interest rates. In the event, the stimulus was kept to a very modest one-half of one per cent of GDP. When the markets did show their nervousness during this period, the yield curve shifted upwards over its entire length, suggesting a market perception that any fiscal expansion was unlikely to be temporary. In the event, the market was proven right, with fiscal consolidation having to wait until a change of government over four years later.

Contrast this with the monetary policy expansion announced by the Reserve Bank of Australia in 1996. In each case, other things being equal, policy easing could be expected to stimulate growth and so, to some extent inflation. In such circumstances, one would expect markets to price this into long-term bond yields.

In fact, when the Reserve Bank announced its first easing for some time in mid 1996, long bond yields fell by approximately half a per cent in the week of the announcement, falling by 25 basis points on the day of the easing. The Reserve Bank had sufficient credibility in mid-1996 to ease monetary policy without exacerbating inflationary expectations. Indeed, the markets indicated they had greater faith in the Reserve Bank than in their own perceptions before the easings. The Reserve Bank's easing was taken as evidence that there was room in the economy for this to occur – that is more room than the markets had expected. As the Reserve Bank eased policy, long-term bond yields – a measure of expected inflation into the future – actually fell (see Figure 2).[1]

As Alan Blinder, former Vice-chairman of America's Federal Reserve, has commented, such a model of flexibility and independence is worthy of development in policy areas other than monetary policy management – and Blinder puts forward the model of tax policy (Blinder, 1997). At about the same time, both American and Australian economists were proposing a concrete model of how one might re-engineer the institutions of fiscal policy along the lines of monetary policy (Ball, 1996; Gruen, 1997; see also Box 2).

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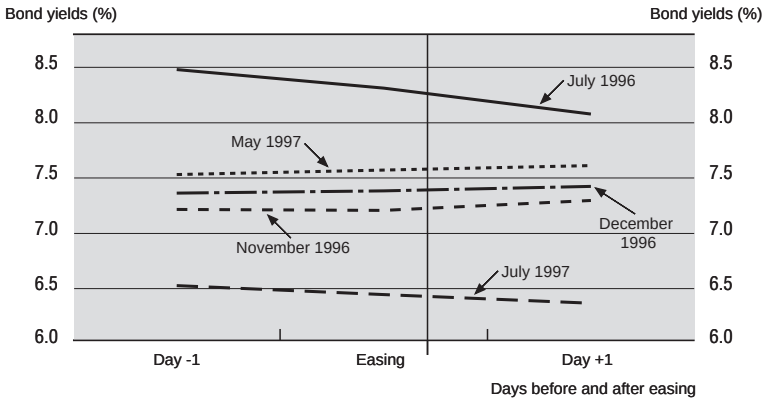
Figure 2. **Ten year bonds and monetary easings (1996-97)**



Source: Reserve Bank of Australia.

To skip directly to propose such a model, however, might give the appearance that the proponents want to bring forth a "brave new world"; one which is naïve about the political realities of bringing it about, or indeed about the differing histories and philosophies attaching to monetary and fiscal policy. The attraction of these ideas lies precisely in the direction in which they offer to further develop existing trends in the contemporary evolution of fiscal policy.

Accordingly, the next section explores the way fiscal policy might evolve in such a way as to move closer towards the institutional model of monetary policy. While some of the steps would take more courage than others, none seem without precedent of one kind or another. As the precedents indicate, none seems politically impossible, and some steps are positively inviting for either governments or oppositions seeking to demonstrate the responsibility necessary to be taken seriously as an alternative government.

And having charted the kind of moves which might be made on the road to greater fiscal responsibility and responsiveness, we can speculate in the following section on what fiscal policy might look like as such an evolution matured.

5. Towards More Fiscal Flexibility and Independence

5.1. *Extending Fiscal Transparency – Developing the Institutions of Fiscal Independence*

The first and perhaps most obvious way of beginning to address the problems raised would be to further enhance fiscal transparency by furthering the

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independence of our fiscal institutions. Of course, most OECD Member countries already have one very important fiscal institution which has strong independence from executive government – the Auditors-General.

The independence accorded such agencies is the foundation upon which they provide assurance for fiscal policy in terms of "micro-integrity" – the integrity of individual transactions, agencies and policies.

Of course, simply identifying this as "micro-integrity" draws attention to the similar importance of "macro-integrity" – the integrity of the aggregate financial accounts and projections. If we think "macro-integrity" is of a similar order of importance as "micro-integrity", there is a case for developing institutions with a similar degree of independence as those which provide "micro-integrity" assurances. In most countries, the lead agency for delivering macro-integrity has the status of a department of state (ministry).

While the traditions of independence differ, in most OECD Member countries politicians can, at the very least "lean" on the senior officials. This compromises the extent to which they can operate as guardians of the integrity of politicians. In the United States, the Congressional Budget Office prepares a complete set of fiscal and economic forecasts for Congress to be considered alongside those provided by the Executive.

Where such institutions do not exist, it is possible that existing interests within a government or its agencies would resist such a development. Nevertheless, this is the kind of thing which has already attracted one Opposition – that of the Opposition in the State of Victoria in Australia. Oppositions are frequently assailed with the cry "where's the money coming from". So, providing they do intend to be fiscally responsible, it suits them to publicly constrain themselves by promising enhanced and independent fiscal macro-integrity measures.

Having promised to do so as Opposition at the last elections, they have now done this, as the new government, by extending the existing role of the Auditor-General from reporting on micro-integrity to reporting on macro-integrity. This kind of approach provides the platform for developing fiscal institutions which have greater independence from the Executive than a traditional department of state (ministry). And it does so in a way which has been repeatedly successful in Australia – by developing further the role of an already well respected institution.

The points made in this section are very much in sympathy with the themes which emerge from recent work from both the OECD (2001) and the IMF (1999) on the importance of integrity in ensuring budgetary transparency.

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5.2. *Developing the Instruments*

5.2.1. *Minimising Lags and Broadening the Base of Fiscal Policy*

How then can we address the problem of implementation lags? And in doing so, should we focus on the tax or the outlays side of the ledger?

In the budgets of many OECD Member countries, there are opportunities for fiscal consolidation in reducing spending, particularly on transfer payments to those who do not need them and in further extending "user pays" principles. But, however, promising such areas may be on occasions when fiscal consolidation is necessary, or in the long run battle to keep taxes as low as possible, there are strict limits to the extent to which they provide a systematic foundation for ongoing and timely adjustments to the stance of fiscal policy.[2]

As Professor Lawrence Ball summarises:

> *Fiscal policy can mean changes in taxes or changes in government spending. For purposes of macroeconomic stabilization, I think changes in taxes are best. Decisions about government spending should be determined by long-run, microeconomic considerations – by whether the benefits of public projects are worth the costs* (1996).[3]

We will return to this issue below, but let us proceed with Ball's assumption for the moment. We may also note that, at least in principle, the more broadly based the tax changes, the lower the costs they will impose on the economy. The broader the base over which taxes change, the less any given change in the fiscal stance will impose deadweight costs and tax uncertainty upon the economy. This suggests across-the-board tax changes.

There are, of course, clear precedents for the use of tax changes as a major plank in fiscal policy. Certainly in many OECD Member countries, in the economic golden age of the 1950s and 1960s, tax driven fiscal policy changes were a common place instrument of macroeconomic management with "horror" budgets to tighten policy and "give away" budgets to ease.

The use of fiscal policy as one of the arms of macroeconomic policy has waned in the last two decades. In Australia, such measures became less and less politically feasible for two reasons. Economically, they became more problematic as we failed to "reload the fiscal cannon" during periods of growth. This meant that fiscal expansion could only occur at the cost of gradually rising national debts, a policy which fortunately became progressively less acceptable.

The poor growth, chronic deficits and concomitant increases in government debt during the period threw the policy focus on fiscal consolidation, prudence and medium term consolidation and structural reform – even while the economy was not performing strongly.

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Secondly, the conservative dominance of the Australian Senate from the late 1940s to the mid-1970s gave way in the late-1970s to a situation where no government could command a sympathetic majority in the Senate. This had clear implications for the extent to which a government could rely on flexibility in its handling of fiscal policy.

Nevertheless, in the 1960s, the idea of developing fiscal policy institutions to enable more rapid policy response to emerging developments was both talked about and implemented. President John F. Kennedy asked Congress for the right to cut taxes at short notice to facilitate rapid discretionary fiscal expansion to enable a rapid response if an economic slowdown developed in the future. We might smile today that the problem is not so much to ease fiscal policy rapidly as it is to enable fiscal consolidation when appropriate although that was much less of a problem at the time he sought the power.

While President Kennedy was unsuccessful in his quest, the United Kingdom in the 1960s developed the kind of institutional infrastructure which takes us half way towards the monetary policy model of fiscal policy. Parliament delegated to the Executive the authority to adjust indirect taxes up and down without further reference to it.

It would not be easy, indeed it would probably be impossible, to introduce such a system into our fiscal policy decision-making quickly. Politicians promising such a reform could be vulnerable at the next election because it would be easy to portray the reform as an executive grab for power and something which makes tax increases easier. For this reason, the most opportune time to begin to make progress would be when taxes were being cut in any event. This tends to happen every few years in most OECD Member countries as governments return the proceeds of "fiscal drag", economic growth and any spending restraint they have achieved to the electorate as tax cuts.

In such circumstances, it would be possible for a government to cut personal tax rates by an amount it considers to be well within the bounds required by prudence. At the same, time it could offer further tax cuts that are deliberately offered as a variable "buffer" and earmarked to be implemented and/or taken away as appropriate.

Another circumstance in which progress might be made would be a situation where a temporary fiscal stimulus was considered appropriate, as was the case in Australia in 1992. Any action in these circumstances could be improved if concurrent measures were taken to entrench community and market expectations that this easing was temporary. The kinds of arrangements explored here, and in the next section, could provide the appropriate institutional framework for such policies.

Another way of making progress would be long-term targeting. In Australia, superannuation (pensions) has been massively expanded through the 1980s and 1990s with the adoption by government of a long-term target of 12% of salaries going into superannuation. They are not there yet, but despite a change of govern-

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Box 2. **Professor Lawrence Ball on Inflation, Monetary and Fiscal Policy**

Today, policy makers control inflation by shifting interest rates and exchange rates. Under my proposal [with an independent fiscal authority], they would also shift taxes or government spending. This would improve things for two reasons.

First, fiscal policy affects the economy more quickly than monetary policy. Using fiscal policy would allow policy makers to offset macroeconomic shocks with a shorter time lag. As a result, both inflation and output would be more stable.

Monetary policy is notorious for the "long and variable lags" in its effects, to use Milton Friedman's famous phrase. We can understand these lags by reviewing the channels through which policy affects the economy. When the Reserve Bank (central bank) raises interest rates, firms delay or cancel investment projects, and consumers buy fewer houses and cars. And higher interest rates lead to higher exchange rates. A higher exchange rate makes domestic goods more expensive relative to foreign goods, reducing net exports. Lower spending on investment and exports eventually drags down overall spending in the economy, and inflation slows.

Higher interest rates and exchange rates are always successful, eventually, at bringing down inflation. But this process can take a long time. Economists are not sure exactly how long it takes for monetary policy to affect spending. But a rough estimate is a year. It will take even longer for inflation to fall, because it takes time for lower spending to convince firms to moderate their price increases. This process may take another year.

There are some lags in the effects of fiscal policy. In particular, while fiscal policy affects spending quickly, there is still the lag between changes in spending and changes in inflation. But, overall, fiscal policy can control inflation more quickly than monetary policy. If policy makers used their fiscal tools, they would not need to forecast as far ahead, and they would make fewer mistakes. And mistakes could be corrected more quickly.

Shorter time lags are the first major advantage of using fiscal policy as a macroeconomic tool. There is a second advantage which is equally important. Monetary policy is an awkward tool not only because it works slowly, but also because its effects are spread unevenly across the economy. The entire economy benefits from the Reserve Bank's policy of controlling inflation. But the costs of this policy fall disproportionately on certain sectors. With more active fiscal policy, the costs would be shared more equally.

Source: Ball, 1996.

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Box 3. **Tax Cuts and Medium-term Goal Setting**

In releasing the recent New Zealand Budget, the New Zealand Government announced that it intended to cut taxes in the future. However, it did not specify the precise cost or nature of those tax cuts because they were intended to be delivered more than two years in the future.

The government announced instead its intention to "assess the scope for further tax reductions" in the light of a range of considerations. It indicated that it would be prepared to fund the tax cuts from reduced spending on new policy initiatives, ongoing savings, tax rationalisation and "reductions in projected operating surpluses, *if subsequent fiscal projections indicate larger operating surpluses in the medium term and more rapid progress towards the net debt objective*".

Such a commitment is not unlike the mechanism being proposed above, namely the announcement of tax cuts which are contingent upon certain circumstances being met which ensure their appropriateness.

Source: New Zealand Treasury.

ment, superannuation has recently risen from 6 to 7% and is on track to rise to 9% within the next few years. Targets like this cannot guarantee undisturbed progress, but they can help focus the community and the political process on longer term economic and institutional goals.

In its discussion paper, the BCA floated the idea of having a fiscal buffer of 0.5% of GDP by 2005 and 1% by 2010. This would create fiscal flexibility but would not of itself increase the degree of fiscal independence. Fiscal independence might actually make the flexibility more attractive. Thus, the public might be more disposed to understand small movements in their tax rates (as they do with – even relatively large – changes in interest rates) if they are seen to be strongly influenced by an independent and expert body.

5.2.2. *Addressing Fiscal Drift*

Finally, we need some mechanism to deal with the bias towards fiscal drift. Here the lessons from monetary policy seem compelling. In democratic countries, monetary policy and fiscal policy are subject to almost identical problems of political economy. Both can be managed to generate short-run gains, with those gains generating long-run costs. Where monetary policy is too loose, subsequent generations of voters lose by having to bear the costs of inflation – and/or the more concentrated costs of reducing inflation. Imprudent fiscal policy can also impose

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inflation on future generations of voters but it also lowers government net worth (increasing net liabilities). This reduces future growth. In short, both instruments involve remarkably similar trade-offs.

Contemporary monetary policy institutions provide some counterweight to the political process. It should be possible to increase the influence of independent policy-makers in fiscal policy in a gradual and evolutionary way which builds on existing traditions and developments. The example of the State Government of Victoria in Australia has already been cited. If the government had control of some instrument such as those canvassed in the previous section, as the Government of the United Kingdom did in the 1970s, it would be possible to build the advice of an independent fiscal agency into the management of the instrument.

In the first instance, the independent agency might simply be free to, and/or required to, give the government advice on the use of the instrument. A further level of constraint would be the requirement that the advice to the government be made public. This requirement to receive public advice approximates the level of independence in the area of tariff setting in Australia. There, the relevant act requires that advice be received from an independent agency – originally the Tariff Board now the Productivity Commission – before tariff rates can be changed. The particular provision goes all the way back to the Tariff Board Act of the 1920s, although it took until the late 1960s for a courageous chairman of the Board to begin acting with the independence which lay dormant within the Board's charter.[4]

It would take time and debate to get to this stage. It seems ultimately worthwhile to proceed further towards the monetary policy model. How far is of course a matter of opinion. But the extent of formal independence in Australia might be a good place to aim for in the medium-term. Here the independent body, the Reserve Bank of Australia, is responsible for the conduct of monetary policy, but consults closely with the government. More importantly, the government has ultimate power to overrule it, providing it makes public the instrument with which it overrules the bank. As has been suggested, this offers a way of inducing engagement and collaboration between the government and the Bank.

5.3. *The Importance of Credibility*

Of course, as the independence of fiscal policy increased, policy would enjoy the benefits of increased credibility with the markets. In a world of free capital flows, credibility has become a fundamental precondition of policy effectiveness.

Today, budget deficits undermine market confidence. Markets take a dim view of fiscal laxity long before governments actually encounter difficulty meeting their financial obligations. This is because – not unreasonably given the history of

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the last few decades – fiscal laxity today is often taken as evidence that fiscal irresponsibility is becoming endemic in the political system itself.

6. What Would a Fully Evolved Model Look Like?

The previous section has outlined ways in which existing fiscal policy institutions in OECD Member countries might evolve in the direction of the monetary policy model. A wide range of questions remain, and this section sketches out possible answers to those questions, although it does so in a tentative fashion. The distance we are trying to look into the future calls for humility. And as we make the journey, we will gain more practical insights than are available today.

6.1. *Coverage of* Fiscal Discretion

What taxes should change and what would be the mechanism for their change? The BCA has proposed that the relevant instrument should be income taxes – both personal and corporate. The mechanism floated was a "fiscal parameter" which would work as follows. Imagine for the sake of illustration that all personal income above a threshold and all corporate income is taxed at 30%. Legislation could be passed specifying that all tax rates were now the tax rates specified in earlier taxation legislation *multiplied by a taxation parameter*.

The taxation parameter would initially be set at 1. Accordingly, there would be no immediate change in tax rates. Once such a system was established, a change in the fiscal parameter could be accommodated within a few pay-days for those paying withholding taxes on their income (pay-as-you-go; PAYE), and could be accounted for on a *prorata* basis by others in their annual returns and/or reconciliations where immediate changes were inconvenient. The following table illustrates how the system would work using a simplified indicative tax system in which all income (above a tax-free threshold in the case of income tax) was subject to a 30% rate. In Australia, moving the fiscal parameter between the .97 and 1.03 would deliver a fiscal buffer of over 1% of GDP.

Table 1. **Tax rates and the fiscal parameter**

Parameter Value	Tax rate on income below threshold (%)	Tax rate on income above threshold (%)	Company tax rate (%)
0.97	0.0	29.1	29.1
0.98	0.0	29.4	29.4
0.99	0.0	29.7	29.7
1	0.0	30.0	30.0
1.01	0.0	30.3	30.3
1.02	0.0	30.6	30.6
1.03	0.0	30.9	30.9

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It would be possible to include indirect taxes in this mix, but the BCA concluded that the disadvantages probably outweigh the advantages. The advantage is that the base over which taxes are varied is so broad that the amount they have to be changed is minimised.

On the other hand, fiscal policy tightening will generally be implemented with the intent of reducing inflation and/or inflationary expectations. In such circumstances, increases in indirect taxes raise prices in the economy and so are counterproductive in the short-run. This problem is also evident in the case of monetary policy – a fact highlighted in Australia when mortgage interest rates were included in the consumer price index. As policy is tightened, inflation rises as a result of the price effect of tightening. In both instances, this means there is an unfortunate lag between policy tightening and the desired result of reduced inflation.

There is also a problem with anticipation. If the economy were sluggish and there was speculation that indirect taxes might soon be lowered to ease policy, people would have an incentive to hold off on purchases until the anticipated tax cuts came through.[5] In fact, the tax cuts would be sufficiently small that it is unlikely they would have a big effect, but to the extent that this effect occurred it would detract from the efficacy of the instrument.[6]

Also, it is likely that small changes in the rate of indirect tax would involve higher transaction or "menu" costs than changing other taxes as all shops and other payers of indirect tax had to change their tax rates.

Likewise, whether or not corporate taxation should be subjected to short-term discretionary changes also involves trade-offs. On the one hand, it would somewhat increase financial planning uncertainty for firms. On the other hand, the marginal nature of any tax changes is surely important here. The uncertainty it would involve for firms' planning pales into insignificance against some of the other costs and prices which change for business like interest and exchange rates and input and output prices. Moreover, the contribution that more flexible and credible fiscal policy could make to stabilising the economy should outweigh any impact arising from marginal changes in company taxation. The BCA felt that there was symbolic appeal in the corporate sector being involved in the new arrangements, rather than simply recommending a new regime for the rest of the community.

Another option for introducing flexibility into personal income tax payments would be to allow the lowest marginal tax rate to vary. Such a system would maximise the macroeconomic efficacy of changes in the fiscal stance, as those on lower incomes are more liquidity constrained and so would respond more sharply to changes in their income. On the other hand, it might be perceived as unfair compared with across-the-board tax changes, as it imposes a disproportionately higher risk burden on those with lower incomes.

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A compromise between the two approaches has some appeal in Australia because the appropriate mechanism already exists and is widely perceived as a fair tax. Over a certain (low) income Australia's "Medicare Levy" functions as a flat tax (in addition to income tax) at a uniform rate on everyone's income. At a rate of 1.5%, the Levy currently raises about 0.75% of GDP. The BCA floated the idea of moving the rate between zero and 3% to create a fiscal buffer of nearly 1.5% of GDP. Coupled with some similar degree of flexibility in corporate income tax, this approach may offer the best mix of equity and administrative simplicity.

The Australian public has recently shown themselves quite understanding of small temporary Medicare style tax surcharges where they have helped fund particular and unusual spending projects for which there was broad community support. Thus, in 1996 and again in the coming financial year levies have been imposed in the former case to fund a gun buy-back following the horrific Port Arthur Massacre and in the latter to help meet the cost of peacekeeping troops in East Timor.[7]

6.2. *What About Spending?*

A legitimate question is whether one wants fiscal policy driven by tax or spending changes. Lawrence Ball's response to this question has already been quoted. Most spending – and so spending changes – should be driven by medium to long-term assessments of the cost-benefit of different spending options. In theory, this seems reasonable. But we should not forget *the importance of the urgent* in driving fiscal responsibility. Long overdue fiscal tightening, often involving spending reductions, is often driven by the economic and budgetary crises that arise from time to time. Without this urgency, spending reductions which are warranted on equity and fiscal policy grounds often do not occur at all.

The BCA's approach was slightly different to Ball's. In designing the proposed mechanism, it was thought that across-the-board spending changes imposed from above involve numerous implementation problems. This does *not* mean that spending changes should not drive changes in the fiscal stance, only that they would remain at the discretion of the government – with the central fiscal arrangements operating in the background to discipline the government.

The proposed arrangements do not seek to preordain how fiscal policy outcomes should be engineered. They should be seen as a kind of *prudential architecture* for providing assurance for fiscal prudence and flexibility. Providing they meet the independent authority's standards of fiscal responsibility, governments are free to tax and spend as they wish. The new arrangements have the effect that *if* the independent authority considers that a change in fiscal policy is required, and the government does not wish to accommodate them, pressure is brought in the first instance to change tax rates. The government can always respond by addressing the independent authority's

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Box 4. **The Politics of Independent Fiscal Policy**

Contemporary monetary policy institutions do not put an end to the political realities of macroeconomic policy, but they do provide a successful institutional means of mediating them. macroeconomic easing remains popular and politicians are likely to step forward to take credit for it. But the very fact that they have not themselves executed the easing tends to have politicians claiming responsibility for *creating circumstances conducive* to easing, rather than taking the decisions into their own hands. By the same token, at a time of tightening, politicians can take some comfort in the presence of another, independent authority which is there to take, explain and justify appropriate action.

Likewise, at elections, political parties continue to promise that they will keep interest rates low. However, political parties addressing this issue must now argue that they will deliver *the economic preconditions* of low interest rates. The political contest has shifted away from unexplained and irresponsible promises towards a focus on how particular parties can create the economic circumstances that will deliver the desired outcomes.

Something similar would occur with fiscal policy under the proposed arrangements. Political parties seeking to convince voters that theirs would be a low tax regime would need to do more than promise tax cuts. They would need to focus on the credible means by which this could be brought about *consistent with fiscal prudence*. For without such prudence, the electorate would expect an independent fiscal authority to compensate for specific tax cuts with general increases in tax rates across the board. This provides a way of introducing into a democratic policy system an appropriate premium for fiscal responsibility and market credibility.

By the same token, politicians and pressure groups proposing spending increases or revenue reducing measures would come under more immediate pressure to specify how they would address the hole their proposals would otherwise make in the budget. The fact that, in the absence of such measures, taxes would have to rise to meet the shortfall would be transparently present to the community through the independent fiscal policy arrangements. The community would then be in a much better position to choose between the costs of the additional taxes and the benefits of new proposals.

concern with a different mix of spending and tax changes than those which would ultimately be delivered by the prudential architecture.

6.3. *Extent of* Independence

It is possible to envisage greater levels of independence than those set out in the previous section, although once substantial independence is reached it is not clear that more independence will always be better.

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If legislators considered it appropriate, the stance of fiscal policy could be set by an independent authority that could not be directly overruled by the Executive government (although, of course, it would be capable of being dismantled at any time by repeal of the relevant legislation).

6.4. *Criteria for* Policy Management

To delegate management of the fiscal stance effectively, it would be necessary for enacting legislation to specify the fiscal and economic goals the authority should pursue. The setting of such objectives would need to be carefully thought through. Short- and medium-term fiscal policy moves would have to be ultimately consistent with the long-term objectives. Budgeting should preserve or enhance government net worth over the cycle, although opinions will differ as to where the economy is in the cycle at any one time.

One of the symptoms of fiscal drift is that fiscal activism is constantly associated with the idea of running looser fiscal policy. As can be gathered from the emphasis on fiscal drift, the BCA discussion paper was highly *un*sympathetic towards loose fiscal policy. But it stands to reason that the delivery of much greater fiscal responsibility should enable changes in the stance of fiscal policy to take on more of the burden of managing the economy than the minimal role it currently enjoys. Providing we "reload the fiscal cannon" we should be able to fire it when appropriate to moderate the economic cycle to the extent possible.

The proposed arrangements would reassure markets that fiscal discipline is vigilant, ongoing and supported by independent institutions. As such, markets would be more willing to fund the fiscal expansions that might be desirable from time to time either to ameliorate a downturn in the business cycle, or to fund investment where benefits outweigh costs. In a world of free flows of capital, fiscal discipline and strong institutional guarantees of discipline become the foundation for flexibility.

6.5. *Extent of* Discretion

In introducing change such as that set out here, it might well be appropriate to constrain within fairly narrow bands, the fiscal discretion being delegated. This would reassure the community that change would be incremental rather than revolutionary. It may well be that a very large part of the gains from the change can be delivered at the same time as operating the system within tight constraints. After the community gains experience with and confidence in such arrangements, it would be appropriate to further extend the bounds of fiscal discretion. Using the example set out above of the fiscal parameter, the mechanism might be allowed to move between .99 and 1.01 for an introductory period with the band being gradually extended over time.

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6.6. *Co-ordination Between Macroeconomic Instruments*

To optimise their joint effectiveness, fiscal policy and monetary policy must operate together in an integrated fashion, and this must be taken into account in any institutional reform. This occurs more by default than design at present. In many countries, fiscal policy is simply unavailable to share any of the weight of managing the economy and so monetary policy is left as the residual – the "swing instrument" – for managing the economy. Worse than this, monetary policy must sometimes "pick up the pieces" where fiscal policy has been politically driven or otherwise mismanaged.

The proposed arrangements offer the prospect of doing better than this. Broadly speaking, there are two choices – to integrate policy by integrating the management of two separate agencies, or to integrate policy by merging independent monetary and fiscal authorities.

Lawrence Ball (1996) proposes to do so through a "macroeconomic policy committee" that would have the power to vary tax rates and to direct the central bank. Membership of the committee would include both the senior civil servant in the Finance Ministry and the governor of the central bank and other officials chosen for their expertise.

Another possibility would be for the central bank (with its professional expertise appropriately augmented) to exercise the discretions inherent in the proposal. However, this may be seen as undermining the central bank's current focus on monetary policy.

Another point might usefully be made in this context. Where monetary policy is constrained in moderating the cycle, the importance of fiscal policy's contribution becomes even greater. In this regard, from the perspective of individual countries within Europe, the Monetary Union constrains the whole of Europe to a single monetary policy. While monetary policy itself will be targeted to the needs of Europe, by definition the monetary policy needs of Europe as a whole will not always correspond to the macroeconomic needs of particular countries. To the extent that they wish to preserve some capacity to influence macroeconomic outcomes in their domestic economies, the idea of building institutions capable of more credible and flexible fiscal policy hasclear attractions.

7. Conclusion

In conclusion, we may note that the kind of reforms being explored in this paper would give a flexibility and credibility to fiscal policy that it has not enjoyed since at least the 1960s. It would provide an additional instrument with which to fight the forces of recessions and of booms when and if they threaten. While monetary

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Box 5. **Democracy and an Independent Fiscal Stance**

It might be argued that the arrangements for more independent fiscal policy would be less democratic than existing arrangements. However, as we have seen there is little in the ideas being explored in this paper for which there are not precedents elsewhere in OECD Member countries. A wide range of government bodies and authorities in our society are distanced from – but still ultimately accountable to – representative democratic institutions.

The ideas explored here would be incapable of implementation – and nor should they be capable of implementation – without the democratic sanction of legislation. The degree of independence given to any government policy-making body is itself ultimately legislated by Parliament and so accountable to the people. In this sense, Governor Ian Macfarlane of Australia's Reserve Bank, has argued, the issue of "independence" is best seen as "a discussion about the optimal degree of delegation, including the circumstances in which the delegation could be withdrawn" (1996).

In this context, it must be remembered that the kind of power to be delegated is of a precise and closely circumscribed kind. An independent fiscal authority would have none of the kinds of power of the legislature to do any favours or impose specific costs on any section of the community. It could not introduce any new taxes or tax concessions. Politicians would continue to perform their democratic duty in deciding who pays what rate of tax, what concessions there are, how much money is spent and on what.

But an independent body would have an important role in influencing the management of the total tax take. It would take the entire tax system from existing legislation and, by calibrating that system across the board, have influence over one economic variable which is critical to both long- and short-run economic performance – the relationship between outlays and revenue.

Beyond the fact that it could deliver better performance, fewer and milder recessions, and lower unemployment, the philosophical justification for fiscal policy independence is analogous to the philosophical justification for monetary policy independence.

The fact that we have an intermediary in the area of monetary policy and do not have one in the area of fiscal policy is a product of the different history of the relevant institutions rather than differing principles. But it's not hard to appreciate a very sound political philosophical justification for some independence in monetary policy management. One political generation's undermining of the value of the currency to underwrite an unsustainably high rate of economic growth for itself is not only unfair. It is undemocratic. It represents oppression of the minority.

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Box 5. **Democracy and an Independent Fiscal Stance** (*cont.*)

And protecting the minority from oppression does on occasion require departures from strict representative democracy – most obviously concerning the independence of the judiciary, for instance. But such protections from oppression of the minority are, in many senses, things which are necessary to the checks and balances which constitute and protect democracy. They are building blocks of democracy rather than derogations from it.

Clearly if the government of the day set short-term interest rates it would be more democratic in the simple sense but so too would electing the Auditor General or the judges of superior appellate courts. In that light, it does not seem entirely foolish to say that current protections against debasing the currency in democratic countries are, like property rights, part of the apparatus of checks and balances that underpins democracy and makes it more rather than less secure. Precisely the same could be said of checks and balances against one generation running up government liabilities for the next generation to pay in higher taxes.

policy would retain its critical role in the macroeconomic took-kit, institutional change would enhance fiscal responsibility and the timeliness with which fiscal policy could make a contribution to macroeconomic management.

Despite the apparent boldness of the ultimate vision for fiscal policy, the steps proposed to get there appear manageable. Some will not be easy. But, on the other hand, they seem economically and politically well within the bounds of practical policy reform. And those steps make sense in their own right whether or not the final vision sketched out here is ever reached.

In the ultimate vision, politicians would continue to discharge their democratic duties in deciding the detail of all tax and spending policy. Only the *stance* of fiscal policy – the relationship of revenues to outlays – would be influenced by the new arrangements.

Finally, can such reform be made attractive to the politicians who must ultimately legislate it if it is to become a reality? Like much reform, it depends upon the clarity which reformers bring to the task of articulating the case for change and the interests which might be brought to bear in supporting change. However, something else is also generally critical to successful reform.

Often politicians come to see that a proposed reform may entail short-term discomfort and risk, but that it is ultimately in their own enlightened self-interest. The widespread support of politicians for independence of monetary policy is

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ultimately the fact that most politicians who considered the matter would not want the power back. They recognise it for the poisoned chalice that it is.

The politicians' world is one of short-term drama; one in which grassfires are forever having to be put out. Under such pressure, it stands to reason that introducing constraints to power is a risky thing to do. But as the political science literature and common-sense and experience illustrate, recessions are much more than a grassfire for governments. They are one of the surest avenues to political disaster and even destruction. Good macroeconomic policy provides the best way of avoiding or ameliorating a recession.

A former Australian Prime Minister who floated the Australian dollar when he was Treasurer, used to talk of "wearing the hair shirt" of a floating exchange rate – allowing the market to pass judgement on the economic policy of the government each and every day. This was one of the critical disciplines on that government and, despite the plethora of grass-fires which are the stuff of being in government, helped constrain the government to stick to the "straight and narrow" of policies which were broadly acceptable to the market place. And let's not forget that politicians sometimes find constraints attractive when they help them manage internal political pressures within their own parties. This was very much the case with the previous Australian Government.

Likewise, today, monetary policy independence has become one of the "hair shirts" that governments wear. It helps them govern well and so preserve their longevity.

Another way of dramatising what is at stake – of appealing to the idea of the enlightened self-interest of politicians – is to contrast the experiences of Australia and some of its neighbours over the last four years. In Australia, an independent Central Bank was able to withstand considerable market pressure to raise interest rates in response to the falling Australian currency in the wake of the Asian financial crisis. Whether by bad luck or bad management, few other countries in the region were so lucky. And it is remarkable how many of them – both democratic and less so – have changed their governments since then.

Of course, some of the countries which experienced recession had independent central banks so a good deal of the explanation for the difference in policy lies in the superior judgement – or luck – of one bank over the other and in the existence of other factors. Nevertheless, one critical ingredient of Australia's success was the independence of Australia's Reserve Bank.

If monetary policy had been in the hands of the politicians of the day, it would have been very much harder to stand against the market in resisting the pressure to raise short-term interest rates. Rising interest rates might well have induced a recession, or at the very least an economic slowdown. Central bank

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independence was, therefore, probably a necessary, but certainly not sufficient condition of avoiding economic slowdown during the Asian financial crisis.

Australia's GDP is now an astonishing 7% higher than it would have been if it had experienced even a mild recession in 1997-98. That illustrates the size of the economic prize for improvements in macroeconomic management. And it also underpins the claim that further fiscal policy reform is well and truly in the enlightened self-interest of the politicians who must embrace it if it is to become a reality. The Australian politicians who were the beneficiaries of Australia's Reserve Bank (and, of course, their own good work in repairing the fiscal accounts early on in their period of office) remain in office. The politicians in some neighbouring countries have not been so lucky.

Having suggested earlier that fiscal policy-makers today bear an unfortunate resemblance to Sisyphus, we may conclude that what we are after is for our political masters to borrow instead from the wily Odysseus. For it was Odysseus who had himself lashed to the mast to overcome the temptation of the sirens. And as we know, in his embrace of self-constraint he saved himself. He lived to fight another day.

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Notes

1. See also the Reserve Bank of Australia's Deputy Governor comparing the monetary easings of 1996-7 with the monetary policy easings of the early 1990s when markets had much less faith in the Reserve Bank's independence, *Reserve Bank Bulletin*, May 1999, p. 52.
2. At least in principle, there are opportunities to develop the wherewithal for fiscal expansion when appropriate by ensuring that public sector infrastructure projects are ready for implementation if suddenly their benefits rise and their opportunity costs fall during an economic downturn. But there are limits to the extent to which this can be systematised.
3. Ball does not address himself to transfer payments here. However, transfer payments – at least where they are justified by social security considerations and the alleviation of poverty – do not lend themselves well to changes up and down as economic circumstances may require.
4. Australia's Reserve Bank also came to its independence long after its independence was formally provided for in its Act.
5. One can make the same point about income taxes. Some people would have an incentive to work more (less) hours when they anticipated income taxes would marginally increase (decrease). But it seems much less important. Most people have much less flexibility about their workflow than they do about when they buy goods and services.
6. This is an additional constraint in Australia. In addressing community fears about the new value-added tax to be introduced in July, the government made a firm commitment not to increase the rate of the tax without the support of all the state governments.
7. In the latter case, while the Levy was spoken of as if it were in the style of Medicare, it was altered in a way which reduced its impact on the bulk of the population and focused it more on higher income earners.

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The Chilean Pension System

By
*Joaquin Vial Ruiz-Tagle and Francisca Castro**

1. Introduction

The introduction in the early 1980s of a privately managed pension system in Chile, based on individual capital accounts, has attracted world-wide attention. This reform – as well as other market oriented structural changes – and the significant improvement in Chilean economic performance has led many observers to conclude a direct link, especially through the rise in private domestic savings generated through the new pension system.

As is usually the case, things are somewhat less clear when examined in depth. Although there is ample evidence of the positive impacts of the new Chilean pension system, there are a number of issues that are not as good. These include the high – and rising – administration costs as well as the size of the fiscal guarantees involved. On the other hand, the very significant fiscal impact of the transition from a mature pay-as-you-go system to a private capital system should dampen the enthusiasm of many potential reformers who already face large fiscal challenges.

In the paper, we describe the new system and the reform process, with a special emphasis on the fiscal impacts. We conclude with a brief discussion of the issues still unresolved in the Chilean pension system.

2. The Old Regime

In the 1920s, Chile implemented a social security system aimed at providing retirement income for the elderly as well as other social benefits. From the early years, different pension schemes geared to servicing different occupational groups

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Table 1. **Contributors in the old pension system**

Institutions	Number of contributors	% Total
Servicio de Seguro Social	1 394 300	62.61
EMPART	430 000	19.31
CANAEMPU	264 200	11.86
Other	138 400	6.22
Total	2 226 900	100.00

Source: Superintendency of Pension Fund Administrators (AFPs).

coexisted. The differences between these schemes were not the result of a well designed social security policy, but rather of lobbying and interest group pressures. By the 1970s, and as a result of this trend, there were very significant differences in the benefits received by different groups of workers.

Although by 1979 there were 32 pension funds ("Cajas") in operation, three of them were dominant in terms of both members and contributions. A common feature of these funds was that they all operated under the pay-as-you-go system. Under this scheme, active contributors financed retirement payments to pensioners. It was expected that increasing obligations would be met both by drawing on the stock of accumulated savings as well as their accumulated net income. The system was linked to public finances through portfolio management. In order to avoid fraud and give a public guarantee to mandatory contributions, the surplus of the funds (contributions minus benefits) were transferred to the government for investment.

During the first decades of operation, the ratio of contributors to pensioners generated a sizeable surplus in the system. Among other problems, this generated incentives to increase benefits that were not sustainable when the system matured. Confronted with the option of reducing benefits or generating a fiscal surplus to finance the pension system deficit, the governments chose to raise the contribution rates. While in 1955 there was one pensioner for every 12.2 active affiliates, by 1980 this ratio had changed to 2.5 active affiliates for every pensioner.

The financing problem was made worse by mounting evasion of social security contributions. The operating rules encouraged workers and employers to pay just the legal minimum; they only became concerned about increasing the real value of contributions during the last few years of active working life when the contributions impacted the calculated value of pensions. Because of these financial problems, contribution rates had to be increased – by 1974, they represented more than 50% of the worker's monthly salary. Although they were cut by more than 20% during 1974-1980, they still represented 33.5%-42% of the pensionable

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Table 2. **Global contribution rate**

Institution	1974	1980	Difference
Servicio de Seguro Social	56.60%	33.20%	23.40%
EMPART	64.50%	41.04%	23.46%
CANAEMPU	54.75%	32.50%	22.25%

Source: Superintendency of AFPs.

salary. This made the evasion problem even more serious, further reducing the financial health of the system. The maximum coverage of the system peaked in 1973 when 79% of active workers were contributing to the system. Coverage decreased slowly since then, reaching 64% in 1989. This trend is explained basically by evasion and an increase in the unemployment rate which rose from 3.3% in 1972 to 14.9% in 1975.

There was little relation between worker contributions and the benefits they derived from participating in the (traditional) social security system. In that sense, contributions were seen as taxes on labour, contributing to the poor performance of the labour market during the 1960s and 1970s. Although the system as a whole was neutral or slightly progressive, there were many inequities. Benefits were higher for the groups which exerted the most pressure; upper and middle class workers were able to get substantial benefits making the system increasingly unfair.

During the last years of the old pension system, contributions and investment returns were not sufficient to cover pension payments, increasing the fiscal grants to finance the system. Between 1977 and 1980, direct fiscal contributions grew at a rate of 8.5% per year.

The unfairness of the system, the fiscal consequences of the highly inefficient management of the funds, and the desire to reduce the role of the government in economic affairs, moved the government to introduce reforms in 1981. Law No. 3500,

Table 3. **Direct fiscal contribution to pensioner payments**

	% of GDP
1977	2.67%
1978	2.51%
1979	2.47%
1980	2.70%

Source: Cheyre (1991) and Central Bank.

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approved in November 1980, created a new pension system based on individual capital accounts managed by private institutions.

The steps to prepare the ground for this reform were taken during 1974-79 when the government put in place a very tight fiscal programme in order to build up a budget surplus to finance the planned reform of social security. The alternatives – to finance the transition by increasing taxes or issuing public debt – were considered too risky from the fiscal point of view. The programme implied a significant public consumption reduction – wages as well as purchases – helped by the economic boom that the country experienced during those years. Two other important steps were taken during this period: the introduction of uniform rules for all pensions and a uniform retirement age of 65 for men and 60 for women for civilian pensions, which represented a rise of about five years for the average worker.

It is now possible to provide an evaluation of this important reform.

3. The New Pension System

The reform of the Chilean pension system – implemented in late 1980 and early 1981 – replaced the pay-as-you-go regime with a fully-funded pension system based on individual capital accounts, managed by private companies known as *Administradoras de Fondos de Pensiones* (AFPs).

To reduce political opposition at the time of the reforms and to increase interest in the new system, contributions rates were set at a level low enough to increase net "take-home" pay. This was financed by the above mentioned increase in the minimum retirement age. On average, workers that opted for the new regime obtained an 11% effective increase in net wages. In addition, and in order to recognise workers past contributions to the old system, the government issued special bonds – known as "recognition bonds" – and deposited them in the transferring workers individual capital accounts. The bonds are paid in full upon retirement. These bonds provided the link between the contributions to the old system and the new retirement funds.

The new system allows the workers to choose the AFP they want to affiliate with, to transfer their funds among them, and to have voluntary savings accounts. It emphasises uniformity of contributions and its structure of benefits covers old age, disability and survivors pensions. There is no collective membership, or any restrictions on mobility between competing funds. Moreover, AFPs cannot discriminate rates or commissions among different contributors, either as a class or individually.

3.1. *Coverage and Contributions*

All dependent employed workers (including civil servants) must contribute to the retirement system. It is, however, optional for self employed people. Paradoxically,

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Table 4. **Average provisional cost**[1]
US$; December 1995

	Gross provisional cost (1)	Pensionable income (2)	(1)/(2) as %
1982	15	287	5.10
1983	20	242	8.27
1984	20	230	8.69
1985	20	299	6.68
1986	18	301	6.05
1987	16	288	5.49
1988	13	326	4.00
1989	12	336	3.54
1990	11	345	3.15
1991	12	371	3.10
1992	12	399	3.07
1993	13	429	3.07
1994	15	489	3.06
1995	15	500	3.06
1996	16	513	3.05

1. Gross Provisional Cost is defined as: GPC = FCC + FCF + (VCF*F)/12 + (AC*PI), where FCC is the fixed commission per contributor, FCF is the fixed commission on the accumulated fund of the individual capital account, VCF is the annual variable commission on the accumulated fund of the individual capital account, F is the accumulated fund, AC is the additional contribution and PI is the pensionable income. Pensionable Income is the real average pensionable income. This includes dependent and independent workers.

Source: Superintendency of AFPs.

the Armed Forces retained their own system. Contributions are equal to 10% of the monthly salary up to US$2 000. There is an additional contribution of 3% of salary as a premium for disability and term life insurance, making the effective contribution rate equal to 13% of the pensionable salary. The relatively low rate of contributions and the strong link between them and benefits play an important role in reducing evasion and stimulated participation in the system.

Considering the rates that the current system imposes on workers, the cost in terms of monthly salary is almost 30% lower than the one imposed by the old regime. On the other hand, the administrative costs charged by the AFPs in order to manage the funds affects directly the size of the individual fund and will show up at time of retirement, thus affecting the efficiency of the contributions. From 1983 to 1987, the average costs dropped significantly mainly due to the reduction in the operational costs and the elimination of some commissions. During 1988-1990, the change in the commission structure, combined with other factors, permitted the lowering of the provisional cost, thereby increasing the system's operational margin. This positive trend changed in the 1990's, notwithstanding significant and persistent gains in real wages. The blame falls on the rising share of marketing costs after membership matured and most of the growth in the

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number of affiliates is due to the normal increase in the size of the labour force. Competition among AFPs has not been in terms of prices and benefits to affiliates, but in terms of "accessibility" to potential customers, causing a big increase in the size of the sales force. This issue will be addressed in greater detail later in the paper.

Required contributions are tax deductible as is the income accrued to the accumulated fund during the contributor's active life. The system allows voluntary contributions to the individual capital accounts, up to an additional amount of US$2 000 per month in order to increase the necessary capital to finance an early retirement. These contributions are also tax deductible. Once the worker retires, their pension become subject to income tax as any other source of income. Affiliates can also have a second account independent of the capital account, as a voluntary savings account. They have free disposition of this fund but only four withdrawals per year are tax deductible, unless they go to increase the capital account where it is possible to transfer the funds. The tax treatment of this second account was based – until 1993 – on the final balance instead of the real returns on it. In 1993, the law changed the tax treatment of this account, now taxing the real returns received by the affiliate corresponding to the portion withdrawn.

3.2. *Pensions and Other Benefits*

The main benefit provided by the Chilean system is pensions based on individual capital accounts, *i.e.* the value of the pensions depends on the amount of funds accumulated and the rate of return of AFP's investment minus fees and commissions. The new regime considers three types of pensions: old age, disability and survivor pension.

When the system was introduced, the minimum retirement age was raised from 60 to 65 years for men and from 55 to 60 years for women. There is however the possibility of an early retirement.[1] When an individual retires, he has two options: he can buy a life annuity from an insurance company with the accumulated funds or make scheduled monthly withdrawals from his account. A life annuity assures a steady and known income stream, protecting against "excessive" longevity. On the other hand, monthly withdrawals – if the individual outlives the programme – assures the minimum pension guaranteed by the government for the rest of his life. If there is any balance left in the event of early death, it is inherited by his heirs. There is also a possibility of a lump sum withdrawal of any balance that exceed the necessary capital to pay a pension equivalent to 70% of the pensionable salary and is at least 120% of the minimum pension.

3.3. *Management and Operation of the System*

Pension funds in the new system can be managed only by specialised companies known in Chile as *Administradoras de Fondos de Pensiones* (AFP). These companies are

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set up as joint-stock companies and their only and exclusive objective is to manage pension funds. An AFP can be established by any group of shareholders. They are supervised by the Superintendency of AFPs and they are allowed to operate only one pension fund for all its affiliates. They have a minimum capital requirement of US$160 000 which rises with the number of affiliates (the minimum for 10 000 affiliates is US$650 000).

AFPs are allowed to freely charge fees and commissions for managing individual capital accounts. These are the main AFPs revenues and currently they consist of 1) a fee for opening a new account; 2) a proportional fee on contributions; 3) a fee for managing programmed pension withdrawals; 4) a fee for managing voluntary contributions; and 5) a flat fee per period when contributions are made. (At present, it is prohibited to charge exit fees.) This is done in order to encourage competition.

The system also has a reserve requirement of at least 1% of the total value of the fund. This requirement was set up to provide the AFPs with the necessary funds in case that they do not obtain the "minimum return" from its portfolio. The Chilean system imposes a maximum and a minimum return to the AFPs to pay their members, which are set in relation with the average performance of the whole system over the last 12 months. The minimum is either 50% of the average return across AFPs, or two percentage points lower than the average. In case the fund falls short of the minimum, the AFP has to make up the difference by withdrawing funds from its reserves. On the other hand, if the AFP has a real investment return above the 50% average for all the pension funds, or exceeds it by two percentage points, it has to deposit the excess funds in a "profitability reserve" account to be used in case its portfolio underperforms. AFPs must invest this reserve requirement in the same portfolio as the pension fund under its administration.

3.4. *Investment* Rules

There are very tight regulations established by law regarding the assets the AFPs can invest in. Safety and profitability are the principles behind these rules. These regulations have taken the form of maximum limits for holdings of particular types of financial instruments as approved by the Risk Classification Commission. This Commission was created in 1985 and its main function is to classify debt securities into several risk categories.

Investment rules have been relaxed since the system was created, giving a larger weight to the risk of the overall portfolio instead of relying on strict limits for specific instruments. In 1985, the funds were allowed to invest in domestic equities, and the limit has been relaxed several times afterwards. In 1990, they were allowed to invest abroad. This had very little effect, because of strong restrictions on the quality of the instruments and the high interest rate differential that strongly favoured investing in Chile.

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Table 5. **Investment instruments**

Central bank maximum limits before and after the new capital market law

Instruments	Before		After	
1. Government securities	45%		50%	
2. Deposits and certificates guaranteed by financial institutions	100%		50%	
3. Mortgage bonds	100%		50%	
4. Public and private corporate bonds	100%		–	50%
5. Public and private stock-exchangeable corporate bonds			15%	
6. Stocks of open-end corporations	30%	40%	40%	
7. Stocks of open-end corporations[1]	30%			
8. Shares in real estate investment funds	30%		–	
9. Shares in corporate development investment funds	5%	20%	5%	
10. Shares in investment funds	20%		10%	
11. Shares in securitized-credit investment funds	Not eligible		10%	
12. Commercial paper	100%		20%	
13. Foreign securities	10%	10% fixed return Not eligible variable return	12% fixed	12% fixed return 6% variable return
14. Other publicly-offered instruments	Not eligible		5%	
15. Pension funds quotes	100%		Not eligible	
16. Hedging operations	Not eligible		15%	

1. The law does not provide for individual limits on said instruments. It does, however set an aggregate limit on real estate risks.

Source: Superintendency of AFPs.

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3.5. *State Guarantees*

The government plays a role that goes beyond the supervision and regulation of the system. The pension system involves three types of government guarantees.

First, the government guarantees a minimum pension[2] to members. The minimum guaranteed is for pensioners that exhaust their accumulated funds in the case of programmed withdrawals, or if the income stream is lower than the minimum pension in the case of a life annuity. In both cases, recipients should have made contributions for at least 20 years.

Second, the government guarantees a minimum return in case that the AFP underperforms the limits imposed by the Superintendency. As was explained, a minimum return relative to the average performance of the system is expected of every AFP. They have to use their profitability fund and investment reserves in order to fill any shortfall in the rate of return. If the funds are insufficient to bring the actual return to the minimum level, the institution is liquidated and the balances of the individual capital accounts transferred to another AFP. In this case, the government covers the difference.

Third, the government guarantees pension payments to pensioners of any insurance company that becomes bankrupt.

4. Costs of the Transition – Effects on the Fiscal Budget

The system is still in a transition phase, the old pay-as-you-go system and the new capital system coexist, and this will continue until the benefits paid to the pensioners that remain in the old system cease (the closing date of the old system is estimated at around 2045). The transition from a pay-as-you-go system to a fully-funded one has major fiscal implications. In term of flows, the government faced a sharp decline in its income due to contributions that moved to the new system, while it fully funds pensions in the old system. The fiscal implications depend essentially on the sources of funds used to finance the reform. There are basically three ways to finance the transition: by debt, tax or a combination of both.

In Chile, in order to finance the reform, the government put in place a very tight fiscal programme to build up a sizeable budget surplus. By 1980, the budget surplus amounted to 5.5% of GDP. Although the alternative of debt financing was avoided for the first two years of the reform, the deep economic crisis of 1982-83 (GDP fell by about 15%, unemployment reached 30%) caused a big drop in government revenues and AFPs were allowed to invest half of their portfolio in Central Bank debt.

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Table 6. **State provisional deficit**
Percent of GDP

	Recognition bond	Deficit in the old system	Total
1981	.01	4.09	4.10
1982	.08	8.22	8.30
1983	.17	7.33	7.50
1984	.20	7.50	7.70
1985	.24	6.46	6.70
1986	.32	5.98	6.30
1987	.38	5.02	5.40
1988	.36	4.84	5.20
1989	.44	4.06	4.50
1990	.51	4.09	4.60
1991	.48	4.02	4.50
1992	.52	3.78	4.30
1993	.63	3.87	4.50
1994	.74	3.76	4.50
1995	.90	3.50	4.40

Source: Arrau, 1992, 1996; Arenas y Marcel, 1993.

The reforms in the pension system have had three effects on the budget: *i*) the government paid pensions to those who remained in the old system, as well as those who were already retired; *ii*) the government had to finance Recognition Bonds for those who had made contributions to the old system and moved into the new one; and *iii*) the government has to guarantee minimum pensions for those in the new system.

It is not surprising that direct government contributions have been the major fiscal burden during the past years. However, we expect a gradual reduction of this component over time. In the medium-term, Recognition Bonds will gradually rise as people in the new system, but who have contributions in the old one as well, retire. Every individual who contributed for at least 12 months in the old system during the previous five years to November 1980, is eligible to receive a Recognition Bond. This bond correspond to the capital that the transferee needs to get an annuity equivalent to 80% of the pensionable salary that he received between June 1978 and June 1980, weighted by the number of years contributed over 35.[3] It yields a 4% return in real terms and it is payable only upon the retirement of members. The servicing and the payments of the bonds – which are deposited in active workers retirement accounts – will peak in 2005, when it will reach 1.2% of GDP (Arenas y Marcel, 1993).

In the long run, the state guarantee of a minimum pension will be the main fiscal risk. However, if a severe economic downturn should occur, then there is also

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a risk due to the minimum return guarantee in case of an AFP bankruptcy. The minimum pension risk is basically endogenous since it depends critically on the rules for early retirement and the value of the minimum pension. Another factor is the rate of return on the pension funds, but this will probably be a minor risk in the next decades since average (real) returns have exceeded by far the initial calculations.

5. System Results

Coverage. To analyse the degree of coverage of the Chilean pension system it is necessary to add up the coverage of both the old and the new system. In the new one, it is important to distinguish between those workers that are members of an AFP, those that have at one time or another enrolled in an AFP, and those who are active contributors to the new system.

In 1996, the number of affiliates to the new system was 5.57 million representing 99% of the labour force. The percentage of contributors is significantly smaller: 3.1 million in 1996, or just 59% of those employed. Adding the contributors to the old system, the total coverage of the Chilean pension system rose form 53% of total employment in 1982 to 65% in 1995. The relatively low percentage of important contributors is one of the most important weaknesses of the system and is explained basically by informality in labour markets, the low rate of contribution of self-employed and the moral hazard created by the existence of the government guarantee of minimum pensions.

Table 7. **Membership and contributors**

	Number of affiliates (A)	Number of contributors (B)	(B)/(A) %
1981	1 400 000	–	–
1982	1 440 000	1 060 000	73.61
1983	1 620 000	1 230 000	75.92
1984	1 930 353	1 360 000	70.45
1985	2 283 830	1 558 194	68.23
1986	2 591 484	1 774 057	68.46
1987	2 890 680	2 023 739	70.01
1988	3 183 002	2 167 568	68.10
1989	3 470 845	2 267 622	65.33
1990	3 739 542	2 642 757	61.22
1991	4 109 184	2 486 813	60.52
1992	4 434 795	2 695 580	60.78
1993	4 708 840	2 792 118	59.30
1994	5 014 444	2 879 637	57.43
1995	5 320 913	2 961 928	55.67
1996	5 571 482	3 121 139	56.02

Source: Superintendency of AFPs.

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Size and composition of the Funds. The volume of pension funds managed by AFPs has risen steadily from 10% of GDP in 1985 to 39% in 1996. As Table 8 shows, the total amount of resources of the funds reached US$26.5 billion by the end of 1996 (37% of GDP).

The evolution of the funds shows the need for new *permanent* investment instruments to widen the range of alternatives in order to satisfy the increasing demand for financial assets of different nature. Since the reforms took place, three major forces have driven the portfolio composition of the pension funds: the evolution of the investment limits, the increase in the size of pension funds, and the development of the domestic capital market. During the first years, the small and unsophisticated capital market and the low volume of the funds were compatible with the investment limits set by the Central Bank. In the second half of the 1980s, as a result of the privatisation of public enterprises and the increase in the pension funds, the capital market deepened, allowing an increase in equity holdings in the AFPs portfolio. However, more than 90% of the AFPs equities portfolio was concentrated into just eight recently privatised utilities. In 1990, AFPs were also allowed to invest in real estate and foreign securities. The last important changes in the pension fund investment limits were introduced in the Capital Market Reform Law passed in 1994, which increased the number of eligible instruments, relaxed the limits and changed the criteria and procedures concerning risk rating.

Table 8. **Pension funds**
Million of US dollars

	Pension funds value	Fund/% of GDP
1981	291.82	0.84
1982	919.50	3.29
1983	1 670.24	5.86
1984	2 177.54	7.73
1985	3 042.00	10.03
1986	3 986.09	12.67
1987	4 883.07	14.20
1988	5 954.12	14.97
1989	7 358.64	17.65
1990	9 758.30	24.21
1991	13 810.67	31.37
1992	15 399.57	30.56
1993	19 788.07	37.02
1994	23 925.72	40.99
1995	25 433.17	38.32
1996	26 505.40	38.98

Source: Superintendency of AFPs.

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Table 9. **Pension funds portfolio**
As a percentage; December each year

	1981	1982	1983	1984	1985	1992	1993	1994	1995	1996
Government and Central bank securities	21.8	26.0	44.5	42.1	42.4	40.9	39.3	39.7	39.4	42.1
Financial instruments										
Deposits $ certif.	61.9	26.6	2.7	12.2	20.4	9.4	6.1	4.8	5.3	4.2
Mortgage bond	9.4	46.8	50.7	42.9	35.2	14.2	13.1	13.7	15.8	17.9
Bonds and stocks	0.0	0.0	0.0	0.6	0.4	1.6	1.4	1.6	2.0	2.5
Enterprises										
Stocks	0.0	0.0	0.0	0.0	0.0	24.0	31.8	32.1	29.4	25.1
Bonds	0.6	0.6	2.2	1.8	1.1	9.6	7.3	6.3	5.3	4.7
Shares of inv. funds	0.0	0.0	0.0	0.0	0.0	0.2	0.3	0.9	2.6	3.0
Foreign instruments	0.0	0.0	0.0	0.0	0.0	0.0	0.6	0.9	0.2	0.5
Cash and current account deposits	0.0	0.0	0.0	0.5	0.5	0.1	0.1	0.0	0.1	0.0
Total pension funds	100	100	100	100	100	100	100	100	100	100

Source: Superintendency of AFPs.

As a consequence of the financial disintermediation process that began in 1986, the financial instruments (intermediated through the banking system) lost their relative weight in the pension fund's portfolio. In 1985, they represented 56% of the portfolio while at the end of 1996 they were only a 24.6%. At the same time, corporate stocks and bonds grew from 1.1% in 1985 to 32.8% in 1996 as a percentage of the total portfolio. This is the result of the change in investment restrictions as well as a switch in the corporate sector away from bank financing and to issuance of stocks and bonds. On the other hand, foreign instruments remain very small and well below legal limits. In December 1996, only 0.5% of the accumulated funds had been invested abroad. This is expected to change in the future.

Rates of Return. The rate of return of the pension funds portfolio has been very high during this period, well above the original expectations. The average rate of return for the period 1981-96 has reached 12.8% in real terms. This has been partly due to the fact that government subsidies to the financial system shielded the pension funds during the 1983-84 financial crash, and they reaped all the benefits of the recovery that started in the second half of the 1980s. However, most of the return in the second half of the 1980s and the 1990s has been genuine and is based on effective market returns of portfolio investments in Chile during the period.

The diversification of the pension funds portfolio towards equity allowed them to participate in the big capital gains that took place in the early 1990s, when domestic and international markets realised that Chilean assets were undervalued

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Table 10. **Annual real rates of return, 1981-1996**
As a percentage; December each year

	Financial system[1]	Pensions accounts[2]
1981	13.2	12.9
1982	12.1	28.5
1983	7.8	21.2
1984	8.4	3.6
1985	8.2	13.4
1986	4.1	12.3
1987	4.3	5.4
1988	4.6	6.5
1989	6.8	6.9
1990	6.0	15.6
1991	4.8	29.7
1992	6.0	3.0
1993	6.4	16.2
1994	5.9	18.2
1995	6.2	–2.5
1996	6.8	3.5

1. Effective interest rates paid to operations of 90 to 365 days.
2. Real return of the system. Deflated by the CPI.
Source: Central Bank, Superintendency of AFPs; Budget Office estimates.

given the success of economic reforms and the political transition to democracy. The 1995 Mexican crisis affected adversely the price of equity, and the economic adjustment induced by the authorities as well as a significant fall in the terms of trade, contributed to produce a negative rate of return in 1995 for the first time since the advent of the new system.

6. Impact on the National Economy

Impact on Domestic Savings. The domestic savings impact of pension reforms such as the Chilean depends essentially on the way they are financed. The transition to a funded system that is not debt financed means an increase in taxes on current generations in order to finance the deficit of the old system and an increase in the stock of capital for the benefit of future generations. Thus on the basis of long-run considerations, the flow of savings must increase. The other side of the coin is a short-term drop in consumption (Diamond, Valdés). However, in the Chilean case there was also a reduction in the rate of contributions from 22% to 13% with the opposite effect. This can be interpreted as compensation for the reduction in benefits for the current generation which had to accept the change in retirement age as well as higher taxes. This is a risky decision which in this particular case seems to have gone well thanks to the capital gains that were mentioned in the previous section. In a more stable economy with mature financial markets, there is no room for this kind of compensation.

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Since the Chilean reform has been fully tax-financed, there has been a significant rise in savings. Probably one of the most remarkable events in this transition has been the fact that government savings after the reform not only remained positive but have been growing, currently reaching about 5% of GDP. The high level of savings not only financed the old pension system deficit, but also a growing rate of public investment and a significant reduction of the public debt. Some might think that this very high burden on current generations was only possible because of military rule. However, these policies have continued after democratic rule was reinstated in 1990. One possible explanation lies in the traumas of periodic economic crises, with a period of economic chaos and extremely high inflation in the 1970s and an economic depression in the 1980s that brought unemployment up to 30% of the labour force.

Whether the reform has increased private savings directly is still an open question. Although some recent research suggest that the reform indeed contributed to the increase in private savings (Haindl, 1996; Morandé, 1996), it is worth noting that most of the growth in private savings has taken place in the corporate sector.

Pension fund evolution and their effect on financial markets. The accumulation of pension funds and their investment in financial markets has contributed to the development of important economic sectors. This influence was most decisive in the housing market since the availability of long term savings gave support to a private market for mortgage bonds. In 1996, 17.9% of the pension funds portfolio was invested in mortgage bonds. In the Chilean housing market, it means that two out of every three houses purchased have been financed by pension savings.

AFPs must also purchase disability and life insurance in order to cover the risk of disability or death of the affiliate. This has led to the development of a

Table 11. **Public savings (Central Government), 1987-1996**
As percentage of GDP

	Current income	Current expenditure	Public savings
1987	25.2	22.2	3.0
1988	22.3	20.0	2.3
1989	21.2	18.2	3.0
1990	20.5	18.1	2.4
1991	22.3	18.6	3.7
1992	22.4	17.5	4.9
1993	22.6	17.7	4.9
1994	21.9	17.2	4.7
1995	21.5	16.2	5.3
1996	22.6	17.0	5.6

Source: Budget Office.

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competitive insurance market, allowing the affiliates to get higher benefits due to drops in premium rates from 29.5% in 1989 to 6.8% in 1995. The modality of life annuities in the new pension system has also contributed to strengthening the industry.

Pension funds are the largest investors in the Chilean capital market. The privatisation of public enterprises and the growth in the pension funds during the second half of the 1980s deepened the capital market. Stocks and bonds of privatised public enterprises grew from 1.1% in 1985 to 32.8% in 1996, as a percentage of the total portfolio. Pension funds optimised resource allocation in order to get the best yield/risk combination and have provided long term financing. This has also led to greater transparency and efficiency in stock and other financial assets markets. The risk rating industry developed as a result of the pension system reform; this has been a key element for the sound operation and transparency of the capital market. New financial instruments have been introduced to meet the growing demand of the pension funds.

7. Pension Fund Perspective

Pension funds have been growing steadily since the creation of the system and they are expected to continue growing for at least a decade. Notwithstanding the problem of a high number of non-contributors to the system, it can be considered mature. Most of the growth is due to the fact contributions are growing according to trends in employment, real wages and real rates of return, while benefits are still low due to the fact that most of the affiliates in the new system are of the working age.

The growing size of the funds poses a challenge for the domestic market in order to create new investment alternatives to satisfy the increasing demand for financial assets by the AFPs, as well as their risk diversification needs. It is expected that pension fund resources will be channelled – either directly or through intermediaries like investment funds – to new sectors such as infrastructure and mining.

Internationalisation. There is no doubt that sooner or later pension funds must invest a significant portion of their portfolio abroad, not only because of the size of the Chilean economy but mainly for risk diversification. The authorities have relaxed the rules to invest abroad, including new instruments that may be purchased by pension funds[4] and the possibility of carrying out hedging operations through derivatives. It also established a broader risk-rating for long-term debt instruments and short-term instruments, in turn, permitting investment in Brady Bonds and ADRs. Through an amendment to Law No. 3500, AFPs are allowed to invest in domestic investment funds whose sole objective is to invest abroad.[5]

At present, pension funds are allowed to invest 12% of their portfolio in foreign securities; of which, up to 12% in fixed return instruments and a maximum of

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Table 12. **Pension funds future estimates**

	Pension funds value (US$ MM)[1]	Pension funds value/GDP[2]	Pension funds value (US$ MM)[3]	Pension funds value/GDP[2]
1997	3 305 412	47.30%	3 135 017	44.86%
1998	3 629 999	49.47%	3 386 740	46.16%
1999	3 981 418	51.68%	3 655 800	47.45%
2000	4 361 530	53.92%	3 943 232	48.75%
2001	4 772 501	56.19%	4 250 169	50.04%
2002	5 222 276	58.55%	4 583 632	51.39%
2003	5 708 383	60.96%	4 939 799	52.75%
2004	6 235 563	63.42%	5 322 078	54.13%

1. Assumed 6% yield.
2. Assumed GDP real growth of 5% per year.
3. Assumed 4% yield.

Source: Superintendency of AFPs.

6% in variable return instruments. Nevertheless, the foreign investment represented in 1996 only 0.5% of the portfolio. It is expected that the new regulations would facilitate investment abroad. However, the main impulse will come when interest rate differentials and exchange rate expectations make investment abroad more attractive. There are some encouraging signs pointing towards a slow change in the trend that has dominated exchange markets in Chile during the 1990s.

Investment in Infrastructure. The Chilean Government has decided to give a decisive role to the private sector in the development of infrastructure and a very ambitious programme of public works concessions has been launched. Due to recent amendments to the rules that regulate the capital market, investors could finance infrastructure works through direct and indirect instruments. At the beginning, some specific problems delayed this process, but they have been solved gradually and a growing role for pension funds in the financing of these projects is expected.

Administrative Costs. One of the major concerns about the new system is the high level of operational costs. This means that the high rates of return of the portfolio will not necessarily translate into better pensions. In 1984, for example, administrative costs were about 9% of wages, or 90% of contributions to the retirement system. These costs, however, declined gradually and by 1996, they amounted to 3% of wages or 10% of contributions. In terms of accumulated assets, administrative costs have declined from almost 15% in 1983 to 1.8% in 1993.

A particularly serious concern among analysts and policy makers is that the trend towards cost reduction has stopped in the last few years. As a result, a discussion on alternative ways to reduce these costs is taking place. Most of the analysts have focused on the role of marketing and sales costs. It has been estimated that in the first half of the 1990s, marketing and sales costs exceeded one-third of

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total costs. Moreover, there is evidence that in the last few years that these costs have increased significantly. Most of these increases have been related to the expansion of sales forces. The number of sales people in the system as a whole rose from 3 500 in 1990 to almost 15 000 in early 1995. This is particularly baffling since the system can be considered mature in terms of members and all this sales effort is focused on switching affiliates from one AFP to another. According to some analysts, limiting the participants ability to switch funds provides an efficient way of reducing administrative costs. Others, however, have argued that this initiative would greatly reduce competition, which could be troublesome since three AFP concentrate most of the active contributors to the system. Along these lines, it has been argued that a preferred approach would be to have participants who stay longer with a particular AFP be charged lower commissions.

It has also been argued that an effective way of reducing administrative costs is by tackling the costs of opening new accounts. Allowing AFPs to manage more than one retirement fund could, in principle, work in that direction. This way individuals could transfer their retirement savings to different funds, within the same AFP, at a reduced cost.

F*iscal* R*isks*. One concern of the authorities is, of course, the size of the fiscal guarantees to the system. High administrative costs is a risk factor that could trigger a high number of minimum pensions and they should be monitored closely. Another factor is the attractiveness of early retirement under the "programmed withdrawals" mode, which triggers the fiscal guarantee once the individual fund is depleted. There is a bill in Congress which raises the requirements for early retirement and could reduce this risk; however, it has been a slow and complicated process.

Another risk factor is more of a *political* nature. As the economy and real wages grow, the value of minimum pensions is becoming less acceptable and political pressures to raise the value of the minimum pension are rising steadily. Of course, this has a significant fiscal impact in the short-term and this has been a factor to deter these pressures, but it is also a significant danger for public finances in the future as it brings more people below the line of the fiscal guarantee.

A final fiscal risk must be mentioned. This is the relatively low level of contributions as compared to members. This probably means that a large number of people "passed trough" the system at one point or another of their working life, but will not have enough funds to finance a decent pension and will not qualify for a minimum pension under the fiscal guarantee (20 years of contributions is one of the requirements). This means that in the next 10 to 20 years, the Chilean Government will face mounting pressures to relax the constraints to get access to minimum pensions.

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Notes

1. Early retirement is possible if the individual capital account balance is sufficient to provide at least 50% of the average salary of the last ten years and the size of the calculated pension exceeds the minimum legal pension by at least 20%.
2. The value of the minimum pension today stands at about US$130 per month, which is close to 75% of the minimum wage. It is adjusted by inflation once a year, or every time that inflation accumulates more than 10% since the last adjustment, whichever comes first.
3. Thirty-five years is the number of working years assumed to obtain a normal pension.
4. New alternatives point at investment in foreign equities, foreign investment and mutual fund shares.
5. These investment funds shall be under the same regulation thet existing domestic funds and their shares will be traded in the local market.

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OECD PUBLICATIONS, 2, rue André-Pascal, 75775 PARIS CEDEX 16
PRINTED IN FRANCE
(42 2001 01 1 P) ISBN 92-64-19060-0 – No. 51641 2001