

Chapter 1

An Overview

Public expenditure management (PEM) is a new approach to an old problem. The problem is the allocation of public money through collective choice. For more than a century, these allocations have been made through the machinery of budgeting—the routines and procedures devised by governments to decide the amounts spent, the balance between revenue and expenditure, and the allocation of funds among public activities and entities. PEM operates through budget decisions, but differs in two important ways from conventional budgeting. First, it supplements the conventional procedural rules with substantive policy norms. In PEM, it is not enough that governments apply the right procedures; it also is essential that they strive to efficiently achieve desired policy outcomes. Second,

PEM covers a broad range of institutional and management arrangements, not just those traditionally associated with budgeting. PEM recognizes that budget outcomes are not likely to be optimal if the public sector is poorly structured and managed, or if the incentives and information given policy makers and program managers impel them to act in ways that produce perverse results.

The first critical difference is that conventional budgeting operates through accepted procedural norms, while PEM emphasizes substantive outcomes. These outcomes pertain to (a) total revenue and expenditure, (b) the allocation of resources among sectors and programs, and (c) the efficiency with which government institutions operate. These elements and their salient characteristics are summarized

in Table 1.1. PEM recognizes that even when a government adheres to accepted budget principles, it may fail to obtain optimal fiscal outcomes. In fact, many developing countries have sound budget and financial management systems but still lack fiscal discipline, are unable to reallocate resources in accord with strategic priorities, and operate inefficiently.

To achieve its preferred outcomes, a government must manage public expenditures to implement avowed policy objectives. It must create an institutional framework that enhances the probability that actual outcomes will conform to professed targets. This consideration leads to the second difference between conventional budget-

ing and PEM. In the former, what matters is how the process of budgeting is organized; PEM by contrast, casts a broader net that takes into account how public institutions are managed. PEM is premised on the notion that budgeting is not a process unto itself but is part of a broader set of institutional and governing arrangements. To achieve positive public expenditure outcomes, it is necessary that information, incentives, and other institutional arrangements be properly aligned.

The reorientation from conventional budgeting to PEM has been driven by unsatisfactory public expenditure outcomes in many developing and developed countries. Developing

Table 1.1: Basic Elements of Public Expenditure Management

Aggregate Fiscal Discipline	Budget totals should be the result of explicit, enforced decisions; they should not merely accommodate spending demands. These totals should be set before individual spending decisions are made, and should be sustainable over the medium-term and beyond.
Allocative Efficiency	Expenditures should be based on government priorities and on effectiveness of public programs. The budget system should spur reallocation from lesser to higher priorities and from less to more effective programs.
Operational Efficiency	Agencies should produce goods and services at a cost that achieves ongoing efficiency gains and (to the extent appropriate) is competitive with market prices.

countries have long been afflicted by severe fiscal imbalances, the maldistribution of public resources, and chronic inefficiency in the provision of public services. Often these adverse conditions have persisted even when the government has implemented the standard budgetary rules and practices prescribed by international organizations. Similar deficiencies have cropped up in industrial democracies, though they often have been masked by affluence and the amplitude of public resources. But even in rich countries, the less robust economic growth of the past two decades has revealed entrenched shortcomings in the management of public expenditure. Many developed countries have experienced chronic deficits, a significant rise in public expenditure as a proportion of the gross domestic product, difficulty in reallocating public money from declining to emerging priorities, and weak productivity gains in government operations that have persistently lagged behind the gains achieved in the market sector.

This publication outlines the concepts of public expenditure management. It explains how PEM supplements formal budget process rules with behavioral norms for allocating

and controlling public expenditure. This chapter introduces the core elements of public expenditure management; and it discusses how the various elements relate to one another. The next chapter explores public expenditure problems of developing countries. Each of the subsequent chapters elaborates on a particular element of PEM.

As an emerging field, PEM still is undergoing conceptual development and refinement as a management tool. The ideas and approaches discussed in this publication are provisional; they are likely to be modified and elaborated as PEM matures and experience on its application accumulates.

Due Process in Budgeting

The practice of budgeting emerged during the 19th century in Europe as a means of dealing with growth in public expenditure. Although the public sector was much smaller in all countries than it has become in the present century, it had grown sufficiently large to require regular procedures for allocating and controlling government expenditure. These procedures generally came to be regularized as budget practices. Since its genesis, budgeting has been defined as a set of procedures that recur, typically with little or no

change, year after year, by means of which governments ration resources among their agencies and control the amounts each spends. Budgeting is the routinization of choice with respect to public finances; this characteristic distinguishes budgeting from other governmental actions affecting public expenditure, such as national planning and cabinet policy decisions.

As routine, budgeting differs from one venue to another. Each government has its peculiar forms and procedures, its distinctive labels and language. Very early in the development of budgeting, however, efforts were made to codify the basic routines into a set of procedural rules that should be followed by all governments, regardless of the political-administrative framework within which budget activities are carried on. The basic principles have been elaborated and refined over the years, but they have had remarkable staying power. They include comprehensiveness (the budget should include all revenue and expenditure); accuracy (the budget should record actual transactions and flows); annuality (the budget should cover a fixed period of time, typically a single fiscal year); authoritativeness (public funds should be spent as authorized by law);

and transparency (the government should publish timely information on estimated and actual expenditures).

The principles of budgeting are implemented and enforced through detailed procedural rules specifying the scope of the budget, the information to be included in it, the timetable for taking particular actions, the forms to be used, the authorization required before public funds are spent, and so on. Every principle is backed by formal rules which are enforced by budget controllers at the center of government and in the spending departments. The accumulated principles and procedures comprise due process in budgeting.

The term “due process” connotes the judgment that if the procedures are sound, the outcomes are the right ones. That is, the outcomes should be assessed in terms of the procedures that generate them, not in terms of substantive criteria. Whatever results ensue from a well-run budget process are appropriate. If, for example, the budget is comprehensive and all bids for resources are submitted and reviewed according to a uniform schedule, then the allocations made to departments or programs are to be accepted as legitimate and efficient. Due process norms are indifferent to

the outcome itself; these norms may result in balanced budgets or deficits, rising public expenditure or stable spending trends, frozen budget priorities or significant reallocations. Due process in budgeting is politically neutral; it can accommodate both left of center and right of center governments. With due process norms in place, actual outcomes are likely to vary with changes in political and economic conditions. As these conditions differ from one country or time to another, so too do expenditure outcomes. Due process in budgeting is analogous to due process in litigation. In the latter, if proper judicial procedure is followed, the ensuing verdict must be accepted as legitimate. Budgeting has the same mind set.

Due process in budgeting provides an active but limited role for international institutions. They may push for improved budgeting practices, demanding, for example, that the budget cover all public expenditures and that special funds and accounts not be excluded. They may insist on accurate budget data and sturdy controls to ensure that the budget is implemented according to plan. This is a politically limited role, for it stops short of dictating particular budget

policies or outcomes. International advisers may caution recipient governments against excessive deficits or urge that budget allocations be shifted from one sector to another. But their main role is to recommend improvements in the machinery of budgeting. A major exception to this limited role occurs when international organizations such as the IMF impose conditions for providing financial assistance. These conditions usually pertain to fiscal outcomes, such as the size of the deficit.

Due process in budgeting encourages governments to centralize the management and control of public expenditure.

The strong hand of central authority is needed to ensure that the budget is comprehensive, that all spending entities conform to the rules, and that routine procedures are completed on schedule. Centralization goes hand in hand with uniformity in budgetary procedure. All spending units must use the same forms, operate according to the same timetable, and follow the same steps in implementing the budget. Agency initiative and variation are discouraged because they increase the probability that due process will be violated.

Due process fosters the notion that budgeting is a self-contained activity,

with its own rituals and roles, cutoff from other management practices. In all but the smallest government, the budget process is operated by a central office which makes the rules, monitors compliance, prepares the budget, and controls spending. Some budget offices have additional management responsibilities, but the budget is their bread-and-butter role and it shapes their posture on other managerial work. Rather than regarding the budget as part of a family of management practices, central control agencies seek to leverage their budget power to gain influence over spending units.

Inherent Shortcomings in Due Process Budgeting

A due process approach to budgeting has some important advantages. For one, it establishes the basis for financial control within government; for another, it seeks to ensure that financial information is reasonably accurate, uniform, and timely. These and other elements of due process are essential building blocks in public expenditure management. A government cannot effectively manage its expenditure if due process is materially breached. Nevertheless, due process is an inadequate basis for managing public expen-

ditures because it systematically leads to unwanted or adverse outcomes.

Looking at the recent fiscal performance of both developed and developing countries, one is compelled to conclude that good budget practices regularly produce outcomes at variance with those sought by the affected governments or regarded as inefficient by outside observers. For decades, international institutions have assisted developing countries in installing sound budget practices, but in many cases the outcomes are as suboptimal today as they were years ago when the first budget reforms were introduced. Arguably, being poor has a lot to do with unwanted outcomes, but even if this point is conceded, one must question whether due process reforms suffice to make things much better. The typical reform package consists of procedural innovations: return excluded funds to the budget; tighten spending controls so that the budget is implemented as planned; install a new accounting system that produces timely, reliable information. As desirable as these reforms may be, they do not by themselves ensure improved budget outcomes in poor countries. If lack of resources is the root cause of adverse budget outcomes, proposed remedies must recognize this condition to produce realistic, achievable outcomes.

Fiscal outcomes generally appear to be more favorable in developed countries because they are not beset by the severe resource constraints that afflict poor countries. Nevertheless, the record in some is not one to boast about. Over the past two decades, many rich countries have had deficits that grew when the economy was weak and persisted when the economy recovered. Most have rigid budgets, with little opportunity for the government to shift public funds from lower to higher priorities. Many have had meager public sector productivity gains that have lagged behind those achieved in the private sector. There have been a few notable success stories; some of these are described in volume two (forthcoming).

Affluence and the availability of incremental resources made it appear that budget outcomes were more favorable in the postwar decades when economic growth was very high than in the more recent period when growth was more modest. When money is plentiful, governments can spend more without tripping alarms about the budget deficit; they can respond to fresh priorities without taking money away from old programs; and they can pay for stagnant produc-

tivity in public organizations by spending more on operations. When resource constraints tighten, however, the inadequacies in public expenditure management become more visible and less tolerable. Deficits become alarming because incremental resources are inadequate to pay for them, and citizens (faced with stagnant or declining disposable income) resist tax increases; old priorities get frozen into the budget and new priorities are frozen out; low productivity impels a shift in national income from private to public consumption. What is different in bad times may not be the performance of government but the awareness or the perception of low performance.

Why Good Procedures May Produce Bad Results

A key question that warrants consideration is why adverse outcomes result from the exercise of due process in budgeting. If robust budgetary procedures are integral elements of PEM, why shouldn't the results that ensue from them be favorable? Addressing this question elicits an important distinction between PEM and conventional due process approaches to budgeting. Procedural rules deal with the formal features of budgeting: how and when decisions are made, the structure

and form of the estimates, the scope of the budget, and so on. These rules do not take sufficient account of the interests and behavior of budgetary participants. In fact, seemingly good rules can generate perverse incentives and lead to unwanted outcomes. For example, rules requiring comprehensive budgets may be undermined by the establishment of extrabudgetary funds or by other actions that weaken fiscal discipline. Because of this, it is essential that expenditure outcomes be assessed independently of the process by which they are generated. PEM does so by focusing on incentives, that is, on informal aspects of budgeting: how participants behave, and how their actions are affected by budget rules.

In considering the behavioral dimensions of expenditure management, one is led to examine the incentives given those who bid for resources or control the pursestrings, the information available to them, and the organizational roles assigned to them. On all three of these counts, procedural due process can produce unwanted budget outcomes.

Incentives

Claimants for resources act on the basis of self-interest, but the collective results of their actions may not be in

their interest. This “tragedy of the commons” problem is ubiquitous in budgeting. A common interest—whether it be in land, money, or anything else of shared value—often has three basic characteristics: it is a finite resource, it has many users, and it is depleted by overuse. Although it is in the collective interest of all users to ration use of the common resource, it is in the individual interest of each user to take as much as he can get. In budgeting, each agency may prefer that the government maintain a sound fiscal posture, but each acts in its self-interest by demanding as much as it can get. Because no single spending agency is responsible for total expenditures, it does not see itself as damaging the government’s fiscal capacity, even though this may be the result of all individual spending actions.

Inasmuch as due process only regulates budgetary procedure, it does not resolve the question of what total expenditure should be. Conventional budget rules structure the process so that the aggregates are decided through competition among spending claimants. As long as the competition is comprehensive (no extrabudgetary spending), fair (no earmarked funds), and authoritative (no improper expen-

diture), then the outcome is deemed the right one. But suppose rather than competition there is collusion (claimants logroll to get what they want) or fragmentation (the various claims are decided sequentially, with little interaction or friction among different parts of the budget), due process will not assure favorable outcomes. Instead of prevailing through competition, spenders win by collectively taking more from the commons, that is, by increasing aggregate spending. When this occurs, fiscal discipline is weakened, and the budget's totals become hostage to individual spending decisions.

The “commons” problem also impairs allocative efficiency, for it discourages claimants from reallocating resources from lower to higher priority programs. Spenders get more by demanding incremental funds, not by volunteering to shift funds to more effective uses. Although they may want budget allocations that reflect the government's strategic objectives, they would be rational in refusing to give up what they already have in exchange for the opportunity to participate in a reallocative competition. They risk losing resources if they offer to reallocate without having advance assurance of what their future budget shares will be.

Operational efficiency also is degraded by rationally-behaving budget makers. The formal rules generally emphasize compliance and control, not managerial initiative and performance. These rules include: spend funds only as authorized by law; itemize expenditures and conform to the detailed schedules in the estimates and other budget documents; make sure to get advance approval before taking actions (such as hiring staff or purchasing equipment) that entail the expenditure of funds; all unspent funds lapse at the end of the fiscal period. These and other rules penalize managers for underspending, not for underperforming. They spur managers to seek more resources, even when these do not result in more output.

Information

Budget outcomes are affected not only by incentives but also by the information policy makers and managers have in spending public money. Information, like the commons, is a constrained resource, not only because it costs money to produce and distribute, but because the amount of information that can be generated and considered in the compressed budget schedule is severely limited. Ignorance

and information asymmetry are widespread behavioral conditions in contemporary budgeting, even in countries that have state-of-the-art expenditure management systems. These conditions are due to two related factors; the cost of generating and disseminating relevant information; and the advantages that information producers (agents) have over information users (principals).

Allocative and operational efficiency depend on an ample supply of relevant data on programs and operations. Almost everywhere, however, much less is known about the relative effectiveness of programs than is needed to make optimal budget allocations, and much less is known about the volume, quality, and cost of outputs than is needed to operate efficiently. A great amount of information is processed in the course of compiling budgets, but in the typical country, most of it describes ongoing activities and itemizes inputs. There are some notable exceptions, but even when program and output data accompany the budget, they rarely are the basis on which budget decisions are grounded. Thus, it is truly rare that increments of budget resources are directly linked to increments of budget outputs, or that funds

are explicitly shifted from less to more effective programs on the basis of evaluative findings.

Why don't policy makers have appropriate information to make efficient budget choices? Part of the answer is that the structure of budgeting contributes to this informational deficit by making those at the top (in departmental headquarters or at the center of government) dependent on those in the middle or bottom ranks. Spenders (program officials and line managers) know more about their programs and operations than do those who pass judgment on their budget requests. It is to the advantage of the spenders to "capture" budget makers by supplying information that enhances the probability that they will get what they want. Spenders may know more about what works and doesn't, how funds actually are used, the interests and strength of program beneficiaries, and other relevant factors than do those who have nominal authority over budget allocations. Moreover, they have little incentive to be forthright in advising policy makers on program and operational issues. Central budget makers often try to redress the informational imbalance by commissioning special studies and analyses, by changing the informational rules for annual budget

decisions, or by strengthening their own capacity to monitor and assess performance. These palliatives may help for a while, but over time, spenders are likely to develop countermeasures that restore their informational advantage.

Formal Roles

In due process budgeting, central controllers have formal authority to decide everything—from the budget's totals to discrete spending items. This centralization reinforces the adversarial relationship between controllers and spenders, and encourages the latter to withhold or color information so as to gain some advantage vis-à-vis their adversaries. When this occurs, the formal powers held at the center of government are weakened, as is the ability of central controllers to reallocate or to extract efficiency gains from operating agencies.

Modern Public Expenditure Management

Contemporary public expenditure management (PEM) is interested in the process of budgeting primarily because procedural rules strongly influence expenditure outcomes. PEM takes the

position that these rules are not substantively neutral; they affect three important outcomes: the total amount spent, the composition of expenditure, and the efficiency of government operations. PEM seeks procedures that increase the probability of achieving preferred outcomes. The key aspects of budgeting affecting expenditure outcomes are institutional arrangements, the types of information available for making and enforcing expenditure decisions, the incentives* provided spenders and controllers to behave in ways that promote desired outcomes, the issuance and implementation of substantive, *ex ante* budget rules, and *ex post* accountability for budget outcomes. These elements of PEM are applied in the follow-up chapters to the three basic objectives of modern public expenditure management: to strengthen aggregate fiscal discipline, to allocate public resources in accord with strategic priorities, and to promote the efficient provision of services. These PEM objectives are introduced in the remainder of this chapter.

Fiscal discipline requires effective control of budget aggregates: total revenue and spending and the balance between these totals. When aggregate

* Incentives are influenced/generated by institutional arrangements. *Ex ante* rules and *ex post* accountability for output are examples of institutional arrangements.

control is effective, these outcomes are disciplined rather than accommodating; they result from explicit, enforced decisions on the aggregates by government. They are not merely the sum of powerful demands on the budget. PEM also seeks allocative efficiency, an expenditure mix that is responsive to changing government priorities as well as to evaluative findings on the comparative effectiveness of alternative expenditure programs. Allocative efficiency depends on the capacity to shift resources from old programs to new ones and from less to more productive uses, in correspondence with changing public policy objectives. Finally, PEM seeks efficiency in administrative operations, the progressive reduction, through productivity gains, in the running costs of government agencies and in the unit cost of services.

Although some of these terms may be unfamiliar to persons schooled in conventional budget processes, the three objectives represent ubiquitous tasks of budgeting. Every national budget system produces spending totals, retards or promotes allocative efficiency, and generates higher or lower operational efficiency. How government pursues these objectives distinguishes modern

public expenditure management from due process in budgeting.

Aggregate Fiscal Discipline

Aggregate fiscal discipline requires that spending (and other budget) totals be set independently of and before decisions are made on the various parts of budget. If they are not, the spending totals will inexorably rise to accommodate demand. The totals must be reasonably firm—hard constraints rather than soft targets—and must be enforced throughout the year while spending is underway, not just during the period when the budget is being prepared. Moreover, the aggregates must be sustainable over the medium-term or longer through policies and instruments that enable the government to maintain discipline year after year. Table 1.2 sets forth basic arrangements for maintaining aggregate discipline.

Aggregate fiscal discipline deals with the interaction between two variables: revenues and expenditures. In a limited sense, a government can be said to maintain discipline even when spending (in real terms or as a share in GDP) rises year after year, as long as this increase is matched by revenue increases. In a broader sense, however, maintaining aggregate fiscal discipline

Table 1.2: Institutional Arrangements for Enforcing Aggregate Fiscal Discipline

Rules	Limits on total spending (in some cases sectoral spending as well) are established before individual spending bids are considered. Total spending must be consistent with these limits. The limits may be expressed in money terms, relative to GDP, as rates of change, or in terms of the balance between receipts and expenditures. The limits are set for the medium-term (3–5 years) and budget decisions are made within a medium-term expenditure framework.
Roles	A strong finance ministry is empowered to enforce the budget aggregates in bilateral negotiations with spending departments and Cabinet discussions. The finance ministry is the official scorekeeper of the budgetary impact of spending proposals and other budget actions. During implementation of the budget, it may intervene to block (or notify the Government) of actions that would cause the fiscal aggregates to be breached.
Information	The medium-term expenditure framework provides a baseline for measuring the budgetary impacts of policy changes. Throughout formulation of the budget, information is provided on changes to the baseline. During implementation of the budget, spending is monitored to ensure compliance with the fiscal aggregates.

entails enforcing spending limits that do not require ongoing increases in revenues. One way of accomplishing this would be to limit total spending as a proportion of GDP; another would be to set absolute limits (in money terms) on total spending; a third would be to specify the maximum amount by which expenditures will be permitted to increase over the previous year's or the baseline level. If total

spending is not controlled, there is a strong possibility that the expenditure objective will be compromised and that the government will seek to achieve the desired fiscal posture by raising taxes or selling assets rather than by constraining expenditure.

Due process budgeting conventionally operates in a bottom-up environment. Spenders are invited to bid for resources through the recurring proce-

dures of budgeting, while controllers review the bids, compare their relative value, trim some bids, and decide on the amounts to be spent. In some governments, the process begins with tentative targets, either for total expenditure or for the amounts that particular spending units may bid for. But these constraints tend to be soft; they are provisional and often yield in the face of pressure for additional funds.

Soft aggregate targets were in vogue during the postwar Keynesian era, when many governments abandoned fixed budget rules (such as the balanced budget principle) in favor of flexible targets that respond to changes in economic conditions. They also were a byproduct of a fundamental change in the composition of national expenditure: relatively less spent on public consumption and investment, and much more on entitlements and transfers. The new mix served Keynesian objectives because, unlike consumption and investment expenditures which typically are limited in amount, entitlements usually are open-ended, with spending rising to satisfy all legally-sanctioned demands. This feature makes entitlements effective stabilizers and safety nets that respond quickly and automatically to changes in economic circumstances.

In retrospect, it is apparent that soft fiscal targets and the changed composition of public expenditure contributed to the postwar uptrend in the ratio of public spending to GDP in almost all democratic regimes. However, faced with chronic budget deficits and structural economic weakness, many governments have retreated from Keynesian demand management and have adopted fixed fiscal targets. The Maastricht norm of budget deficits no higher than 3 percent of GDP is an important manifestation of this trend. PEM is consistent with this movement, but it targets expenditure totals, not just net budget balance.

How hard are the new constraints on aggregates? Probably not as hard as advocates want, but not as soft as the old targets were. They cannot be truly rigid because contemporary governments cannot turn the clock back to the time, decades ago, when public expenditures were concentrated on consumption and investment rather than on transfers. Nor can developed or developing countries insulate themselves against the destabilizing impacts of recessions and other economic shocks on their budgets. It is an open question, therefore, whether national governments have the capacity to stay with

hard fiscal constraints for a period longer than the medium-term (3-8 years) business cycle. Few have tried, and fewer have succeeded. The true test of aggregate fiscal discipline is whether it can be maintained through bad times, when revenues drop and economic adversity generates pressure for more public spending and higher deficits.

But the good times also are a test of fiscal discipline. When the economy is booming and tax revenue is rising, there tends to be strong pressure on the government to spend more. During these times, hard constraints can strengthen the government's resolve to resist new spending demands and thereby mitigate the budget impacts of cyclical weakness in the economy.

Firm but not rigid, resolute but not obdurate—this is the posture that PEM takes with respect to budget aggregates. Effectively managed, even if fiscal discipline were weakened by political or economic force majeure, PEM would produce smaller deficits and less total spending than would ensue in the absence of aggregate constraints.

Allocative Efficiency

No government can effectively control the budget's totals unless it also controls the elements of expenditure. If it

doesn't, sectoral pressures will impel the government to spend in excess of budgeted totals.

Tension between the totals and the parts is ubiquitous in budgeting. Without hard constraints, the totals are the sum of the parts; with constraints, the totals can hold only if sectoral pressures are disciplined. PEM tries to change the contest between the parts and the whole from one in which controllers are on one side and spenders on the other to one in which spenders are entrusted with responsibility for keeping within the constraints. See Table 1.3 for the main features of allocative efficiency.

Due process budgeting is predicated on the notion that controlling the parts depends on a process in which all claims on the budget compete against one another. When the budget is comprehensive, as due process dictates, central controllers can weigh the various claims, establish budget priorities, and allocate resources. The logic of this approach appears unassailable, but the practice often fails to live up to the promise. If spenders and controllers have antagonistic interests, the odds are that in many budget seasons the spenders will get much of what they want. Either within the bounds of due

Table 1.3: Institutional Arrangements for Improving Allocative Efficiency

Rules	Spending limits are established for sectors or portfolios, and ministers are encouraged to reallocate within these limits. Bids to reallocate must be based either on evaluative findings of program effectiveness or on plans to evaluate policy initiatives.
Roles	Strong capacity at center of government to define national priorities and objectives, and make cross-sectoral allocations consistent with its medium-term expenditure framework. Strong sectoral ministers with broad authority to reallocate within their areas of responsibility, subject to review by Cabinet and/or Parliament.
Information	Ministers and managers generate or receive information on the actual or expected effectiveness of programs, as well as on the social outcomes ensuing from ongoing programs, budget actions, and policy initiatives. They also receive information on the expenditure impacts (relative to the medium-term framework) of authorized and proposed budget actions.

process or by infringing some of the rules, spenders can outwit the budget's guardians, evade the controls, pressure the government to raise taxes rather than cut spending, and force it to accept incremental rather than reallocative outcomes.

During the past 30 years, democratic governments have sought to counter budgetary incrementalism in a variety of ways. One has been to link the budget to formal priority-setting procedures such as program budgeting or planning-programming-budgeting systems (PPBS); another has been to direct spending units

to prepare zero-based budgets. Wherever they have been tried, these and similar approaches have failed to strengthen strategic reallocation or to weaken incrementalism's hold on the budget. Although each type of reform has its own deficiencies, all failed because they overloaded the information-processing capacity of central controllers and departmental spenders, they increased budgetary conflict between controllers and spenders, and they spurred those threatened with a loss of resources through reallocation to take counter measures that protected their interests.

Allocative efficiency can be advanced only if informational demands are manageable, budgetary conflict is muted, and spenders do not sabotage the priority setting and implementation process. PEM promotes these conditions by devolving major reallocate responsibility to sectoral ministers and officials. Rather than having all reallocations made by central controllers, PEM shifts a significant part of the burden to politicians and managers. Government still must adjudicate competing intersectoral demands; that is, it must decide how much should be allocated to each major sector or portfolio within the budget. Carrying out this responsibility requires that it have sufficient strategic capacity to establish spending subtargets and program priorities for each sector or portfolio. But once it has made broad inter-sectoral decisions, the government leaves the task of making most of the reallocations to those in charge of the various sectors. In this way, it enlists spending ministers and managers in the cause of allocative efficiency.

In this devolved environment, the big decisions on strategic objectives and priorities continue to be made at the center, but these represent only a fraction of the program decisions and reallocations made in the course of formu-

lating the budget. Most adjustments to programs, including cutbacks, are initiated by the responsible ministers or their managers, not by the government as a whole or by those who operate the machinery of budgeting. This devolved structure (1) reduces information demands, (2) concentrates budgeting on major policy questions, (3) reduces conflict between spenders and controllers over the details, and (4) gives affected ministers incentives to reallocate rather than to fight spending shifts. The result may be more reallocation than occurs when the central machinery of budgeting is organized for reallocation.

At first glance, this conclusion seems anomalous. Why should allocative efficiency be more robustly pursued when the task is dispersed among spenders whose interests may be served by keeping with the status quo? The answer is that for significant reallocation to occur, spenders must be given strong incentives to cooperate; it may not suffice that reallocations are forced on them from the center. PEM encourages spenders to look to their own portfolios for savings because it denies them incremental resources though the annual budget bids and entrusts them with making most reallocations. Depending on the scope of

the reallocation and the policy impacts, in some cases spenders can reallocate only after receiving government approval, in others, on their own initiative.

For PEM to spur reallocation, ministers and managers must be given spending constraints within the government's global budget. In addition, budget decisions must be taken within a framework that enforces the rules of reallocation and discourages evasion. The elements of this framework are described in chapter 4. They include a multi-year budget, baseline projects of future authorized expenditure, an evaluation capacity for assessing the relative value of programs, and computational rules for measuring the budgetary impacts of proposed reallocations. Without these elements, devolving spending responsibility risks significant erosion in spending control.

Operational Efficiency

One of the oldest purposes of budgeting has been to economize on the operations of the government by controlling items of expenditure, the various things (personnel, supplies, equipment, and so on) purchased by government agencies. The conventional means of exercising this control is to

itemize the amount that may be spent on each category of inputs purchased by spending managers. Where itemized input controls are exercised, spending units have to receive central approval before they employ staff, purchase items, or take other actions that spend public funds. Over time, many governments have consolidated the line items into broader categories and established systems of internal control that give managers increased discretion in spending appropriated funds. But in many countries, budgeting continues to focus on the amounts spent on the various inputs.

Input control retards operational efficiency, because it does not give spenders incentives to economize and does not relate the amounts spent to the outputs produced. Not surprisingly, therefore, many governments that maintain seemingly strict expenditure controls have been afflicted by the "relative price effect", the tendency of prices to rise faster in the public sector than in the market economy. Stagnant productivity resulting, in part from an input focus, gives governments little choice but to accommodate the demands of spenders for more resources: if they fail to do so, the delivery of services would suffer.

Table 1.4: Institutional Arrangements for Improving Operational Efficiency

Rules	Running (or operating) costs are cash limited, but managers are given broad discretion in using these resources, including (in some countries) discretion to carryover unused funds or to prespend a small portion of the next year's running costs. Running costs are progressively reduced by a percentage equal to all or a portion of expected efficiency gains.
Roles	Strong line managers authorized to determine the mix of operating resources within fixed limits. Operating discretion devolved to subordinate managers, including those infield or regional offices.
Information	Budgeted outputs are specified in advance, and actual outputs are compared to the targets. Costs are allocated (ideally, on an accrual-basis) to the activities responsible for them. Information on financial and organizational performance is published in annual reports and other documents.

In industrial democracies, erosion in operational efficiency has been masked for decades by the rise in entitlement spending. The assumption has been that inasmuch as government consumption has declined as a proportion of public spending, the problem must lie elsewhere. Moreover, governments have comforted themselves with the notion that consumption expenditure is controllable; they can (and often do) cut the amounts spent on personnel and other items. But despite periodic economy drives and nominal control over spending, in most countries public employment has risen as a

proportion of the labor force as have other operating expenditures.

PEM bolsters operational efficiency by shifting the focus of spending control from inputs to outputs and by decentralizing the management of operating resources. These critical features of public management reform are underway in a number of democratic countries.

Operational reform is centered on the notion that managers should be given discretion to run their operations as they best see fit and should be held accountable for results, including the outputs produced.

The institutional arrangements that encourage better operational efficiency include hard constraints on running costs, use of efficiency dividends and across the board cuts to spur managers to be efficient, managerial freedom to spend running costs, output targets, and audit or review of performance. In pursuing operational efficiency, governments must guard against hidden reductions in service volume or quality. This is one of the reasons why they emphasize output measures, service quality, and performance reviews. Table 1.4 specifies institutional arrangements for operational efficiency.

Restructuring Budget Institutions to Manage Public Expenditure

Improving the management of public expenditure entails changes in budgetary institutions—the roles of spenders and controllers, the rules under which they claim, allocate and use resources, and the information available to them. Without institutional change, there would be no basis for expecting self-interested politicians and managers to behave differently. If they have incentives and opportunity to do so, they would continue to draw more

resources from the public treasury while resisting reallocation and spending budgeted funds with little regard for efficiency.

Getting politicians and managers to change their behavior boils down to a matter of incentives. They have to have a strong inducement to abide by spending limits, and they must be willing to shift resources to higher priority programs and to rearrange operations so as to make them more effective. By changing rules, roles, and information, PEM seeks to alter the incentives available to budget makers. The changes are summarized in Tables 1.2, 1.3, and 1.4, and explained in the paragraphs that follow.

Aggregate Fiscal Discipline

In many countries, aggregate fiscal discipline has been undermined by self-interested spenders who benefit by taking more from the commons because they bear only a portion of the cost. As indicated in Table 1.2, PEM seeks to remedy the common resource problem by enforcing rules that limit the total that all spenders can draw from the pool. This solution is similar to that devised in medieval England when the commons were enclosed and grazing was restricted. In the case of public

expenditures, the limits have to be firm, though not unbending. They have to be established in rules and norms that cannot be easily changed by budgetary expediency or political whim, and they have to be enforced through changes in the balance of budgetary power between spenders and controllers.

The limits can be in the form of norms or targets, such as ceilings on the ratio of spending to GDP or on the size of the deficit. Limits may also be established for the public debt, the rate of growth in public expenditure, or the tax burden. To be useful, the limits must constrain; they should not merely accommodate all claims on resources, nor should they be adjusted whenever strong demands exceed the preset limits. Nevertheless, absolutely rigid limits are not likely to be enforceable when the force majeure of changing political or economic conditions compel politicians to breach the totals. But aggregate constraints should be enforceable in normal times or under moderate fiscal-stress. In these circumstances, yearly limits compel spenders to compete for resources within pre-determined budget totals and (in some cases) sectoral subtotals. For some claimants to get more others must get less.

Budget rules are not self-enforcing, nor can they be enforced when spenders have the upper hand in relations with controllers. In fact, the history of budgeting is strewn in many countries with aggregate constraints that have not worked. Effective limits on the fiscal aggregates require that the role of central controllers (in the ministry of finance or a similar organ) be bolstered, so that they have the authority to block spending actions during formulation or implementation of the budget that would cause the limits to be exceeded. Central controllers must be sufficiently powerful that they can enforce the aggregates, even in the face of opposition from spenders. But as they strengthen their grip on the totals, these controllers may find it expedient to let go of some controls, over personnel and procurement, for example, that finance ministries traditionally have exercised. Devolving responsibility for particular spending decisions to line ministers and program managers may facilitate enforcement of the fiscal aggregates by reducing the number of matters on which the finance ministry must negotiate with the spending departments, thereby reducing budgetary conflict and transaction costs.

Central controllers cannot be effective if they lack timely and accurate information on the status of the budget and on the potential impact of spending demands on future totals. PEM recognizes that asymmetry in the supply of information may undermine enforcement of the totals as well as of their expenditure objectives. When spenders know more than controllers about the political strength and budgetary impacts of ongoing programs and policy initiatives, they may withhold information or provide faulty estimates. To counter these possibilities, central controllers need their own capacity to project the medium-term cost of programs and the impacts on budget baselines. Using this information, central controllers become the authoritative scorekeepers of the budget process, determining whether particular spending bids can be accommodated within the approved medium-term expenditure framework.

With appropriate rules, roles and information in place, budgeting becomes more competitive and less prone to spending drift. Inasmuch as the rules and limits are set in advance, before claims on the budget are considered, central controllers have some advantage in the inherently adversarial

contest between them and spenders. If the rules work as intended, rather than taking as much as they want from the commons, politicians are constrained to spend only up to the amount allowed by the rules. But this is a big “if”, for rules that are made by politicians can be broken by them. In the concluding section of this chapter, we argue that politician-made rules can have teeth. Politicians can bind themselves, though the rules cannot be enforced in all circumstances.

Allocative Efficiency

Enforcing aggregate fiscal discipline is a mixed blessing for allocative efficiency. On the one hand, it may impel old and new claimants to compete for resources within or across sectors; on the other hand, fiscal discipline may make it more difficult to fund new priorities. Whether the first or the second outcome predominates depends on the institutional arrangements that encourage or retard reallocation. The main rules, roles, and informational requirements associated with allocative efficiency are set forth in Table 1.3.

Several conditions must be present to facilitate active reallocation. First, in terms of roles, government and its central organs should be

responsible for strategic guidance and for establishing the main priorities and initiatives for the medium-terms and (where appropriate) beyond. But line ministers and spending departments should be responsible for setting program priorities within the strategic framework laid down by the government. Second, budget rules should encourage reallocation by enabling politicians to shift within sectors without significant risk that doing so will cause them to lose resources. This condition is necessary because spenders will subvert reallocations if they are penalized for trying to shift resources from old to new uses. Reallocation also must be supported by information on program costs and effectiveness. Reallocation must be undertaken in a framework that enables budget controllers to assess the impact of spending shifts on aggregate and (where applicable) sectoral limits, and encourages spending ministers to assess the comparative worth of programs. Finally, spenders should be accountable for program results; if they are not, the government cannot be confident that reallocations will be in accord with its strategic objectives, or that they will promote allocative efficiency.

Operational Efficiency

The conventional rules of budgeting give self-interested managers a strong incentive to spend all available resources, even if the result is an erosion in the organization's operational efficiency. The disincentive to be efficient is summed up in the "use it or lose it" attitude which is said to influence agency managers. Managers routinely assume that if they do not spend all of this year's budget, they will be given fewer resources the next year. Many managers operate in a controlled environment in which their spending actions are overseen by outsiders whose approval is needed before staffing, purchasing and other decisions are taken. Moreover, spending units typically cannot retain unused funds. Finally, and possibly most important, the performance of managers typically is assessed in terms of compliance with procedural rules, not in terms of the outputs they produce or the efficiency of operations.

Operational efficiency depends on managers who are willing to take steps that reduce running costs or that boost the volume or quality of outputs. External controllers can create conditions that foster operational improvements; they cannot dictate these

improvements. Rather, the incentive to improve efficiency must come from the managers themselves, but they can be induced to behave efficiently only if conditions enable them to do so.

Foremost among these conditions are rules that give managers broad discretion in running their operations while holding them accountable for the cost, quantity and quality of outputs. The key rule change gives managers broad flexibility in using budgeted resources, including the opportunity to retain a portion of efficiency gains and to carryover some unused funds to the next financial year. The rules should also require that operating costs be cash limited, so that managers may not seek supplemental funds during the year. These rule changes have to be accompanied by adjustments in the roles and relationships of line managers and external controllers. In the new arrangement, controllers (in central agencies or departmental headquarters) specify performance targets and monitor results, but operating managers are given discretion to optimize the use of budgeted resources.

Promoting operational efficiency requires vast new amounts of information on the cost of producing budget-

ed outputs. This need has spurred some governments to introduce accrual accounting schemes and to improve cost accounting and allocation systems in departments. It also has led to the ex ante specification of output and service targets, and to the publication of annual reports that compare targeted and actual performance.

Integrating the elements of public expenditure management. In an unconstrained world, governments would seek concurrent improvements in all three elements of public expenditure management. Doing so may be difficult, however, because of the political and financial costs of reforming public institutions. Strong political interest and support usually are needed to impose aggregate limits and to transfer resources to higher priority uses. Political support also may be needed to overcome bureaucratic or legislative reluctance to give managers operating freedom. Compliance costs also are high because of the need to develop and maintain new reporting and control systems. Because of the various costs, governments tend to emphasize one or two PEM objectives, but not all three. For example, Australia has pursued a reform strategy focused on improving resource allocation in government, while New Zealand has con-

centrated on operational issues.

Nevertheless, important interactions among PEM's objectives may impel some governments to move on all three fronts. The task of maintaining fiscal discipline is eased when the government improves allocations (and thereby reduces pressure for additional spending on new priorities) and squeezes waste out of agency operations, thereby enabling it to reduce running costs. Moreover, strong constraints on fiscal aggregates may persuade politicians to finance emerging priorities through reallocation; they may spur managers to cover workload increases by improving productivity rather than by seeking incremental funds.

There are inherent linkages of allocation and operational issues. A government that is lax in managing operations does not have an optimal allocation of resources. The converse also holds: a government that drives to improve programs may seek to cut overhead and other operating costs so as to make more money available for policy initiatives. Over time, therefore, a government that pursues one PEM objective may broaden its reform agenda to encompass other objectives as well. A dozen years after Australia initiated reforms that emphasize program effec-

tiveness, it adopted some operational improvements such as accrual budgeting and tighter cost controls. On the other hand, after its operational reforms were bedded in, New Zealand introduced new instruments such as strategic and key result objectives that upgrade the government's capacity to establish and implement strategic priorities.

As PEM matures and additional features are grafted onto older budget practices, compliance and other transaction costs are likely to escalate. At some time in the future, therefore, a new cycle of public expenditure management reforms may be needed to purge redundant or inefficient rules and procedures. Without the periodic consolidation of systems, the last generation's reforms become the next generation's routines, and the focus on budget outcomes, which is PEM's most distinctive feature, may be blurred by procedural rules that get in the way of results.

Do New Budget Institutions Make a Difference?

PEM purports to influence budget outcomes by changing the behavior of spenders and controllers. If the changes have the intended effects, spenders would conserve resources, allocators would reallocate, and managers would

perform, not just comply. One of the unsettled questions in institutional economics is whether changes in the rules of the game suffice to produce the intended results. The argument runs as follows. Rules are needed because without them rational spenders would misuse public resources. They would spend more than the government could afford, favor old priorities over new ones, and operate in a wasteful manner. But if spenders—whether politicians or managers—were driven to behave in these self-interested ways, why don't they break or repeal new rules that stand in their way? Why don't politicians who are inclined to give voters what they want violate or revise aggregate constraints that bar them from spending as much as they want? And if they are truly determined to protect existing programs against cutbacks, why don't they use their power to block reallocation? In other words, if rules are necessary because spenders want to spend, how can they be effective when they prevent spenders from doing what they want?

In the absence of long-term evidence on budget outcomes through one or more economic and political cycles, one can only conjecture on how PEM-oriented rules will work. The

arguments run in opposite directions: some indicate a dismal prognosis for new rules of the game, others are more favorable.

First the downbeat arguments. It may be that rules changes have salutary effects in the short-run, when the new rules are fresh, have a lot of political support and attention, and politicians are on good behavior. Over time, however, constraining rules break down, either because of a buildup of deferred spending pressures or because politicians and others learn how to outwit them. As the rules become routinized, interest in enforcing them wanes, new tactics are devised to evade them, and the rules either are abandoned or are overtaken by events. For example, tough aggregate constraints may become counterproductive if they spur politicians to enact extrabudgetary means of financing coveted programs. Or in the face of economic stress, politicians may vote for more spending despite the impact on the deficit. Allocative efficiency may degrade over time as politicians and managers learn how to “game” the evaluation and performance measurement processes. And operational efficiency may weaken if the new freedom given managers is not reciprocated with more demanding

accountability for results. When these unintended behavioral changes occur, efforts to redirect funds to strategic priorities and effective programs may be defeated by spenders who give lip service to reallocation, program evaluation, outcome measures, and other results—enhancing processes, while protecting their vested program interests. Moreover, line managers may merely comply with the new routines rather than drive for further productivity gains.

But there is another side to the argument. Changing rules and roles can have positive impacts because the same politicians who are spenders also prefer prudent fiscal management, effective programs, and efficient operations. This is why they accept spending limits, new accountability requirements, and other constraining rules. Once the rules are in place, politicians and managers pay a price for violating them. The situation they face after new rules have been introduced is markedly different from the one they faced before there were outcome-based rules. Two additional factors may make them think twice before they stray too far. One is that because PEM rules are outcome-based, they can be more transparent than procedural rules, and vio-

lating them can entail high political cost. Second, the rules have enforcers, central controllers in some cases, the courts in others, international institutions in still others. Their job is to enforce the rules and restrain violators.

In the long term, the answer to the question “do new budget institutions make a difference?” will depend on the balance of power between controllers and spenders, guardians and claimants. When new outcome-based rules are adopted, the immediate effect is to empower the controllers and guardians. As long as they hold on to this advantage, the rules will make a difference. But, if because of economic, political or other developments, the balance tilts in favor of spenders and claimants, the rules will lose effectiveness. If this were to occur, further institutional changes can be expected in the future to reinforce PEM objectives and rebalance the relationship between spenders and controllers. ♣