

**Reforming the Public Expenditure  
Management System:  
Medium-Term Expenditure Framework,  
Performance Management, and Fiscal Transparency**

**The World Bank and Korea Development Institute  
Conference Proceedings (March 2004)**



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## Welcoming Remarks

Choongsoo Kim  
(President, Korea Development Institute)

Honorable Minister,  
Distinguished participants from the World Bank and other organizations,  
Ladies and gentlemen,

On behalf of the Korea Development Institute, it is my pleasure to welcome you all to the Joint Conference of the World Bank and KDI on "Reforming the Public Expenditure Management System." I would like to give a special welcome to Minister Byungil Kim of the Ministry of Planning and Budget who sponsored this Conference.

I want to start by thanking the organizers from the World Bank, Ministry of Planning and Budget, and KDI for their dedicated efforts. I am pleased to see so many leading experts from the international community who came here to share knowledge and experience.

Ladies and gentlemen,

KDI was established in 1971 as the first government-funded research institute in social science. At the time of its inception, KDI focused on policy issues related to the Five-Year Economic Development Plans, which served as a basis for economic management in those days. As Korea made a democratic transition in the 1980s, social issues such as welfare and balanced regional growth came to the fore, and were accorded a greater weight in KDI's research agenda. This change was consistent with its mission as a policy-oriented research institution devoted to the "development" in the broad sense of the term. In fact, KDI is distinguished from other government-funded research institutions for its extensive coverage of research areas and its comprehensive approach.

An important area of research throughout this period has been fiscal policy. Fiscal policy addresses both macroeconomic and microeconomic issues. It is an important determinant of the macroeconomic stability of a nation in the long and the short term; a prudent management of government liabilities is critical for the long-term price stability and economic growth, and a flexible management of budget balances is essential to dampen the short-term cyclical fluctuations.

From a microeconomic perspective, fiscal policy is concerned about reallocating national resources across different sectors. Government policies are implemented in most part through expenditures on education, defense, infrastructure investment, income security, health, environmental protection, and others. These sectoral policies are collated against each other and prioritized in the annual budget process. In this way, fiscal policy works as a disciplining mechanism to impose an overall resource constraint on sectoral demands and maximize the efficiency of public expenditure.

Ladies and gentlemen,

The recent economic crisis that hit the Korean economy at the end of 1997 left an unmistakable mark in every policy area, including the fiscal policy. The budget balance deteriorated substantially, and government liabilities doubled in a matter of two years. However, the rapid recovery in 1999 and 2000 contributed to the regained tranquility in

public finance, with the balance showing surpluses and the debt-to-GDP ratio stabilizing at around 20 percent in the following years.

But challenges still remain. Revenue growth is expected to slow down as the potential growth rate of the Korean economy declines. At the same time, pressures for increased spending are building up to prepare the Korean economy for the intensifying global competition, support the financial-sector restructuring, and finance the expanding welfare programs. In addition, public demand for a transparent management of tax money is increasing.

Faced with these challenges, we found that a thorough reexamination of the public expenditure management system was called for. We need a system that enables us to implement fiscal policy in a strategic way to fulfill all of its promises; contributing to the long- and short-term macroeconomic stability and maximizing the allocative and operational efficiency of public expenditure.

Three issues were selected for our study; (1) medium-term expenditure framework, (2) performance management, and (3) fiscal transparency. Each of them represents a significant departure from the past mode of expenditure management. They are complementary to and interdependent on each other.

The Ministry of Planning and Budget has already made some progress in introducing elements of the needed reforms in these areas. Our study builds on these efforts and aims to provide directions for further improvement. It began early last year and has been carried out in collaboration with the World Bank, with the financial support from the Ministry of Planning and Budget.

This Conference was organized to present our major findings and gather a broad range of inputs from many sources. It will provide a forum for debating policy options for reforming the public expenditure management system. I hope at the end of the Conference, we can have a better understanding on this matter. Any contribution toward providing new thoughts and insights will prove to be both important and meaningful, and will be incorporated into our final report to the Ministry of Planning and Budget. The report will be published next month in Korean.

Ladies and gentlemen,

Now with my welcoming remarks complete, let me turn the floor over to Minister Byungil Kim of the Ministry of Planning and Budget.

I wish you all an informative and productive conference.

Thank you.

# Keynote Speech

Byung-il Kim  
(Minister of Planning and Budget)

## 1. Introduction

Dr. Choong-Soo Kim, President of KDI,  
Mr. Bill Dorotinsky, Lead Public Sector Specialist of the World Bank, and distinguished guests from around the world!

It is my great honor to have this opportunity to be the keynote speaker at today's joint conference of the World Bank and KDI, and talk about fiscal reform in Korea.

I would like to begin by extending my compliments to the staff of the World Bank and KDI for their devoted research on Reforming the Public Expenditure Management System, initiated by the Korean Government last year.

In addition, it is my pleasure to welcome the participants from various countries and international organizations such as the World Bank and IMF, who have travelled a long way to be here today.

Thank you for your participation.

## 2. Korea's efforts to enhance the public expenditure management system

### 2.1. Changes in Korea's fiscal management environment

One of the recent global trends is that the role of public finance as a policy tool is becoming increasingly important, as the scope of government intervention in the economy becomes smaller.

In addition, budget deficits and national debt can have direct effects on the national economy under the open economic system, and are important factors in deciding national credit ratings. Therefore, in reality, the influence of public finance on national economy is significant.

Under such circumstances, Korea's fiscal management environment is changing rapidly.

Internally, economic and social structures are changing and the demand of the citizens is becoming more diverse.

Externally, the security situation in the Korean Peninsula is changing, and the world economy is shifting into bloc economies such as FTAs, constantly giving rise to new demands for public expenditure.

In the short-term, there are demands for building a Northeast Asian Economic Hub, and R&D for the development of new growth-driving forces. Moreover, the need for additional spending in the agricultural sector restructuring is rising, to meet international standards including the opening of the agricultural market.

In the long-term, public expenditure in the areas of public pension, health insurance, and welfare for the aged population is expected to increase substantially due to rapid population ageing.

On the other hand, the revenue situation is expected to become more difficult, as the Korean economy gradually turns into a stable low-growth economy.

In response to such changes in the fiscal management environment, it is time to make substantial changes in the public expenditure management system to enhance the productivity of public finance.

## **2.2. The participatory government's efforts to reform the public expenditure system and management practices**

The Korean government is implementing 3 fiscal reform tasks since the inauguration of the Participatory Government, to enhance the efficiency of public spending while maintaining fiscal soundness.

Firstly, in contrast to previous medium-term fiscal plans that were formulated irregularly, a National Fiscal Management Plan was formulated last year, to be revised and updated every year, allowing the efficient allocation of national resources from a mid to long-term perspective.

The Plan sets aggregate objectives of national fiscal management based on a 5-year macroeconomic outlook and projected public expenditure requirements, and presents sectoral resource allocation priorities and spending size by budgetary programs.

Furthermore, a Top-down budgeting system will be introduced this year. Accordingly, expenditure ceilings will be set using the total budget size and sectoral and ministerial resource allocation sizes presented in the National Fiscal Management Plan.

After an agreement on sectoral and ministerial ceilings has been reached, each line ministry will autonomously formulate their respective budgets within the expenditure ceilings. The budget will be finalized after a final consultation with the Ministry of Planning and Budget.

In response to such changes in the fiscal management system, a Performance Management System is being introduced at the same time, to ensure accountability against expanded autonomy of the line ministries.

Last year, performance goals and indicators have been developed for some of the budgetary programs in 22 line ministries. Beginning this year, the system will be gradually expanded to encompass more ministries and programs, with its full introduction scheduled for the year 2008.

## **2.3. Revising the coverage of public finance to meet international standards**

Turning to the issue of the coverage of public finance and fiscal transparency,

Korea's coverage of public finance has been rather limited compared to international standards. This gave rise to the problem of making it difficult to perform international comparisons in fiscal size and balance, expenditure by areas, and national debt.

The Korean government has formulated a plan to revise the coverage of public finance, and will begin implementing the plan this year. As a result, it will be possible to assess and analyze budgetary activities in accordance to international standards.

In this process, detailed reviews of international standards and country cases will be of great help.

I would like to take this opportunity to request the valuable advice and information from the international experts here at the conference.



### **3. Conclusion**

This international conference will offer an opportunity to discuss a variety of policy recommendations and proposals. I trust that these will provide momentum for reforming the public expenditure management system in Korea, and serve as references for fiscal reform in other countries as well.

Distinguished guests from around the world!

Thank you again for your participation.

Although your stay in Seoul will only be a week long, I hope you will take time to enjoy the beautiful atmosphere of spring in Korea.

May your stay in the Land of the Morning Calm leave you with pleasant and unforgettable memories of the Korean culture.

Thank you.



## Conference Program

March 15, 2004 (Monday)

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### Issue 1: Medium-Term Expenditure Framework

- 09:00 - 10:00     [Registration and Networking](#)
- 10:00 - 10:30     [Opening Ceremony](#)  
Welcoming remarks: Choongsoo Kim (President, Korea Development Institute)  
Keynote speech: Byungil Kim (Minister, Ministry of Planning and Budget, Republic of Korea)
- 10:30 - 11:00     [Break](#)
- 11:00 - 12:00     [Session 1-1: Conceptual Framework](#)  
**Moderator:** Hong Tack Chun (Vice President, Korea Development Institute)  
Topic 1: Developing a Medium-Term Expenditure Framework  
*Presenter:* Bill Dorotinsky (Lead Public Sector Specialist, World Bank)  
*Discussants:* Seok-kyun Hur (Associate Fellow, Korea Development Institute)  
                    Saravuth Sok (Deputy Director, Ministry of Economy and Finance, Cambodia)
- 12:00 - 14:00     [Lunch](#)
- 14:00 - 15:30     [Session 1-2: Introducing MTEF in Korea](#)  
**Moderator:** Bill Dorotinsky (Lead Public Sector Specialist, World Bank)  
Topic 2: Key Issues for Introducing MTEF and Top-Down Budgeting in Korea  
*Presenter:* Soomin Park (Director, Ministry of Planning and Budget, Republic of Korea)  
                    Dong Yeon Kim (Senior Public Sector Specialist, World Bank)  
*Discussants:* Allan Gustafsson (President, Mapsec, Sweden)  
                    Youngsun Koh (Fellow, Korea Development Institute)
- 15:30 - 16:00     [Break](#)
- 16:00 - 17:00     Topic 3: Successful Installation of MTEF to the Korean Fiscal System  
*Presenter:* Seok-kyun Hur (Associate Fellow, Korea Development Institute)  
*Discussants:* YoungJoo Lee (Deputy Director, Ministry of Finance and Economy, Republic of Korea),  
                    Dang Huu Phap (Deputy Director, Ministry of Finance, Vietnam)
- 19:00 - 20:30     [Welcoming Dinner \(invitees only\)](#)  
Hosted by Yangkyoon Byeon (Vice Minister, Ministry of Planning and Budget, Republic of Korea)

## March 16, 2004 (Tuesday)

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- 09:00 – 09:10      **Registration and Networking**
- 09:10 – 10:10      **Session 1-3: International Experiences in MTEF**  
**Moderator:** Joel Turkewitz (Senior Public Sector Specialist, World Bank)  
**Topic 4: MTEF in Sweden (1)**  
**Presenter:** Allan Gustafsson (President, Mapsec, Sweden)  
**Discussants:** Hongsang Jung (Director, Ministry of Planning and Budget, Republic of Korea)  
Mulia Nasution (Head of State Financial Accounting Agency, Ministry of Finance, Indonesia)
- 10:10 – 10:20      **Break**
- 10:20 – 11:20      **Topic 5: MTEF in Sweden (2)**  
**Presenter:** Niklas Frank (Deputy Secretary, Swedish Parliament)  
**Discussants:** Junghun Cho (Public Sector Specialist, World Bank)  
Munhyu Bang (Director, Ministry of Planning and Budget, Republic of Korea)
- 11:20 – 11:30      **Break**
- 11:30 – 12:30      **Topic 6: MTEF in Germany**  
**Presenter:** Astrid Lübke (Deputy Head of Division, Federal Ministry of Finance, Germany)  
**Discussants:** Ki-Baeg Park (Research Fellow, Korea Institute of Public Finance)  
Ratanak Hav (Deputy Director, Ministry of Economy and Finance, Cambodia)
- 12:30 – 14:00      **Lunch**
- 14:00 – 15:00      **Topic 7: MTEF in US, UK and Other Countries**  
**Presenter:** Bill Dorotinsky (Lead Public Sector Specialist, World Bank)  
**Discussants:** Changho Lee (Director General, The Embassy of Korea in US)  
Sanya Praseuth (Deputy Director, Ministry of Finance, Lao PDR)
- 15:00 – 15:30      **Break**
- 15:30 – 17:00      **Panel Discussion: MTEF and Top-down Budgeting**  
**Moderator:** Bill Dorotinsky (Lead Public Sector Specialist, World Bank)  
**Discussants:** Eonseog Song (Director, Ministry of Planning and Budget, Republic of Korea)  
Seok-kyun Hur (Associate Fellow, Korea Development Institute)  
Astrid Lübke (Deputy Head of Division, Federal Ministry of Finance, Germany)  
Niklas Frank (Deputy Secretary, Swedish Parliament)  
Jambaa Jargalsaihan (Director-General, Ministry of Finance and Economy, Mongolia)

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**March 17, 2004 (Wednesday)**

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**Issue 2: Performance Management**

- 09:00 – 09:30     **Registration and Networking**
- 09:30 – 10:30     **Session 2-1: Conceptual Framework**  
**Moderator:** Ilho Yoo (Professor, KDI School of Public Policy and Management)  
Topic 1: Overall Design and Framework of Performance Management  
*Presenter:* Joel Turkewitz (Senior Public Sector Specialist, World Bank)  
*Discussants:* Ho-seung Moon (Director, Board of Audit and Inspection,  
Republic of Korea)  
Younghee Lee (Staff, Presidential Committee on Government  
Innovation and Decentralization, Republic of Korea)
- 10:30 – 11:00     **Break**
- 11:00 – 12:00     **Session 2-2: Performance Management in Korea**  
Topic 2: Performance Management in Korea  
*Presenter:* Youngsun Koh (Fellow, Korea Development Institute)  
*Discussants:* Bill Dorotinsky (Lead Public Sector Specialist, World Bank)  
Jangro Lee (Senior Deputy Director, Ministry of Planning and  
Budget, Republic of Korea)
- 12:00 – 14:00     **Lunch**
- 14:00 – 15:00     **Moderator:** Allan Gustafsson (President, Mapsec, Sweden)  
Topic 3: Performance Management in the Health Sector  
*Presenter:* Heesuk Yun (Associate Fellow, Korea Development Institute)  
*Discussants:* Joel Turkewitz (Senior Public Sector Specialist, World Bank)  
Eui Kyung Lee (Senior Researcher, Korea Institute for Health and  
Social Affairs)
- 15:00 – 15:30     **Break**
- 15:30 – 16:30     Topic 4: Performance Management in the Education Sector  
*Presenter:* Ju Ho Lee (Professor, KDI School of Public Policy and Management)  
*Discussants:* Cheonsik Woo (Fellow, Korea Development Institute)  
Kioh Jeong (Professor, Korea National University of Education)

## March 18, 2004 (Thursday)

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- 09:00 - 09:10      **Registration and Networking**
- 09:10 - 10:10      **Session 2-3: International Experiences in Performance Management**  
**Moderator:** Niklas Frank (Deputy Secretary, Swedish Parliament)  
Topic 5: Strategy for the Introduction of Performance Management System  
**Presenter:** Harry Hatry (Research Associate, The Urban Institute, US)/  
Joel Turkewitz (Senior Public Sector Specialist, World Bank)  
**Discussants:** Byoung Sik Park (Professor, Dongguk University)  
Ui-hwan Tcha (Director General, Office for Government Policy  
Coordination, Republic of Korea)
- 10:10 - 10:20      **Break**
- 10:20 - 11:20      Topic 6: Performance Management in Australia  
**Presenter:** Richard Murray (Executive Director, The Treasury, Australia)  
**Discussants:** Choi, Joon Ook (Fellow, Korea Institute of Public Finance)  
Jin Park (Professor, KDI School of Public Policy and Management)
- 11:20 - 11:30      **Break**
- 11:30 - 12:30      Topic 7: Performance Management in Sweden  
**Presenter:** Allan Gustafsson (President, MAPSEC, Sweden)  
**Discussants:** Park, No Wook (Fellow, Korea Development Institute),  
Dang Huu Phap (Deputy Director, Ministry of Finance, Vietnam)
- 12:30 - 13:30      **Lunch**
- 13:30 - 15:00      Topic 8: Performance Management in US and UK  
**Presenter:** Bill Dorotinsky (Lead Public Sector Specialist, World Bank)/  
Joel Turkewitz (Senior Public Sector Specialist, World Bank)  
**Discussants:** Allan Gustafsson (President, Mapsec, Sweden)  
Mulia Nasution (Head of State Financial Accounting Agency, Ministry of Finance, Indonesia)
- 15:00 - 15:15      **Break**
- 15:15 - 17:00      **Panel Discussion: Lessons from International Experiences on Performance Management**  
**Moderator:** SungIl Lim (Senior Fellow, Korea Research Institute for Local Administration)  
**Discussants:** Joel Turkewitz (Senior Public Sector Specialist, World Bank)  
Youngsun Koh (Fellow, Korea Development Institute)  
Ohbong Kwon (Director, Ministry of Planning and Budget, Republic of Korea)  
Saravuth Sok (Deputy Director, Ministry of Finance and Economy, Cambodia)  
Sanya Praseuth (Deputy Director General, Ministry of Finance, Lao PDR)
- 19:00 - 21:00      **Dinner (invitees only)**  
Hosted by Choongsoo Kim (President, Korea Development Institute)

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## March 19, 2004 (Friday)

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### Issue 3: Fiscal Transparency

- 09:00 – 09:10     [Registration and Networking](#)
- 09:10 – 10:10     [Session 3-1: Transparency in Public Expenditure Management](#)  
**Moderator:** Bill Dorotinsky (Lead Public Sector Specialist, World Bank)/  
 Topic 1: Coverage of the Government Sector in Korea  
*Presenter:* Dong Suk Oak (Professor, Incheon University)/  
                                 Yongsun Koh (Fellow, Korea Development Institute)  
*Discussants:* Bum-Ki Woo (Presidential Committee on Government Innovation  
   and Decentralization)  
   Dongho Hong (Director, Ministry of Planning and Budget, Republic  
   of Korea)
- 10:10 – 10:20     [Break](#)
- 10:20 – 11:20     Topic 2: Information Flow under the Medium-Term Expenditure Framework  
*Presenter:* Junghun Cho (Public Sector Specialist, World Bank)  
*Discussants:* Seok-kyun Hur (Associate Fellow, Korea Development Institute)  
                                 Geum-Nam Kim (Senior Deputy Director, Ministry of Finance and  
   Economy, Republic of Korea)
- 11:20 – 11:30     [Break](#)
- 11:30 – 12:30     [Session 3-2: Integrated Approach to Public Expenditure Reform](#)  
**Moderator:** Joel Turkewitz (Senior Public Sector Specialist, World Bank)  
 Topic 3: Relationship between MTEF, Performance Management, and Fiscal  
   Transparency  
*Presenter:* Bill Dorotinsky (Lead Public Sector Specialist, World Bank)  
*Discussants:* Allan Gustafsson (President, Mapsec, Sweden)  
                                 Batsukh Batmunkh (Vice Director, Mongolia Development Institute)
- 12:30 – 13:00     [Wrap Up and Closing Remarks](#)  
 Bill Dorotinsky (Lead Public Sector Specialist, World Bank)
- 13:00 – 14:30     [Lunch](#)





## LIST OF PARTICIPANTS

**Batsukh Batmunkh**

Vice Director  
Mongolian Development Institute  
Government Building-3  
Baga Toiruu-44  
Ulaanbaatar-20a, Mongolia  
Phone: (976) 11-322311  
Fax: (976) 11-324518  
Email: [batmunkh\\_b2002@yahoo.com](mailto:batmunkh_b2002@yahoo.com)

**Munhyu Bang**

Director  
Industrial Public Finance Division III  
Ministry of Planning and Budget  
Republic of Korea  
Phone: (82) 2-3496-5045  
Fax: (82) 2-3480-7980  
Email: [mkbang@mpb.go.kr](mailto:mkbang@mpb.go.kr)

**Yangkyoon Byeon**

Vice Minister  
Ministry of Planning and Budget  
Republic of Korea  
Phone: (82) 2-3496-5100  
Fax: (82) 2-3496-5104  
Email: [ykbyeon@mpb.go.kr](mailto:ykbyeon@mpb.go.kr)

**Joon Ook Choi**

Research Fellow  
Research Division III  
Korea Institute of Public Finance  
Phone: (82)-2-2186-2221  
Email: [jchoi@kipf.re.kr](mailto:jchoi@kipf.re.kr)

**Junghun Cho**

Consultant  
Public Sector Group  
The World Bank  
Phone: (1) 202-458-0661  
Fax: (1) 202-522-7132  
Email: [JCho@worldbank.org](mailto:JCho@worldbank.org)

**Hong Tack Chun**

Vice President  
Korea Development Institute  
Phone: (82) 2-958-4011  
Fax: (82) 2-960-4570  
Email: [htchun@kdi.re.kr](mailto:htchun@kdi.re.kr)

**Bill Dorotinsky**

Lead Public Sector Specialist  
Public Sector Group  
The World Bank  
Phone: (1) 202-473-7189  
Fax: (1) 202-614-1065  
Email: [wdorotinsky@worldbank.org](mailto:wdorotinsky@worldbank.org)

**Niklas Frank**

Deputy Secretary  
Committee on Finance  
Swedish Parliament  
100 12 Stockholm, Sweden  
Phone: (46) 8-786-5935  
Fax: (46) 8-786-6171  
Email: [niklas.frank@riksdagen.se](mailto:niklas.frank@riksdagen.se)

**Allan Gustafsson**

President  
Mapsec  
Kungsbron 1, D4, Stockholm  
Sweden  
Phone: (46) 708-24 24 34  
Fax: (46) 8-506 362 01  
Email: [allan.gustafsson@mapsec.com](mailto:allan.gustafsson@mapsec.com)

**Harry P Hatry**

Research Associate  
Office of Public Affairs  
The Urban Institute  
2100 M Street, NW  
Washington, DC 20037  
USA  
Phone: (1) 202-261-5709  
Email: [HHatry@ui.urban.org](mailto:HHatry@ui.urban.org)

**Ratanak Hav**

Deputy Director  
Department of Economic Integration and ASEAN

Ministry of Economy and Finance  
St. 92, Wat Phnom, Phnom Penh  
Cambodia  
Phone: (855) 12-555-929  
Fax: (855) 23-430-745  
Email: [hrationak@hotmail.com](mailto:hrationak@hotmail.com)

**Dongho Hong**

Director  
Medium-Term Fiscal Planning Division  
Ministry of Planning and Budget  
Republic of Korea  
Phone: (82) 2-3496-5028  
Fax: (82) 2-3480-7625  
Email: [dhong@mpb.go.kr](mailto:dhong@mpb.go.kr)

**Seok-kyun Hur**

Associate Fellow  
Division of Public Finance and Social Development  
Korea Development Institute  
Phone: (82) 2-958-4239  
Fax: (82) 2-958-4090  
Email: [shur@kdi.re.kr](mailto:shur@kdi.re.kr)

**Jambaa Jargalsaihan**

Director-General  
Economic Policy and Planning Department  
Ministry of Finance and Economy  
210646 Ulaanbaatar  
Mongolia  
Phone: (976) 11-991-18345  
Fax: (976) 11-32-02-07  
Email: [jargalsaihan@pmis.mof.gov.vn](mailto:jargalsaihan@pmis.mof.gov.vn)

**Kioh Jeong**

Professor  
Korea National University of Education  
Phone: (82) 43-230-3420  
Fax: (82) 43-233-6366  
Email: [kiohjeong@hanmail.net](mailto:kiohjeong@hanmail.net)

**Hongsang Jung**

Director  
Public Funds Management & Research Division  
Ministry of Planning and Budget  
Republic of Korea

Phone: (82) 2-3480-7963  
Fax: (82) 2-3480-7976  
Email: [junghs@mpb.go.kr](mailto:junghs@mpb.go.kr)

**Byungil Kim**

Minister  
Ministry of Planning and Budget  
Republic of Korea  
Phone: (82) 2-3496-5000  
Fax: (82) 2-3496-5010  
Email: [bkim91@mpb.go.kr](mailto:bkim91@mpb.go.kr)

**Choongsoo Kim**

President  
Korea Development Institute  
Phone: (82) 2-958-4001  
Fax: (82) 2-960-2952  
Email: [chskim@kdi.re.kr](mailto:chskim@kdi.re.kr)

**Dong Yeon Kim**

Senior Public Sector Specialist  
WBIPR  
The World Bank  
Phone: (1) 202-458-2633  
Fax: (1) 202-676-9810  
Email: [Dkim@worldbank.org](mailto:Dkim@worldbank.org)

**Geum-Nam Kim**

Senior Deputy Director  
Government Finance Information & Management Division  
Treasury Bureau  
Ministry of Finance and Economy  
Republic of Korea  
Phone: (82) 2-503-9131  
Fax: (82) 2-3679-6107  
Email: [kgn3579@mofe.go.kr](mailto:kgn3579@mofe.go.kr)

**Youngsun Koh**

Fellow  
Division of Public Finance and Social Development  
Korea Development Institute  
Phone: (82) 2-958-4096  
Fax: (82) 2-958-4090  
Email: [yskoh@kdi.re.kr](mailto:yskoh@kdi.re.kr)

**Ohbong Kwon**

Director  
Fiscal Analysis Division  
Ministry of Planning and Budget  
Republic of Korea  
Phone: (82) 2-3496-5047  
Fax: (82) 2-3480-7653  
Email: [obkwon@mpb.go.kr](mailto:obkwon@mpb.go.kr)

**Changho Lee**

Director General, Ministry of Planning and Budget  
The Embassy of Korea in the U.S.A.  
Phone: (1) 202-939-5638  
Email: [greenchho@orgio.net](mailto:greenchho@orgio.net) / [chho56@yahoo.co.kr](mailto:chho56@yahoo.co.kr)

**Eui Kyung Lee**

Senior Researcher  
Department of Health Policy  
Korea Institute for Health and Social Affairs (KIHASA)  
Phone: (82) 2-384-3085  
Fax: (82) 2-353-0344  
Email: [eklee@kihasa.re.kr](mailto:eklee@kihasa.re.kr)

**Jang-ro Lee**

Senior Deputy Director  
Fiscal Analysis Division  
Ministry of Planning and Budget  
Republic of Korea  
Phone: (82) 2-3480-7657  
Fax: (82) 2-3480-7653  
Email: [genre@mpb.go.kr](mailto:genre@mpb.go.kr)

**Ju Ho Lee**

Professor  
KDI School of Public Policy and Management  
Republic of Korea  
Phone: (82) 2-3299-1016  
Fax: (82) 2-968-5072  
Email: [jhl@kdischool.ac.kr](mailto:jhl@kdischool.ac.kr)

**Younghee Lee**

Fellow  
Local Tax Division  
Korea Research Institute for Local Administration  
Staff  
Presidential Committee on Government Innovation and Decentralization

Phone: (82) 2-3488-7331

Fax: (82) 2-3488-7364

Email: [yhlee@krila.re.kr](mailto:yhlee@krila.re.kr)

**YoungJoo Lee**

Deputy Director

Treasury Division

Ministry of Finance and Economy

Republic of Korea

Phone: (82) 2-2110-2560

Fax: (82) 2-503-9282

Email: [jamty@mofe.go.kr](mailto:jamty@mofe.go.kr)

**SungIl Lim**

Senior Fellow

Division of Local Finance

Korea Research Institute for Local Administration

Phone: (82) 2-3488-7321

Fax: (82) 2-3488-7306

Email: [lsi@krila.re.kr](mailto:lsi@krila.re.kr)

**Astrid Lübke**

Deputy Head of Division

Division II A 4

Directorate-General of Budget

Federal Ministry of Finance

Wilhelmstrasse 97, D-10117 Berlin

Germany

Phone: (49) 1888-682-1341

Fax: (49) 1888-682-3690

Email: [astrid.luebke@bmf.bund.de](mailto:astrid.luebke@bmf.bund.de)

**Ho-seung Moon**

Director

Corporate Policy and Research Division

The Board of Audit and Inspection

Republic of Korea

Phone: (82) 2-2011-2420

Fax: (82) 2-2011-2848

Email: [noseung@hotmail.com](mailto:noseung@hotmail.com)

**Richard Murray**

Executive Director, Fiscal and Corporate

The Treasury, Australia

Langton Crescent, Parkes ACT 2600,

Australia

Phone: (61) 2-6263-3745  
Fax: (61) 2-6263-3360  
Email: [rmurray@treasury.gov.au](mailto:rmurray@treasury.gov.au)

**Mulia P Nasution**

Head of State Financial Accounting Agency  
Ministry of Finance  
Jl. Lapangan Banteng Timur 2-4  
Jakarta Pusat 10710  
Indonesia  
Phone: (62) 21-345-0959  
Fax: (62) 21-345-0959  
Email: [kabakun@bakun.go.id](mailto:kabakun@bakun.go.id) / [muliapn@hotmail.com](mailto:muliapn@hotmail.com)

**Dongseok Oak**

Professor  
Incheon University  
phone: (82) 32-770-8538  
Email: [dsock@incheon.ac.kr](mailto:dsock@incheon.ac.kr)

**Byoung Sik Park**

Professor  
Department of Public Administration  
Dongguk University  
President  
Korean Association for Policy Analysis and Evaluation  
Phone: (82) 2-2277-4809  
Fax: (82) 2-2277-6478  
Email: [parkbs@dongguk.ac.kr](mailto:parkbs@dongguk.ac.kr)

**Jin Park**

Professor  
KDI School of Public Policy and Management  
Republic of Korea  
Phone: (82) 2-3299-1027  
Fax: (82) 2-3299-1240  
Email: [jinpark@kdischool.ac.kr](mailto:jinpark@kdischool.ac.kr)

**Ki-Baeg Park**

Research Fellow  
Research Division 1  
Korea Institute of Public Finance  
Phone: (82) 2-2186-2227  
Fax: (82) 2-2186-1065  
Email: [kbpark@kipf.re.kr](mailto:kbpark@kipf.re.kr)

**No Wook Park**

Research Fellow  
Center for Fiscal Analysis  
Korea Institute of Public Finance  
Phone: (82) 2-2186-2267  
Fax: (82) 2-2186-2320  
Email: [npark@kipf.re.kr](mailto:npark@kipf.re.kr)

**Soomin Park**

Director  
National Resource Allocation Improvement Team  
Ministry of Planning and Budget  
Republic of Korea  
Phone: (82) 2-3496-5035  
Fax: (82) 2-3480-7651  
Email: [goodday@mpb.go.kr](mailto:goodday@mpb.go.kr)

**Dang Huu Phap**

Deputy Director  
State Budget Department  
Ministry of Finance  
8 Phan Huy Chu, Hanoi  
Vietnam

**Sanya Praseuth**

Deputy Director General  
Accounting Department  
Ministry of Finance  
Lanexang Avenue, P.O.Box 46  
Vientiane, Lao PDR  
Phone: (856) 21-252462  
Fax: (856) 21-217451  
Email: [lao96005@laotel.com](mailto:lao96005@laotel.com)

**Saravuth Sok**

Deputy Director  
Economic and Financial Policy Planning and Monitoring Unit  
Ministry of Economy and Finance  
St. 92, Wat Phnom, Phnom Penh  
Cambodia]  
Phone/Fax: (855) 23-430-745  
Email: [srvsok@hotmail.com](mailto:srvsok@hotmail.com)

**Eonseog Song**

Director  
Construction & Transportation Budget Division  
Ministry of Planning and Budget



Republic of Korea  
Phone: (82) 2-3496-5146  
Fax: (82) 2-3480-7675  
Email: [esong@mpb.go.kr](mailto:esong@mpb.go.kr)

**Michael L. O. Stevens**  
Consultant  
Africa Region  
The World Bank  
Phone: (1) 202-473-7493  
Email: [Mstevens2@worldbank.org](mailto:Mstevens2@worldbank.org)

**Ui-hwan Tcha**  
Director General for Policy Analysis and Evaluation  
The Office for Policy Analysis and Evaluation  
The Office for Government Policy Coordination  
Republic of Korea  
Phone: (82) 2-3703-3915  
Fax: (82) 2-734-8795  
Email: [chaeh@opc.go.kr](mailto:chaeh@opc.go.kr)

**Ha Duy Tung**  
Senior Officer  
International Cooperation Department  
Ministry of Finance  
8 Phan Huy Chu, Hanoi  
Vietnam  
Phone: (84) 4-933-0106  
Fax: (84) 4-933-2351  
Email: [haduytung@mof.gov.vn](mailto:haduytung@mof.gov.vn) / [hdtung@softhome.net](mailto:hdtung@softhome.net)

**Joel A. Turkewitz**  
Senior Public Sector Specialist  
WBIPR  
The World Bank  
Phone: (1) 202-458-2365  
Email: [jturkewitz@worldbank.org](mailto:jturkewitz@worldbank.org)

**Cheonsik Woo**  
Fellow  
Division of Knowledge Economy  
Korea Development Institute  
Phone: (82) 2-958-4139  
Fax: (82) 2-962-7810  
Email: [cswoo@kdi.re.kr](mailto:cswoo@kdi.re.kr)

**Bum-ki Woo**

Director

Fiscal and Tax Team

Presidential Committee on Government Innovation and Decentralization

Phone: (82) 2-3703-3217

Email: [bkwoo@mpb.go.kr](mailto:bkwoo@mpb.go.kr)**Ilho Yoo**

Professor

KDI School of Public Policy and Management

Republic of Korea

Phone: (82) 2-3299-1058

Email: [yoo@kdischool.ac.kr](mailto:yoo@kdischool.ac.kr)**Heesuk Yun**

Associate Fellow

Korea Development Institute

Public Investment Management Center

Phone: (82) 2-958-4689

Fax: (82) 2-962-9143

Email: [heesuk@kdi.re.kr](mailto:heesuk@kdi.re.kr)

## Part I

### **Medium-Term Expenditure Framework**



## CHAPTER 1

# Developing a Medium-Term Expenditure Framework

by

*Bill Dorotinsky, The World Bank*

## 1. Overview

Moving towards a Medium-Term Expenditure Framework (MTEF) involves building upon the current budget and policy decision-making process, with an aim to overcome some of the current incentives in the process and improve public expenditure decisions and management. This paper will explore the stages of a MTEF process, the role of some of the key institutions in the MTEF process, and references international practices to illustrate points. The paper is not exhaustive, but tries to provide more insight into a good budget formulation process, and some considerations for countries to keep in mind as they seek to strengthen budget formulation. Some aspects of improved budget formulation have already been addressed in the main paper, and this Annex seeks to pull these together into a broader context.

Generally, a MTEF tries to integrate policy with resource allocation decisions in a multi-year context to better reflect the effects of decisions on public finances, and generally lead to improved policy decisions. It also involves structuring the decision-making process to encourage economy and efficiency, and focus spending and policy on attaining the government's objectives. So a MTEF could be said to be about strategic allocation of resources in line with government priorities and the opportunity costs of decisions.

A very simplified outline of a MTEF process can be represented in three steps<sup>1</sup>:

- (1) Estimating total available resources for the public sector over a multi-year period, usually within a multi-year macroeconomic and fiscal policy framework.
- (2) Estimating the actual cost of current government policy and programs by sector, again in a multi-year context.
- (3) Reconciling the information in steps 1 and 2 to align policies with available resources, and using this information as a basis for improved policy and funding choices, and ultimately improved outcomes.

This simplified framework provides the general thrust of the MTEF concept, but is necessary to break the process into greater detail to explore the dynamics of the process. Actual decision-making processes and institutions will vary by country, but for ease of exposition, an MTEF process can be divided into five general operational stages:

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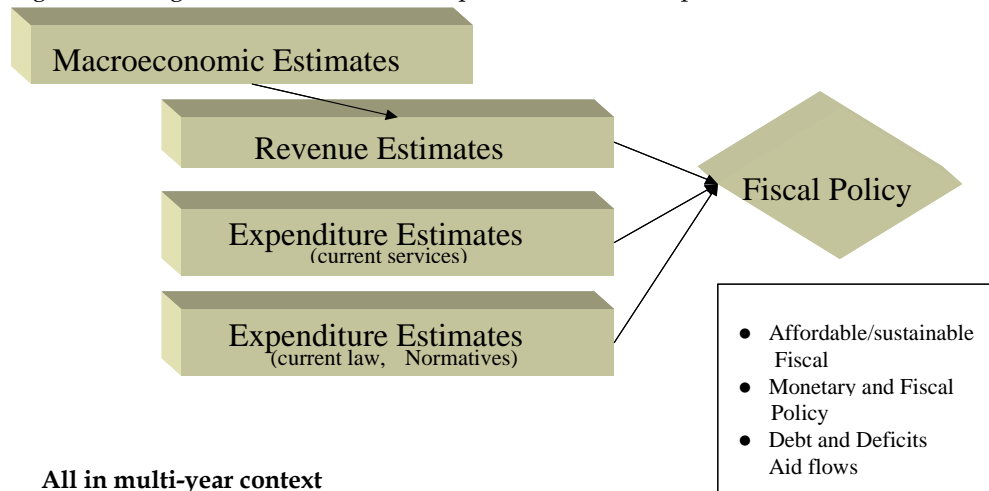
<sup>1</sup> Drawn from Muggeridge (1997).

- Stage 1: Macroeconomic and public sector envelopes.  
 Stage 2: High-level policy: aligning policies and objectives under resource constraints.  
 Stage 3: Linking policy, resources, and means by sector.  
 Stage 4: Reconciling resources with means.  
 Stage 5: Reconciling strategic policy and means.

In general terms, Stages 1 and 2 are about developing macroeconomic estimates for the economy, and shaping public fiscal policy within the multi-year framework. Stage 3 is about sectoral (e.g. health, education, welfare, etc.) policy development. Stages 4 and 5 are about reconciling competing claims on public resources with available resources.

## 2. Stage 1: Macroeconomic and public sector envelopes

Figure 1-1. Stage 1: Macroeconomic and public sector envelopes



### 2.1. Macroeconomic forecasts

Stage 1 begins with the development of sound, conservative macroeconomic forecasts for budget development. It is important to distinguish between political macroeconomic estimates – estimates of desired or hoped for growth – and sound estimates for budget development. The former are optimistic estimates prepared for public consumption, to convey the governments goals, and to build optimism in the general public over the economic direction of the government. This is serving primarily a political purpose. For a variety of reasons, these are not good estimates to use in developing the budget. Being optimistic, they will lead to excessive spending relative to likely revenues, and higher deficits and debt. More importantly, they are not estimates that will influence the public or private sector investors (foreign or domestic). Investors have many sources of information, and generally government's own estimates will be the least credible and least relied upon for investor decision-making. Moreover, the simple fact that more economic researchers are using consumer

confidence surveys as leading indicators of economic direction suggests that it is consumer sentiments that serve as early indications of trends rather than government economic estimates that heavily influence citizen perceptions.<sup>2</sup>

## 2.2. Institutional measures to support sound macro-estimates

Countries use a variety of techniques to assure sound economic estimates, some during the budget development stage (*ex ante* to budget enactment) and some after budget passage (*ex post* to budget passage) to assure alignment of the budget with best estimates or emerging trends. Among *ex ante* good practices are: comparison with private or other forecasts during forecasts development<sup>3</sup>; vetting of forecasts through academic or non-government fora or blue-ribbon panels<sup>4</sup>; early release of forecasts to Parliament and the public; using the median forecasts of several reputable non-government organizations as the government forecasts<sup>5</sup>; technical rules (publicly announced) for making the forecasts more conservative<sup>6</sup>; economic updates prior to budget enactment that allow modifications to the budget proposals to fit emerging trends;<sup>7</sup> inclusion in the budget of a table comparing the key economic variables of the government forecast with several reputable private or public forecasts, with explanations for significant variation for median forecasts; and having multiple government forecasts that could be the basis of budget development (e.g. Central Bank or legislative budget office, the latter being more applicable to presidential systems with separation of powers where the legislature can enact a budget entirely different from the executives).<sup>8,9</sup>

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<sup>2</sup> For a longer discourse on the adverse effects of overly optimistic forecasts, see Dorotinsky (1999).

<sup>3</sup> Current practice in Poland, Canada, and U.S..

<sup>4</sup> Also current practice in Poland.

<sup>5</sup> For example, the United States Government does not have a macroeconomic forecasting office for budget development. Rather it purchases six leading blue-chip and academic forecasts which form the basis of forecasts. Economists from the Office of Management and Budget, Council of Economic Advisors, and Department of the Treasury gather to evaluate the forecasts with respect to the most recent Government data and expected trends, and collectively agree on the most likely evolution of key variables. The variables are then fed into a mini-model to produce all those variables needed for producing the budget.

<sup>6</sup> Canada, for example, had systematically over-estimated economic growth and public revenues during the 1980s, contributing to their annual deficits. To compensate, Canada averages several non-governmental forecasts, then adds 50-100 basis points to interest rates to assure a conservative forecasts, and runs these through a small model to produce the forecast variables for budget formulation.

<sup>7</sup> Finland prepares economic forecasts four times each year: in February for the Government decisions on aggregate spending limits; in May as a mid-year update; in August for the budget discussions; and a smaller exercise in November to confirm the estimates used in budget development.

<sup>8</sup> Many countries have independent Central Banks that produce their own forecasts for monetary policy, but these are rarely used in budget formulation. In the U.S., the Federal Reserve and Executive branch forecasts are informally shared at a technical level to try to assure some consistency in the basis of policy formulation by both institutions. Also, the Congressional Budget Office also produces its own independent set of economic estimates for Congress, which can serve as the basis of Congress' budget development.

<sup>9</sup> Coordination, at least informally, of Central Bank estimates and expected monetary policy with Government economic estimates and fiscal policy, is important to assure a sound basis for both monetary and fiscal policy. Doing so informally, at a technical level, can preserve the independence of the Central Bank and still assure Government fiscal policy is fully informed and sound. Developing a budget expecting moderate monetary policy can be easily undermined where the central bank adopts a tight monetary stance, driving up

Good practices include: ‘reserves’ set-aside during budget formulation to account for some variation in forecasts after budget passage<sup>10</sup>; mid-fiscal year economic updates after budget passage, combined with required proposals to bring the budget into line with emerging trends during the fiscal year; formal procedures for passing supplemental budgets during the fiscal year, and use of these procedures<sup>11</sup>; and subsequent annual budgets which include a comparison of prior year budget forecasts with actual economic variables to assess the quality of the estimates.

Countries process the economic estimates themselves in different ways: Ministry of Finance staff share the estimates only with the Minister of Finance for information purposes or for general approval to move to the next stage of budget formulation; economic estimates are shared with Cabinet for general information and ‘blessing’; or economic estimates are sent by the Government to Parliament (or general public) early in the budget cycle for information and transparency. While distribution of the economic forecasts varies, it is accepted practice that policy officials not modify the economic estimates or alter the technical details, and certainly not for political expediency. The estimates need to be the best, objective estimates possible by technical staff in order to form a sound basis for setting economic policy and for budget development.

### 2.3. Revenue envelope

Once the macroeconomic estimates are prepared, sound estimates of government revenue are developed. Equally critical as sound macroeconomic estimates are conservative revenue estimates based on collection experience. Overly optimistic revenue estimates can also lead to excessive spending. Even if the budget will contain proposals for tax increases or improvements in collection rates, it is valuable to separately identify the base estimate for revenues without policy or administrative changes and those revenues expected because of policy changes or planned improvements in compliance and collection rates. The latter could be further divided into revenues expected with a high degree of certainty (e.g. new revenue from a 1 percent increase in the sales or income tax, or foreign aid under already signed agreements) and revenues with low certainty of materializing (e.g. promised foreign aid, revenues from entirely new taxes or fees, and improved collection rates from improved enforcement). By differentiating the different sources of revenue and their likelihood of materializing, better judgment can be used in setting fiscal policy as well as in *ex post* assessment of the quality of estimates used in budget formulation. Of course, all revenues must be considered, including user fees, administrative fees, ministry own revenues, etc., to provide a complete picture of government financing levels and needs.

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interest rates and lowering economic activity.

<sup>10</sup> Canada also builds a reserve into the budget that can only be used for variations from forecast and unexpected events. If unspent at year end, these funds automatically pay off outstanding debt. Sweden similarly uses unspent reserves for debt reduction, but rather than conservatively adjusting the macroeconomic estimates Sweden reduces its public expenditure target below its estimated affordable expenditure estimates to build a margin of safety. These reforms provide a systematic bias towards conservative expenditures and a prudent use of unspent funds for debt reduction.

<sup>11</sup> Sweden has two formal supplemental budgets, one in the spring accompanying the spring fiscal policy update and one in the fall accompanying the budget proposals for the following year. In the U.S., supplemental requests can be transmitted at any time, but are discouraged unless large and of high importance.



External aid flows must also be included to provide the comprehensive revenue picture. These deserve some special treatment in the estimates for several reasons: counterpart funds must be identified and available from domestic resources; the aid flows themselves may be highly unpredictable, and it is important to assure that spending does not occur in advance of receipt of aid funds that may not materialize; in selected cases, domestic expenditure must occur before the aid flows are released as reimbursements, and these must be identified as well; the future cost for operating and maintenance of infrastructure financed by foreign aid must be factored into the budget, and this is more difficult if the budget does not even contain all aid revenues; ideally, aid inflows would match government sectoral priorities rather than driving them; for foreign loans, debt service costs must be factored into the multi-year plan.

Also important is identification of tax expenditures – special exemptions from general taxation for special interests, industries, regions, etc. These are revenues foregone, and future estimates should assume current laws or policies remain in place, and model the multi-year trends in tax expenditures for appropriate factors such as economic growth. Tax expenditures should be explicitly identified for each type of tax revenue, allowing policy officials to assess the benefit of this tool.

## 2.4. Expenditure estimates

With conservative economic estimates in hand, the Ministry of Finance can prepare broad expenditure estimates based on current policy, and explore expenditure sensitivity to changes in economic estimates. The objective of this exercise is to explore, at a relatively aggregate level of spending, the trends in spending and gauge affordability over several years. The multi-year aspect allows the Ministry of Finance an early warning indicator if some programs are likely to grow beyond affordable limits, as well as to explore general policy options (e.g. pay policy) and their impact on spending trends (as well as explore policy changes that might liberate resources in current and future years for new initiatives). It is important to explicitly note that this covers ALL public spending trends – consolidated central government in GFS terminology. If only budgetary central government is included, the picture is only partial, and does not allow exploration of all sources of spending, identification of over-all trends that may require Government attention, and will lead to suboptimal policy decisions.<sup>12</sup>

These initial estimates are often termed ‘baseline’ estimates, and while different countries use different bases for calculating them, the general concept is to forecast future spending assuming continuation of the current spending levels or laws – that is, assuming no changes in policy or spending trends, what do the out-years look like?<sup>13,14</sup>

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<sup>12</sup> While more attention in projections and sensitivity analysis will be paid to consolidated central government, especially extrabudgetary and social funds, trends in subnational government revenues, spending, and deficits also need to be reviewed. Excess subnational spending can directly threaten the central budget, and monitoring trends early for possible Government intervention is important for long-term fiscal health.

<sup>13</sup> The U.S. develops baseline estimates on ‘current law’: for mandatory spending (spending that occurs through statute, rather than annual budget bills), the forecast assumes no change to laws, and uses economic estimates and demographic trends to extrapolate spending to the budget year plus nine additional years. For discretionary spending (spending that occurs only through the annual budget), the most recent enacted budget is extrapolated out nine years using basic economic assumptions supplied by the budget office, typically the consumer price index for wage and non-wage expenditures.

<sup>14</sup> Australia uses the concept of current policy, focusing more on the policy commitments of the current

A useful exercise would be to prepare two broad baseline estimates: one assuming current funding levels of discretionary spending and current laws for mandatory spending as a current 'policy' baseline; and one assuming current norms and other laws with implicit commitments were fully funded (which may require spending ministry assistance, and which may in fact also represent the current annual requests from spending agencies). The exercise would be instructed to identify the 'policy gap' or difference between current levels of public spending and those required to fulfill policy commitments as contained in normative laws (and gauge the realism of normative sector policies).

With conservative revenue estimates in hand, the Ministry of Finance can prepare a fiscal policy paper for presentation to Cabinet. This document draws together the results of the modeling and forecasting exercises into an understandable report of trends and policy implications for senior government officials and the public. The paper explores implications of monetary and fiscal policy for economic growth, as well as trends in fiscal policy, deficits and debt projections under current trends, and broad options for changing policies. It serves as a useful vehicle – if clear in presentation and readily assessable to non-economists – for educating senior policy officials of basic economic issues, and linkages between government policies and outcomes (economic, fiscal, etc.). The paper should include recommendations of MoF on a path for sustainable or improved economic growth, including aggregate revenue and expenditure paths (including deficits and debt policy).

The fiscal policy paper would be presented to Cabinet for discussion, with the objective of obtaining some Cabinet decision on over-all government revenue, expenditure, and deficit policy or framework. The focus of the decisions should be on the policies for revenues and expenditures, the path over the budget and subsequent years, to attain government objectives. The discussion should generally not turn on the economic forecasts themselves, especially if these represent best estimates.

Countries follow different practices in releasing the fiscal policy and expenditure estimates to the Parliament and public. Finland releases this information to the public and parliament for informational purposes, while Sweden actually submits for passage by parliament the fiscal policy, expenditure envelope, and allocations to sectors. In Sweden, this was done to bind Parliament to the expenditure totals and sector ceilings, and prevent unproductive amendments that added to expenditure rather than encouraged efficient choices within sectors. In other countries, such as the U.S., the fiscal policy, expenditure targets, and sector funding levels are not released until the formal budget is proposed.

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government over several years. Termed 'forward estimates,' Australia's multi-year forecast separately identifies revenue policies, including tax expenditures, as well as general spending. For a good example of a comprehensive multi-year document, see Australia's [2002-2003 Budget Paper No. 1](http://www.budget.gov.au/2002-03/bp1/html/) at <http://www.budget.gov.au/2002-03/bp1/html/>.

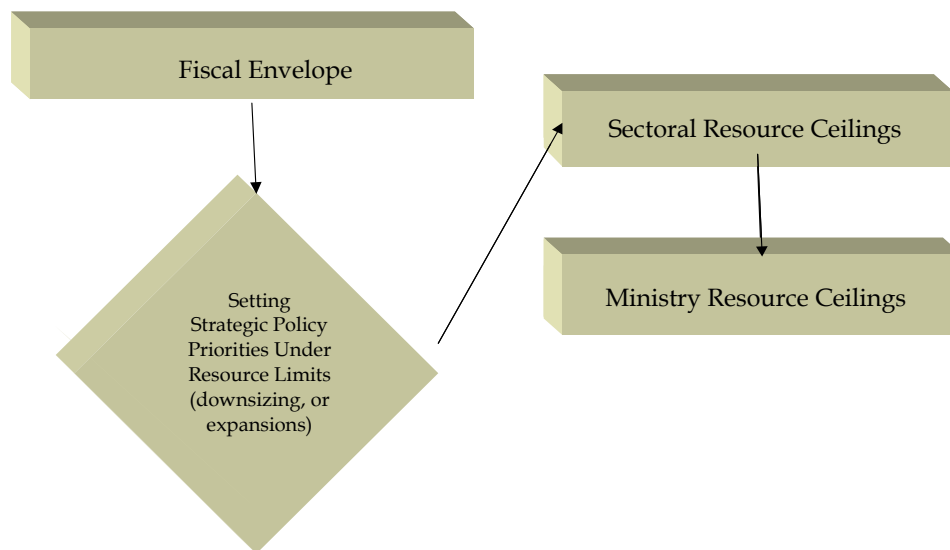
### 3. Stage 2: High-level policy: aligning policies and objectives under resource constraints

After the fiscal policy envelope is developed setting the aggregate public revenues and the expenditure ceiling, decisions need to be made on the allocation of this ceiling across sectors (e.g. health, education) and ministry (which may be the same as sectoral or not, depending on the budget classification system). These indicative ceilings may have been provided in the fiscal policy paper by the MoF, or may be addressed as a separate exercise. Sweden combines discussions on the fiscal policy, expenditure envelope, and sector ceilings into one two-day Cabinet retreat, after which the approved levels are sent to Parliament for ratification. Each ministry is then bound to meet the ceiling set by Cabinet and Parliament.

Some sectoral allocations may have developed in the course of the fiscal policy discussions,<sup>15</sup> where key sectoral spending trends may have been identified as threats to policy or fiscal stability. The remainder of funds need to be allocated, and the allocations would reflect at least general policy directions of Government (e.g. additional education spending), and specification or modification of Government objectives, in broad terms, for each sector.

A good starting point for setting the indicative ceilings for sectors and ministries is the second year of the prior budget's multi-year forecast, adjusted for known modifications in Government priorities and policies, improved spending estimates, major revisions in revenues and expenditure targets, etc. Some countries also reduce sector ceiling allocations and create a central 'policy reserve' that is used to fund new initiatives after spending requests are received in Stage 4.

Figure 1-2. Stage 2: High-level policy



<sup>15</sup> In Finland and The Netherlands, the allocation stage is 'easier' during budget preparation as many of the policy priorities have been set in government coalition agreements. Absent coalition governments, it is not clear these pre-specification of policy priorities would continue.

Within sectors, it is important to distinguish between mandatory and discretionary spending in making allocations. Unless major policy changes are expected for extrabudgetary funds and mandatory programs, the best estimate of spending for these programs would receive its full allocation. Discretionary programs would receive residual amounts for the sector – perhaps lower than desired. This stage can generate much debate on growth of entitlement spending and its crowding-out of other government spending, and helps clarify the tension in these programs. Box 1-1 describes the Brazilian approach to making these decisions.

Also important for sectoral allocation is a review of *revenue earmarking* and the constraints it imposes on reallocation of spending across sectors or programs.

Once approved by Cabinet, these indicative ceilings for each sector/ministry are transmitted to Ministries, usually as part of the annual budget call circular that initiates the budget process and provides instructions for ministry budget submissions.

Whether the indicative ceilings are actually cabinet-approved can differ by country. In the U.S., indicative ceilings are not approved by the President, and thus do not carry much weight with the spending ministries. Moreover, in the U.S. system, even if the ceilings were presidentially-approved, it is not very likely there would be adverse consequences to a cabinet secretary that submitted spending requests in excess of the ceiling. It certainly is not a serious enough transgressions to warrant dismissal from cabinet. The US Budget Office could try to impose some sanctions or negative incentives for such behavior, but it currently does not, and such efforts would be difficult to sustain in the US context. In Parliamentary systems, Cabinet sanction can be important for compliance, as it represents a collective Government decision, which each Cabinet Member is more bound to follow.<sup>16</sup> Regardless, adherence to indicative ceilings by ministries in developing budget proposals makes budget preparation far easier in following stages.

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<sup>16</sup> For a more thorough treatment of cabinet dynamics, see Manning, Barma, Blondel, Pilichowski, and Wright (1999).

**Box 1-1. Brazilian Budget Process**

The broad functional steps in the Brazilian budget formulation process are:

- Define the macro-economic projections, estimate public revenues, and plan/set expenditure and debt levels.
- Develop indicative sectoral limits based on analysis of current operating costs, programs, and activities. The ceilings include several subsets of estimates:
  - a) Personnel costs – A detailed personnel registry provides information on wages, new hires, and early retirements. This is a known number.
  - b) Debt – Part of debt service for loans related to each Ministries programs are allocated to each Ministry and part to the Ministry of Finance. The budget office knows all contracts, and knows this number.
  - c) Activities, continuing – The cost of continuing the current programs is estimated by the budget office, and refined by the line Ministry. This includes administrative costs in support of personnel (utilities, etc.), plus mandatory activities (health, pensions, etc.)
  - d) Activities, new or expansions – Line Ministries develop these proposals and submit to the Ministry of Planning for review.
  - e) Projects, continuing – Line Ministries estimate the cost of maintaining the economic viability or continuing on-going projects.
  - f) Projects, new or expansions – Line Ministries estimate the cost of expansion of projects or of new projects.
- Within the available resource estimates, subsets a, b, and c are treated as priorities in the annual budget process. Subsets d, e, and f are treated as residual: if resources are available to allocate, they first go to new or expanded *activities*, then to *continuation of projects*, and finally to *new or expanded projects*.
- Note that items d through f are only the marginal cost of the activity or project. The personnel costs and associated overhead costs (running costs) are separately funded in a and c.
- This process assures the basic obligations of the state – debt service, mandatory social benefits, personnel (which are fixed in Brazil) and fixed administrative costs, as well as transfer payments, receive funding first.

## 4. Stage 3: Linking policy, resources, and means by sector

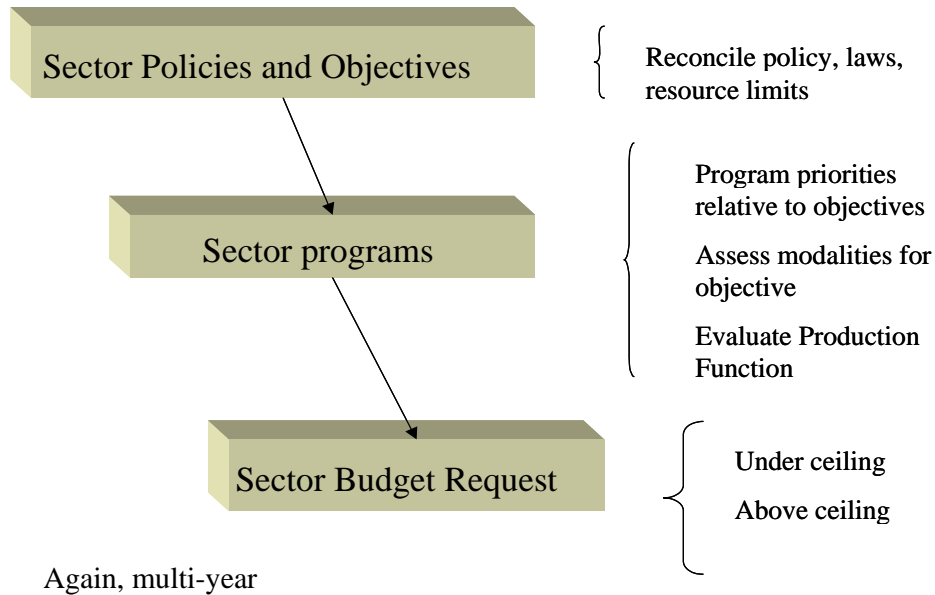
### 4.1. Preparing budget proposal

Having received sector or ministry indicative ceilings, each line Ministry must develop its budget proposal. The expectation is that each Ministry would take the resource ceiling as given, and allocate spending among its activities and programs to attain its objectives.

This is particularly important to assure harmonization of normative laws and sectoral and ministry strategic plans and attendant objectives, organization and staffing, with the resources available. These decisions include both capital and current

spending, encouraging ministries to think strategically about their programs, to evaluate what are the necessary labor and capital inputs to attain an objective or implement a program.

Figure 1-3. Stage 3: Linking sector policy



This is important for maximizing the effectiveness and efficiency of spending. An example may illustrate the point. Assume a health ministry wants to develop a health policy for the country, and it convenes expert groups as well as various groups involved in the sector, such as the Chamber of Doctors, hospital administrators, nurses organizations, etc. Collectively these groups will use their best professional judgment in devising an optimal health policy. This policy may include specific targets of number of beds per capita, physicians per hospital, etc. It may also specify vehicles for advancing the policy, such as the nature and type of health benefits included in the national health insurance plan, or assume certain modes of service delivery (e.g. expansion in government-owned clinics). Now, when it comes to financing the policy, it is commonly the case that the entire package is unaffordable. If the policy is retained as formulated, the best that can be hoped for is, for arguments sake, 60 percent of the total cost of the policy. The result is that the policy cannot be implemented, objectives cannot be achieved, and even the reduced funding level may be too low for individual elements of the policy to be effective (e.g. funding for vaccines may be too low to assure adequate coverage of the population).

In contrast, if the over-all funding level were known in advance, framing the policy discussion, entirely different objectives, programs, or means of production may be explored. Instead of government-owned clinics, perhaps the government would contract with private clinics to provide services at lower cost. Or, vaccination programs would be considered essential and fully funded. The package of health benefits covered under the health insurance plan might be adjusted. The point is that both

objectives and means of achieving the objectives will be different under different resource constraints.

A second example, more narrow, also illustrates the point. During the 1980's, the U.S. Consumer Product Safety Commission, an agency charged with regulating consumer products to assure their safety, trained staff in offices across the U.S. by sending specialists from Washington, D.C. to provide the training. As the budget became tighter, the agency changed its means of delivering training. Instead of sending trainers from Washington and incurring travel and lodging expenses, the agency made training videos in Washington, and mailed these to its offices. Evidence suggested this means of training was as effective as the live trainers. However, the agency used this as an example of the terrible effects of the budget restrictions. The Budget Office used this same case to illustrate the point that such evaluation of activities and improvements in efficiency are exactly what an agency should be doing. Different levels of funding influence choice of means of production.

Ministries may have begun to develop their budgets prior to receiving the call circular, and such early budget development can assure that ministry budgets are carefully developed. Ministries may have undertaken their own strategic planning exercise, or undertaken a special review of the effectiveness or continued usefulness of policies, programs and projects. These reviews and plans should be undertaken, either as part of the annual budget cycle, or prior to it and then fed into the resource allocation decisions in the budget process.

#### **4.2. Resource allocation flexibility**

Different countries provide different degrees of freedom to ministries to allocate spending among alternatives. In the Australia and New Zealand New Public Management model, ministries are assumed to allocate resources optimally among programs, and are given great discretion in their choices. Similarly, Sweden provides great latitude for allocating resources to ministries. In these systems, the Ministry must justify and defend its choices, and bears responsibility for the consequences of their choices. This transparency and accountability provides some incentive for sound allocation choices.

In other systems, such as Finland, fewer degrees of freedom are offered. The Ministry of Finance not only has indicative ministry or sector ceilings, but also indicative spending targets for programs within the sector ceiling. Spending ministries that want to reallocate across programs face difficulty doing so because of the Ministry of Finance targets.<sup>17</sup>

In the United States, the incentives work differently. Spending Ministries' budget requests form the President's Budget, and the President is responsible for the policies contained therein. Allocations that would cause interest groups to strongly object would fall upon the President to advocate or defend, rather than the minister responsible. The dynamics promote gamesmanship, where spending ministries propose budget reductions in areas they know would never be approved by Congress, and reallocate those resources to ministry priorities, which may not be the President's priorities. As a result, the US Budget Office pays very close attention to the proposals of ministries. While in principle the ministry can propose any change, in practice, the proposals are carefully scrutinized for practical effect, incidence, and likelihood of being enacted, as well as technical justification.

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<sup>17</sup> OECD (2002), p. 6, paragraph 18.

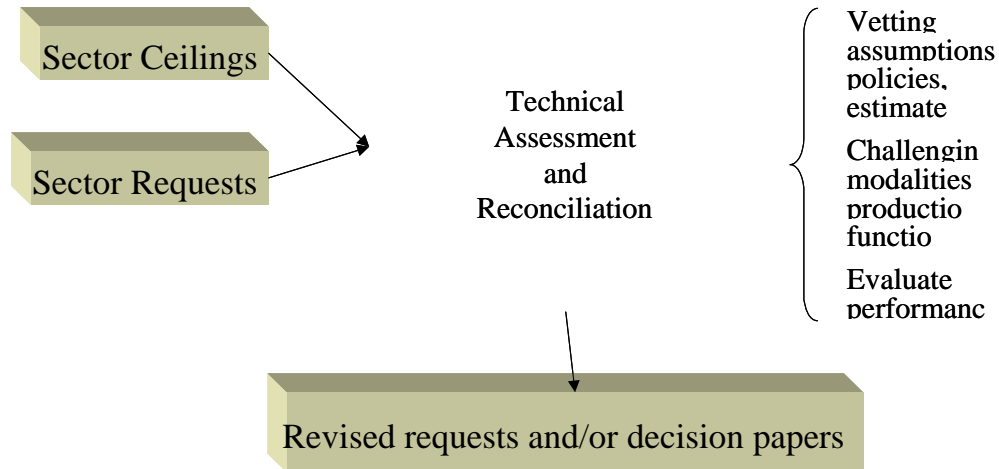
An important issue is the extent to which the spending ministries have the policy and program analysis skills to undertake the reviews of activities and laws, assess their effectiveness and cost, and develop options for the responsible Minister. These are skills that have heretofore not been in great demand, and may require training to further develop.

At the end of the stage, the ministries will submit their budget requests to the Ministry of Finance. The format of the requests will vary by country, but something more than tables of numbers with a cover memorandum is appropriate. Text explaining the policies contained in the proposals, changes in policy from prior years, significant reallocation decisions, new objectives, all should be included. As countries move towards performance budgeting, the budget requests should include the output or outcome targets associated with the resource levels and allocations contained in the request. Moreover, simple identification within the request of on-going activities and programs from new programs assists in evaluating the proposals.

#### 5. Stage 4: Reconciling resources with means

After receiving the requests, the requests must be reconciled with the resource ceilings, competing demands and policies reconciled, and final policy and funding decisions reached. This stage can be contentious or productive depending on how the process is structured (extent to which ceilings were respected), whether budget retrenchment or expansion is the trend, and Ministry of Finance relations with spending ministries.

Figure 1-4. Stage 4: Reconciling



Assuming the sector ceilings and Sector requests match, the Ministry of Finance's role becomes one of providing critical analysis of the agency requests, and conducting a process that leads the Ministries feel they had a fair hearing for their requests. Ministries should be questioned in detail about their requests, especially the assumptions and data underlying their requests. It is also useful to conduct budget



hearings, where the Ministries have an opportunity to meet with government officials to make the best possible case for their budget request. These hearings can be time consuming, but are important to give the Ministries a further stake in the budget process. The less Ministries feel they have had a fair chance to make their case, the less likely they are to accept the results of the process or to support the approved budget during budget execution.<sup>18</sup>

Generally, the Ministry of Finance needs to vet the spending requests, probing whether recurrent spending is needed and ministries have adequately reviewed existing programs, and whether new programs are well-developed. *How* the MoF interacts with spending ministries can influence outcomes. The MoF should seek to engage in a dialogue with ministries to assess whether they have in fact considered the questions of mix of inputs, whether there are benchmarks for assessing staffing patterns, whether there are alternate means or modes of achieving the objectives, and should use these issues to develop a budget. It is the dialogue that is important – the questions and answers. These issues must regularly be raised, or they will go unaddressed: thus, current staffing and production patterns will remain fixed, and only the increment for new programs or activities will be considered. For example, the MoF may provide additional funds to spending ministries for official pay raises but may provide no funds for “promotions.” Assuming there is a salary cap per ministry, this puts a slight but palpable pressure on spending ministries to economize on salaries and the wage bill, examining where savings can be achieved within the wage bill, to provide some level of promotions. It also forces economical decisions on the number of promotions, which may differ from the “normal” practice of automatic promotions based on seniority and tenure (perhaps substituting performance evaluations and merit as the basis of promotions).

Ministry of Finance’s performance assessment should include reviews of capital spending and progress in capital projects, as well as assessments of whether external and internal audit findings have been addressed by each ministry. The assessment can cover many aspects of performance, and the results should be fed into the MoF recommendations on funding. In the U.S., policy papers with funding options are prepared for each program by the budget office, and these papers are used by senior policy officials in the administration to make budget decisions. These papers integrate findings on agency performance along many aspects in arriving at a funding decision.

If the sector requests and ceilings are not the same, differentiation between recurrent and new spending as suggested above allows the Ministry of Finance to quickly assess if recurrent spending is over target, and respond appropriately to the source of the problem.

In some countries, review of budget requests, especially recurrent spending, is given higher priority and more formal attention. The U.K.’s former Public Expenditure Surveys served as an annual ‘functional review’ of ministry programs. In the early 1990s to facilitate its fiscal retrenchment, Canada instituted program reviews under the auspices of a cabinet committee to review spending proposals in detail.

In addition to Ministry of Finance’s vetting of requests, this stage serves as a forum for the various new funding proposals to compete for resources. If the Government sets

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<sup>18</sup> The Swedish Ministry of Finance does ‘second-guess’ spending ministry budget submissions, especially on social transfer programs, mainly through seeking additional technical details on the estimates. The MoF does not directly challenge the requests. The Ministry budget requests are used to develop the Ministry of Finance’s recommendation to cabinet, but does not directly respond to each Ministry on their request. The MoF is prepared to detail its views at the two-day cabinet retreat where MoF allocations are below Ministry requests.

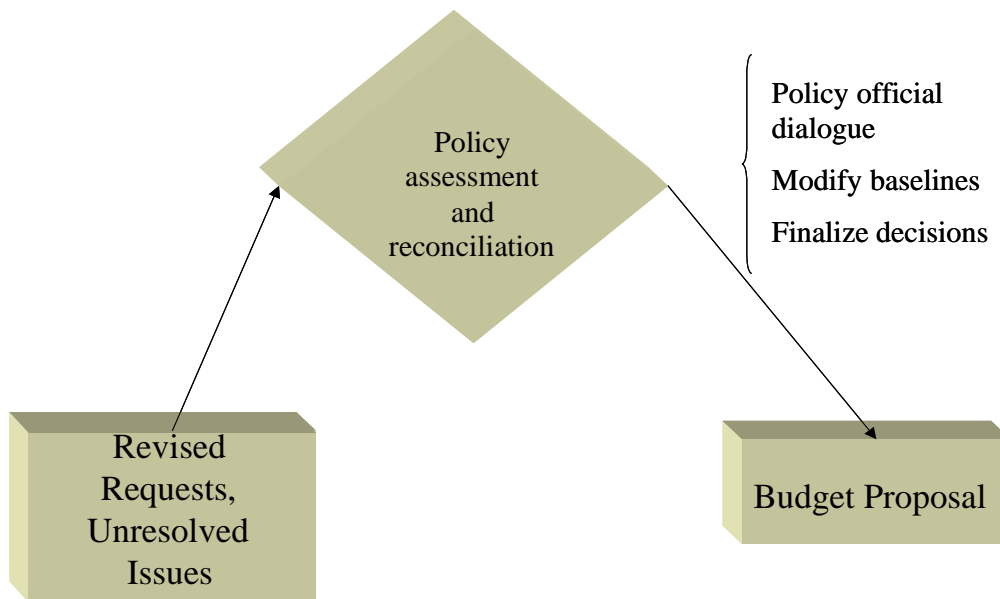
aside some resources during the sector ceiling stage for new funding proposals, these funds would be used to fund the best of the new spending initiatives. (If no reserve was established, and instead government allocated all available funding to the sectors, giving some priority to some sectors over others, then competition between proposals may have occurred within the sector.)

As noted earlier, this stage may proceed with varying degrees of cooperation or conflict between MoF and spending ministries. In Australia, the process is a professional dialogue where both parties to the discussion bring their unique skills and perspective to the table to improve the projects and proposals. Ministries themselves revise the requests based on discussions with MoF, and may reconsider the means being proposed to attain an objective.

At the end of the day, the MoF must make some recommendations, and forward these on to Cabinet for final approval.

## 6. Stage 5: Reconciling strategic policy and means

Figure 1-5. Pulling it all together



This final stage will take markedly different forms depending on the structure of the budget process. In the U.S., after decisions have been taken, results are passed back to each Ministry, which has an opportunity to appeal the results to the budget office. If issues are not resolved at that level, they may appeal upward, eventually to the President. Not many issues reach this stage. After appeals are resolved, then ministries must revise their budget request to be in alignment with the President's policy. This process of appeals is intended to assure some due process to Ministries in funding decisions, but makes for a contentious process.

In Australia, MoF discussions with line ministries are less contentious, and more in the nature of a management consultant (MoF) advising a client (line ministry). Line Ministries take on board the MoF suggestions they agree with, and revise their budget requests to come into alignment with MoF.

Line ministries of course are busy revising their requests, preparing their own justification material, and even drafting legislation that may be required to support the policies contained in the budget.

A primary role for the MoF in this stage is resolving any loose-ends in the decision process, finalizing or refining numbers and policies to assure consistency. MoF efforts move into production of documents and tables and graphs, getting everything ready for final review and approval by Government and transmission to Parliament.

A further MoF role in many countries is preparation of communications strategy and material to clearly explain decisions, elaborate the rationale for choices taken, and explaining the directions for budget policy. An effective communication strategy, well executed, is a critical factor in the success of the budget proposals and sustainability of reforms. Careful attention to preparing policy officials to answer questions and defend the proposals, as well as to the positive messages that need to be communicated to the public, would increase the likely success and acceptance of any budget proposal.

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CHAPTER 2

**MTEF Implementation in Korea**

by

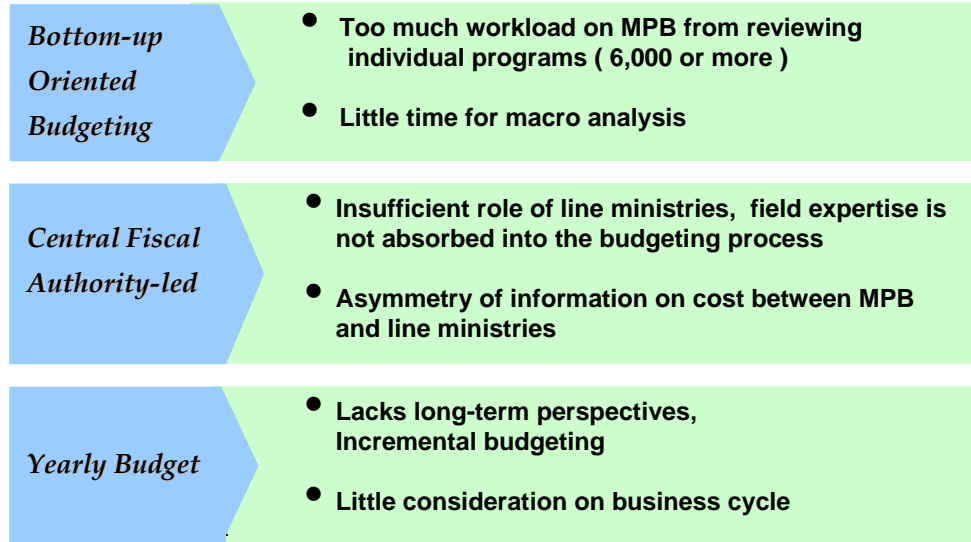
*Soomin Park, Ministry of Planning and Budget*

**1. The Starting Point of Reform**

**Why did MPB look for a new resource allocation system?**

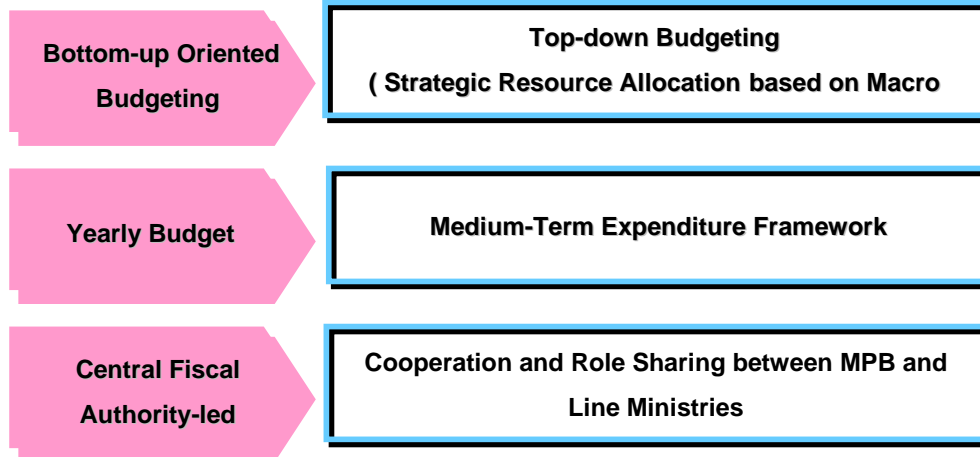


## Weaknesses in the present fiscal system

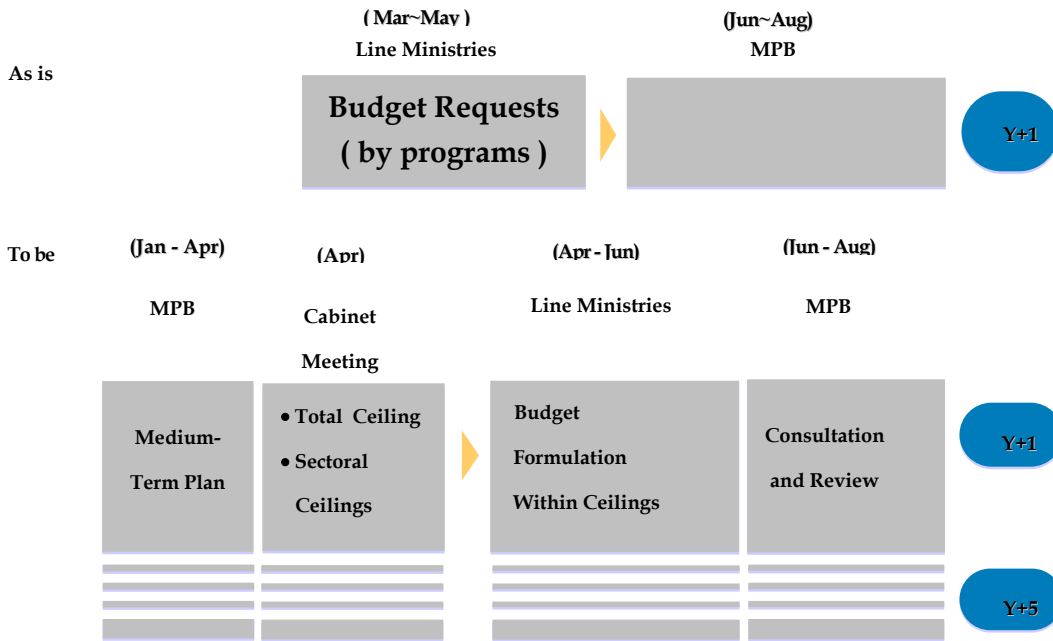


## 2. The Vision of MPB

Where do we want to go?



**The Korean Model (still evolving ...)**



*Stage 1: Establishing Medium-Term Plan (National Fiscal Management Plan)*

**“Supporting Strategic National Management”**

- **Analyzes 5-year Fiscal Balance & Total Expenditure Levels**  
- Gives way to Medium-term Budget Balance
- **Sets National Policy Goals & Priorities for resource allocation**
- **Proposes Sectoral and Ministerial Ceilings & Major National Projects**

**Stage 2: Cabinet Meeting****“Melting pot of Policies Making and Resource Allocation”**

- **In-depth Discussions on Sectoral & Ministerial Ceilings**
  - 5-year fiscal targeting
  - Resource allocation by national priorities
  - Review Major Policies upon Future Resource Allocation Projection
- **Based on MPB Proposal**

**Stage 3: Line Ministries' Budget Formulation****“Change of Role and Mindset”**

- **Autonomous Resource Allocation within Ceilings**
  - Own priorities by sectors
  - Using field expertise in budgeting
- **Yearly → 5 years**
- **MPB's Stand Alone Decision-making**
  - **All the Line Ministries' Decision-making**
    - Provides “ Budget Formulation Manual ”



**Stage 4: MPB's Consultation & Review****"Player → Coordinator"**

- **Reviews Spending Plans of Line Ministries**
  - Decisions from the Cabinet Meeting
  - Conformity to the Formulation Manual
- **Reflects Changes after Cabinet Meeting**
  - Macro Variables, unexpected issues ...

**3. What Lies Ahead****What are we expecting?**

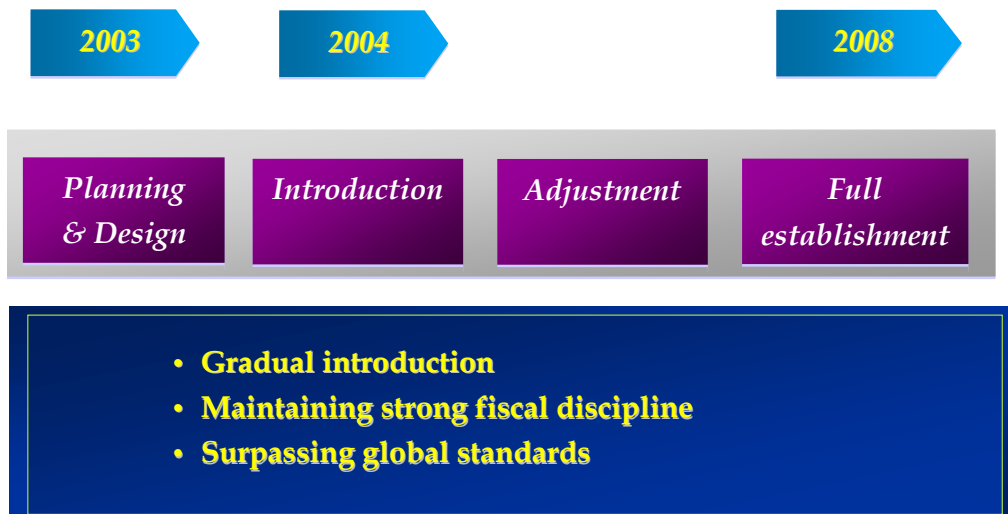
(The Starting Point)

<b>Fiscal Soundness</b>	<ul style="list-style-type: none"> <li>● Long-term Perspective</li> <li>● Symphony of Sustainability &amp; Economic Stabilizing</li> </ul>
<b>Efficiency of Public Expenditure</b>	<ul style="list-style-type: none"> <li>● Macro Analysis → Strategic Resource Allocation</li> <li>● Role Sharing → Self Expenditure Restructuring</li> <li>● Cost Information Sharing → Extinction of Excessive Budget Request ( 20~190% Increase )</li> </ul>
<b>Fiscal Transparency</b>	<ul style="list-style-type: none"> <li>● A new Consolidated Structure over special accounts and public funds</li> </ul>

### The road ahead ...

1. Not enough long-term fiscal forecasting background
2. Early stage of Performance Management System
3. Potential difficulties in gaining consensus of the National Assembly

### Our roadmap ...



## CHAPTER 3

# Key Issues for Introducing MTEF and Top-down Budgeting in Korea

by

*Dong Yeon Kim, The World Bank*

## 1. Introduction

Budget reforms usually reflect specific political, social, and economic problems and issues. The rationale to undertake fiscal reform is invariably one of tackling problem areas and addressing identified weaknesses. Even traditional line-item budgeting, for example, was itself an evolutionary reform in response to serious concern about the lack of adequate spending control and substantial corruption. So too were performance budgeting, program budgeting, and zero-based budgeting.

Medium-term expenditure framework (MTEF), along with top-down budgeting, has drawn particular attention from many OECD and developing countries over the last decade or so.<sup>19</sup> MTEF, by integrating long-term perspectives into budgeting, is a practical tool to control fiscal risk and facilitates effective allocation of resources through strengthened strategic decision-making in resource allocation. For example, Sweden adopted MTEF to contain and reduce fiscal deficit. Since the introduction of MTEF, fiscal balance has improved from a deficit of 10.8% of GDP in 1994 to a surplus of 4.8% in 2001.<sup>20</sup> On the other hand, U.K. intended to increase public investment, which continued to decrease. Through MTEF, public investment has increased from 20 UK billion pounds in 1997 to 31 billion pounds in 2003.<sup>21</sup> Recognizing its value, the World Bank has advocated MTEF as part of fiscal reform to improve fiscal discipline, strengthen effective resource allocation, and improve policy efficiency and effectiveness. To this end, the World Bank has promoted operations to introduce MTEF into client countries.<sup>22</sup>

Korea has initiated a series of fiscal reforms since the East Asian financial crisis that occurred in late 1997. The new Administration, since its inauguration in 2003, has been striving to further plans for reform, central to which is MTEF along with top-down budgeting. The primary objective of MTEF is to integrate national policy priority into budgeting and set up a new strategic decision-making mechanism. The reforms to introduce these new initiatives are due to be implemented in 2004 with the aim of full application for the 2005 budget. This change will be a turning point in Korean public expenditure management (PEM), because it is not limited to bringing about changes to the budgeting process, but seeks to set up a strategic decision-making mechanism

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<sup>19</sup> More than 20 OECD countries surveyed prepare multi-year expenditure estimates and 7 OECD countries surveyed prepare a medium-term fiscal framework([http://www.oecd.org/document/61/0,2340,en\\_2649\\_34119\\_2494461\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/61/0,2340,en_2649_34119_2494461_1_1_1_1,00.html)).

<sup>20</sup> Swedish Ministry of Finance (2003), p. 7.

<sup>21</sup> The number is expressed in nominal term. See Liz Passman (2003), p.4.

<sup>22</sup> The World Bank has provided assistance, financial and/or technical, to at least 45 client countries as of 2003 to implement MTEF to help strengthen countries' public expenditure management system.

which, through a top-down and more discretionary approach, will alter managerial behavior and organizational culture in the government.

This paper deals with Korea's MTEF and top-down budgeting reform plan by analyzing key issues which may affect successful implementation of reform. More specifically, the paper identifies why MTEF is considered necessary and what new budget process it will involve. Then, this paper addresses key challenges which Korea may confront and provides suggestions for implementation strategy to mitigate risks for successful reform. While this paper deals mostly with Korea's PEM system and addresses issues pertaining to Korea, it will be useful for other countries to draw some policy implications and lessons.

## **2. Background and features of MTEF initiatives in Korea**

More than most countries, public finance in Korea played a critical role in propelling economic growth during its development era. However, this arrangement also created numerous problems such as input and growth-oriented budgeting, restrictions of line ministries' discretion, and lack of transparency in the fiscal system.<sup>23</sup> These issues came to the fore at the time of the Asian financial crisis and prompted the Korean government to introduce many fiscal reform measures.<sup>24</sup> The results of these measures, however, have been mixed. Aware of many unresolved problems, the new Administration has initiated PEM reforms focusing on MTEF with top-down approach. This chapter elaborates on the current problems which MTEF may address, characteristics of the new initiatives, and the budgeting process under the new system.

### **2.1. Why MTEF?**

#### ***2.1.1. Short-term perspective with bottom-up approach***

Korea's current budget process operates on a short-term perspective, *i.e.* yearly based, and is highly tilted toward bottom-up approach. Under this system, revenues are calculated for only the upcoming year and expenditure prepared based on anticipated revenues for that year only. Although a medium-term fiscal plan was developed in 1999 to handle these short-comings, this plan has not been integrated into the annual budgetary process and has failed to significantly impact budget decision-making. The most pronounced problem in the current system thus is the lack of medium/long-term perspective and weak linkage between national policy priorities and budget.

Bottom-up approach tends to lead to gradual yet consistent increases across almost all budget items. Due to this incrementalism, the structure of public expenditure has barely changed over the past decades. For example, expenditure on 'economic affairs', the biggest item by function, has remained at relatively the same level between 1970 (27.4 percent of GDP) and 2000 (25.2 percent) even though the purpose of this expenditure, spending for economic development, has become less relevant in today's market-oriented economy.

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<sup>23</sup> MPB (2003), pp.124-125.

<sup>24</sup> Some of these reforms were the preliminary feasibility study requirement, tighter management of project ceiling budgets, performance-oriented budgeting, reforms to the public fund system, consolidation of quasi-taxes, and double-entry bookkeeping (MPB, 2003, pp.126-149).

Another concern regards the strategic decision-making mechanism in resource allocation. At present, little high-level discussion is conducted in the executive body between ministries and within the Ministry of Planning and Budget (MPB) regarding how public spending should be related to policy priorities. This lack of communication means consensus is seldom achieved during the early stage of the budgeting process. As a result, national policy objectives receive less than proper consideration in the resource allocation process. This also contributes to the lack of transparency in decision-making for resource allocation and setting policy priorities.

### 2.1.2. Future fiscal risk

Since the early 1980s, the Korean government has maintained strong fiscal discipline through tight fiscal and monetary policy. Notably, the deficit of the consolidated central government budget averaged 1.5 percent of GDP in 1981-1986 and the size of government debt was successfully restrained at a manageable level. Further, the Korean government, having experienced fiscal deficit at 4 percent of GDP in 1998, has made consistent effort to contain expenditure growth. Largely due to the rapid growth in revenue arising from a dramatic rebound in the economy and well-controlled expenditure increases, the fiscal balance returned to surplus of 1.3 percent in 2000, 2.0 percent in 2001 and 2002.<sup>25</sup>

However, there are many dormant problems, threatening fiscal soundness in the future. Unless properly handled, these threats could burgeon beyond manageable levels, necessitating that they be addressed sooner rather than later.

One of the most serious risks lies in social welfare demands. These represent a major upcoming burden on Korea's public finances. Especially, major public pension schemes have many problems such as generous benefits relative to contributions, implying that the reserve will be depleted in a foreseeable future.<sup>26</sup> Lee (2003) outlines Korea's expected social welfare burden from the four public pension schemes showing that benefits due will peak at 11.1 percent of GDP by 2035.<sup>27</sup>

This problem becomes more serious in the context of Korea's aging society. The aged – those 65 years old and above – population in Korea was 7 percent of total population in 2000 but that figure is expected to reach 14 percent by 2019. It should be emphasized that a key dimension to the aging population in Korea is the speed with which the demographics of society are shifting. What this fast aging phenomenon implies is that expenditure demand will rise rapidly and on a large scale and revenue source will decrease near in the future.

The second issue is restructuring of the financial sector. The fiscal support to financial restructuring mostly took the form of government guaranteed loans. Consequently, high net lending during financial sector restructuring in the aftermath of the financial crisis has left irretrievable debts of 69 trillion won, equivalent to 12

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<sup>25</sup> The consolidated budget surplus is arguably overstated due to the National Pension Fund, net lending, and obligations for repayment of restructuring bonds. A perhaps more accurate picture of the fiscal balance appears after adjusting for these, showing fiscal balances of -0.5 percent, 0.1 percent, and 0.1 percent in 2000, 2001, and 2002 respectively (Koh, 2003, p.10).

<sup>26</sup> The four main pension schemes are the National Pension Scheme (NPS), Government Employees' Pension Scheme (GEPS), Private School Teachers' Pension Scheme (TPS), and Military Personnel Pension Scheme (MPPS).

<sup>27</sup> Koh (2003), p.13.

percent of GDP in 2002.<sup>28</sup> This will inevitably make it harder to maintain fiscal balance for quite a long time.

Thirdly, of no small concern is the current division of the Korean peninsular and financial burden this situation continues to place on expenditure demands. This unique issue, whose outcome remains very ambiguous, requires sufficient planning in terms of public finance. The future of Korea, including possible unification with North Korea, is unclear but suffice to say all contingencies warrant due consideration. Reducing the negative effects of unification under any circumstances, will depend heavily on preparation and organization prior to such an eventuality.<sup>29</sup>

Moreover, the revenue side poses as high a risk to the fiscal balance as the expenditure side. Further aggravating the potential danger of threats is the outlook of Korea's economy growth rate, which is expected to slow markedly in the coming years. Reduced economic growth rates necessarily imply declining rates of revenue, which will test Korea's fiscal discipline.

### **2.1.3. Inefficiency from managerial inflexibility**

Under the current system, there is a lack of managerial flexibility and limited autonomy in line ministries both in planning policies and implementing budget. It is believed that the existing centralized, input-control based, bottom-up approach in budgetary decision-making is one of the main causes of inefficiency and rigidity.

Currently, the MPB reviews all projects in the budget review stage, thus it intensely influences line ministries. This induces line ministries to exaggerate budget proposals and often leads to laborious bargaining between line ministries and the MPB. Such circumstances also often incur enormous transaction costs and foster informality in the public sector,<sup>30</sup> representing a misuse of time toward unproductive efforts.

It also causes accountability problems. The link between responsibility and the discretion to perform flexibly and autonomously may be tenuous, creating a mismatch between policy and accountability. The lack of managerial flexibility in the public sector has undermined government's efforts, by performance management system, to improve accountability.

## **2.2. Korea's reform initiatives<sup>31</sup>**

Korea is in the process of preparing public expenditure reform plans with the following characteristics representing the main directions.

*Long-term Perspective:* Under the new system, the MPB will prepare a 'Long-term Financial Management Plan', which makes a long term – more than 10 years – projection of the overall fiscal balance and sectoral allocation. For this projection, the MPB will factor in various macroeconomic and social variables including sustainable debt level and tax burden, national policy agenda, and sectoral expenditure demand. This Plan will serve as a baseline to determine fiscal balance and sectoral allocation for

<sup>28</sup> Koh (2003), p.1.

<sup>29</sup> IMF estimates that it will cost 975 trillion won, equivalent to 820 US dollars, if the two Koreas were united as of 2001 and North Korea's GDP will reach the same level as South Korea in fifty years (Funke and Strulik, 2002, p.18).

<sup>30</sup> For informality in the culture of government, see Schick (1998), pp.127-129.

<sup>31</sup> This plan is in the process of being prepared so this section is not necessarily representative of the official position of the Korean government.

the upcoming three years and be reviewed and updated on a rolling basis to reflect any unexpected changes.

*Top-down Budgeting:* Fiscal targeting, of which sustainable fiscal balance over the economic cycle is a core aspect, will be driven by the Long-term Financial Management Plan and macro-economic forecasting. Based on fiscal targeting and revenue estimates, the decision is to be made for the budget aggregate for three years. Following this, and with consideration to policy objectives and priorities, sectoral and ministerial expenditure limits, for three years, will be finalized.

*Strategic Decision Making Mechanism:* As part of the new strategic decision-making mechanism, cabinet-level meetings will be held to discuss long-term plans, macro-economics, budget aggregate, and sectoral limits. The main purpose of the cabinet meeting is to establish a forum wherein consensus-building on national policy priorities and expenditures will be made at the early stage of budget formulation. The additional objective is to obtain strong commitment from the cabinet, and enhance transparency through open and direct discussions. To support this meeting, the MPB should prepare a draft fiscal target, fiscal aggregate, and sectoral ceilings. During the preparation process, the MPB should interact closely with the President, who will preside over the cabinet meeting, on proposals in order to foster greater coordination and obtain critical support.

*Decentralization:* Currently, the MPB is heavily involved in preparing appropriations for individual projects in the budget process, which leaves very little room for line ministries to maneuver. In contrast, the new system will make line ministries play a much more substantial role. Within the boundary of the sectoral ceiling and policy priorities set by the cabinet meeting, line ministries will have more autonomy to prepare their own budget proposals. The MPB will focus its efforts on reviewing budget proposals to ensure that sectoral ceilings have been respected and that proposed requests sufficiently reflect policy priorities. Increased line ministries' discretion over their budget preparation can significantly contribute to enhancing the accountability of line ministries, because line ministries will be held accountable for what they can control rather than for what they can not. A proper system of checks and balances including performance management should be in place to align managerial discretion with accountability.

Under the above direction, Korea's budgeting process will undergo fundamental change. The changes, incorporating the introduction of MTEF, will lead to new processes and stages outlined below:

#### ***Stage 1: Long-term financial management planning***

This stage covers medium-term macro-economic forecasting, and review of social and economic factors that may affect public finance. Various national debt levels such as the debt ratio to GDP or total expenditure would also be reviewed at this time. Contingent upon the findings and reviews conducted at this stage, the Long-term Financial Management Plan should be constructed by the MPB. In the Plan, the long-term national agenda and sectoral expenditure demands should also be checked and a strategic, long-term resource allocation plan suggested.

#### ***Stage 2: Fiscal targeting and budget aggregate***

In this stage, based on the macro-economic forecasting and the Long-term Financial Management Plan, the fiscal target and important fiscal policy for three years will be set. The core fiscal target under consideration should be fiscal balance policy. Additionally, along with analyses of other important factors including revenue estimates, the budget aggregate for three years should be suggested.

***Stage 3: Sectoral and ministerial ceilings***

Following stage two, the MPB should suggest strategic resource allocation in line with sectoral and ministerial expenditure ceilings. In this stage, the national strategic policy objective and sectoral objectives are considered and major budget projects are classified according to strategic importance.<sup>32</sup>

***Stage 4: Cabinet meetings***

For this stage, a special Cabinet meeting will be convened to discuss and agree on macro-economic forecasting, long-term plans, fiscal targeting, and expenditure aggregates and sectoral ceilings. Consensus among cabinet members should be built through constructive and informed discussion and unanimous support attained at the cabinet level. It is perceived that cabinet meetings should be convened twice during a fiscal year. The first, held in March, would discuss and agree on the fiscal target, total size of budget, and sectoral ceilings. The second in August would update macroeconomic conditions and review the necessity of adjustments, and finalize the coming year's budget proposal. After consensus is reached at the cabinet meeting, the MPB should present and explain the proposal to the National Assembly.<sup>33</sup>

***Stage 5: Line ministries' requests***

Line ministries should prepare their budget proposal so that it clearly reflects policy priorities and respects sectoral ceilings. Through this, line ministries would have more autonomy and discretion and the MPB, to facilitate line ministries' preparation, would provide guidelines, including criteria for common expenses. In case of complicated projects which involve more than one ministry such as R&D and regional development projects, the MPB could consider establishing committees, consisting of relevant stakeholders inside and outside government, to reach an objective and concerted decision.

***Stage 6: Review and budget documentation***

The MPB reviews line ministries' budget requests for sectoral ceiling compliance and policy priorities. In this stage, negotiation/bargaining between the MPB and line ministries will still occur. Even where budget proposals remain within sectoral ceiling, the MPB may raise questions and suggest changes to line ministries if the MPB believes policy objectives can be better achieved with different projects/programs. The type and frequency of discussion between the MPB and line ministries, however, will change such that discussion will be based upon transparent and fact-based rules.

**3. Key issues to be addressed**

The principle of linking policy with budgeting, which MTEF embodies, is useful and popular for many countries around the world. However, not every country has been successful in introducing MTEF or fully realizing its benefits. One of the commonly cited reasons for less successful MTEF in many countries, developing and

<sup>32</sup> One possible classification scheme considered by the MPB is to sort all budget projects as A, B, or C, where A is projects related to national strategic objectives and sector objectives, and mandatory expenditures such as debt payment and debt interest; B is core projects in each sector; and C is projects that are classified into neither A nor B.

<sup>33</sup> The role of the National Assembly and legislative procedures are integral to the budgeting system and important for reform. However, legislative issues are beyond the scope of this paper.



developed alike, is that too much attention is given to the technical aspect of MTEF and little consideration on how to change the institutional framework, decision-making process, and organizational culture of public sector. International experience clearly suggests that basic principles of MTEF must be carefully adjusted to fit into country context.

In this regard, it will be necessary to analyze key issues Korea may face down the road of reform and suggest how Korea can prepare itself to address these challenges. Special attention should be paid to country context in the areas of macro-economic forecasting, strategic decision-making, setting the level of line ministries' discretion, designing incentive systems, and reforming budgetary basics such as budget structure, scope and improving information system.

### 3.1. Macro-economic forecasting

Questions concerning macroeconomic forecasting are two-fold, *institutional* and *functional*. Institutional questions are, *how can a macro-economic forecasting function be set up in the MPB under the current institutional setting, and how can capacity be developed in the MPB?* Functional questions are, *how can unbiased macro-economic forecasting be undertaken, and how can macro-economic uncertainty be overcome?*

Korea has organizational complexity regarding macro-economic forecasting and policy coordination. Currently, the Ministry of Finance and Economy (MoFE) has macro-economic forecasting and policy coordination functions, while the MPB's duties lie in fiscal policy and budgeting.<sup>34</sup> In addressing organizational complexity, dramatic change of organizational structure is likely to not only be unfeasible but also create significant resistance to the change that MTEF will bring in. Rather, it is recommendable to clarify roles of each ministry under the current system and set up a coordination mechanism.

Although the MPB will conduct macro-economic forecasting under the new scheme, its role should be limited, considering the current institutional environment. The MPB's macro-economic forecasting function should be implemented only within the range of fiscal policy making. This may help avoid undesirable institutional conflict in government. Beyond that, it would be valuable for the MPB to embrace the findings of other government agencies and organizations, and coordinate the works from all sources for better macro-economic forecasting. To this end, forming an advisory committee, comprising of MoFE, Bank of Korea, and public and private research institutes might be worth considering. However, it is the MPB who should be in the driver's seat when it comes to deciding on macro-economic forecasting, at least for setting the baseline for the Long-term Financial Management Plan and fiscal policies.

Unbiased, honest, and realistic forecasting is essential. MPB's well-trained technocrats and the independent advisory committee may be a way to move toward this end. It is advisable to devise a macro-economic forecasting formula for objective

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<sup>34</sup> By way of background of Korea's institutional changes, economic forecasting and budgeting has seen several important changes. These changes have occurred at the institutional level directly impacting the decision-making mechanism and coordination functions. In 1994 the EPB was merged with the Ministry of Finance to form the Ministry of Finance and Economy (MoFE). This was soon fractured leading to the establishment of the Planning and Budget Commission (PBC) and the Office of National Budget (ONB) as separate bodies from the MoFE. Shortly thereafter, the PBC and ONB themselves were merged to create the MPB, leaving the MoFE and MPB as two independent ministries.

analysis and avoid pressure from outside political circles. In developing this formula, a conservative method would be preferable to contribute to fiscal soundness.<sup>35</sup>

It is recommended to establish a unit/department within MPB responsible for macro-economic forecasting and assessment of social/political factors that affect fiscal policy. This new organization could comprise of one or two divisions. Having such an organization within the ministry could allow the MPB staff to appropriately deal with macro-issues, undergo training to enhance their capacity, and to coordinate greater links with outside experts. The MPB may make both judgemental and predictive errors, but will perform better over time as they build up experience.

Lastly, to cover macro-economic uncertainty, the concept of 'budget margin' should be created in the annual budget. The budget margin acts as a kind of buffer and mainly aims "to absorb fluctuations in the expenditure level due to changes in the cycle and other macro-economic uncertainties."<sup>36, 37</sup> It can be utilized in cases of forecasting deviations and new presidential policy initiatives. The size of the budget margin may depend on accuracy of information. The budget margin should be no larger or smaller than what is considered enough to fulfil its role of accommodating uncertainty. It is perceived from international experience that, over time, macro-economic forecasting tends to become more accurate allowing the size of the budget margin to decrease.<sup>38</sup>

### 3.2. Strategic decision-making on budget aggregate and sectoral ceiling

*How should decisions about total budget aggregate and sectoral ceilings be made and by whom?*

Regardless of the type of decision-making mechanism, consensus and commitment at the highest level of government is a critical component for reliable fiscal targeting, budget aggregate and sectoral ceiling levels. In some OECD countries, such as Sweden, Norway, and the Netherlands, decisions are made through cabinet meetings. On the other hand, in the UK, H.M. Treasury fulfils the leadership role which is enhanced through a close relationship with the Prime Minister. Different again, in the USA there is a close informal interaction between OMB and the President, with informal cabinet level discussions, resulting in a strong commitment at the highest level and across the board. In all these countries' systems, the common and important characteristic is consensus and commitment at the highest levels of government.

Korea is now strongly pursuing top-down decision-making mechanisms to link policy and budgeting.<sup>39</sup> In this regard, cabinet meetings should provide the forum where strategic decisions on fiscal targeting, total aggregate, and sectoral ceilings take place. Through this meeting, agreement will be reached in the Cabinet ensuring

<sup>35</sup> For example, the Canadian Department of Finance systematically revises the private sector forecasts downwards as a further measure of prudence. This takes the form of the government adding 50-100 basis points (0.5-1.0 percentage points) to the average private sector economic forecasts for interest rates and then feeding this through its entire econometric model, thus producing lower forecast economic activity. This provides a buffer in order to maintain the government's fiscal objectives (OECD, 1999, p.9).

<sup>36</sup> Swedish Ministry of Finance (2002), p.13.

<sup>37</sup> Budget margin is different from 'budget reservation' in Korean budgeting which represents a permanent allocation in the budget for unexpected demands such as natural disasters.

<sup>38</sup> The Sweden case shows the budget margins for 1997-2001 were 3.33, 0.28, 0.20, 0.65, and 0.59 percent and are projected for 2002-2004 as 0.04, 0.05 and 0.07 percent, respectively (Swedish Ministry of Finance, 2002, p.13).

<sup>39</sup> However, it should be noted that MTEF consists of top-down resource allocation and bottom-up approach for cost estimation. In this sense, the bottom-up element should not be overlooked.

commitment at the highest level. The MPB should play a key role by preparing its proposal on fiscal policy, total budget aggregate, and sectoral ceiling for the cabinet meeting. Furthermore, it is important that the MPB works in close consultation with the President in preparing the proposal. From this, mutual benefit can be achieved as the President can input his policy priority into the budget and the MPB can gain political support.

A concern may arise over the possibility of disagreement at the Cabinet meeting, particularly over sectoral ceilings. This concern arises because Korea has been weak in forming consensus through consultation and negotiation processes. Added to this, lack of negotiation experience is the growing voice from numerous interest groups as Korea becomes a more democratized society. While valid demands should be heard and brought to the table for discussing national agenda, many not-in-my-back-yard type protests are becoming ubiquitous as well. This situation calls for special attention to be paid to the design and implementation of MTEF, since the cabinet meeting is likely to experience difficulty reaching agreement.

Given this situation, it may be advisable that the cabinet meetings adopt a two-stage approach. The first stage would be to decide the budget aggregate, and the second stage would determine the sectoral allocation. If these two were placed on the table together, it would be very difficult to reach an agreement. Thus, division of these two in decision-making becomes important as the decision on the total budget aggregate turns the discussions on sectoral ceilings into a zero-sum game. Against all these efforts, if cabinet meeting fails to reach an agreement, it should be understood that the President will make the final decision, with the MPB's objective and professional support.

### 3.3. Discretion of line ministries

*How much discretion should line ministries be given?*

A centralized budgeting process has been with Korea for a long time, with the MPB's deep involvement in almost all facets of the budgeting process. Entrenched in this all-under-my-control mechanism, the MPB may be reluctant to relinquish its influence over appropriations. Meanwhile, concern over line ministries' lack of capacity and experience in areas such as prioritizing within a sector may also lead to hesitation for greater discretion to line ministries.

Such barriers, however, can only be overcome by making steps to directly address these issues. A new incentive system must be introduced so that MTEF can be perceived by the MPB as being beneficial to them and that their influence over appropriation will be upgraded to more professional and legitimate influence. Ultimately, discretion to prepare a budget request within sectoral and ministerial ceilings should be granted to line ministries. This may afford line ministries greater ownership over their respective budget proposals and make them more likely to identify policy priorities within their sectors as well as grant managerial flexibility resulting in greater efficiency. Through these experiences, line ministries can also build up necessary in-house capacity to manage increased discretion over their policy and budget more effectively and responsibly.

On the other hand, Budget proposals prepared by line ministries should be subject to the MPB's review. This review should mainly act as a checkpoint to ensure that line ministries' proposals are in line with the national policy priority agreed on at the Cabinet meeting and stay within the sectoral ceiling. Also the MPB should provide guidelines, including criteria for common expenses, and perform monitoring and

coordinating roles to ensure line ministries' proposal is prepared according to the provided guidelines.

In addition, an incentive system should be developed to promote more efficient spending for line ministries. Presently any money left over at the end of fiscal year is returned to the General Account. Obviously, this system provides little or no incentive for line ministries to save money. One way to alter the incentive of line ministries is to classify any remaining funds at the end of the fiscal year into two categories; *savings* and *over-budgeting*. The first, *savings*, would refer to amounts arising due to efficient spending and genuine efforts to reduce spending and improve efficiency. For funds falling into this category, a certain percentage of savings – empirically at least more than half of the savings should be allowed<sup>40</sup> – could be retained by the line ministry for use in the upcoming fiscal year. The second category, *over-budgeting*, should be returned to the General Account as per the current system.

### 3.4. New incentive system

*How can the new incentive system overcome resistance to implementation, and what should be the new role of the MPB and line ministries under this new system?*

It is possible that both the MPB and line ministries will resist reforms for many reasons. The MPB may be concerned with potential loss of influence and power through the proposal to diminish its role in allocating resources. On the other hand, line ministries may be skeptical about receiving more discretion in their own budget preparation. Both the MPB and line ministries may also perceive the changes as merely additional work without any real benefit.

Two main considerations should be given to deal with resistance to the new system. First, some resistance may arise from a lack of knowledge regarding the real nature and characteristics of the proposed new system; how annual budgeting process changes under MTEF, what will be the new roles of MPB and line ministries, what kinds of benefits can be expected from MTEF. Secondly, uncertainty over individual incentives under the new system, if not handled appropriately, may lead to resistance. MPB and line ministries' staff may not be sure how the changes will affect their personal interest.

For the MPB, the existing system places a large work burden on the staff and much time is devoted to micro-level decision on individual activities.<sup>41</sup> However, under the new system, focus will shift to higher level decision-making, analyses of macro-economics and national policy priorities, and preparation of draft proposals for the cabinet meetings. Furthermore, the MPB could have the privilege to interact closely with the President. From all these, the MPB will not lose its current standing as a 'prestigious' ministry. On the contrary, its influence and power may be strengthened. The MPB's influence will remain high through monitoring and coordination over line ministries' budget proposals during the budget review stage and through performance evaluations of major projects.

On the other hand, line ministries have an opportunity to enhance their level of influence, providing an incentive to gain greater discretion in decision making. Line ministries, firstly, will be granted discretion in planning and prioritization within their

<sup>40</sup> Allen and Tommasi (2001), p.359.

<sup>41</sup> The number of projects per budget examiner in the MPB has jumped from 81 in 1994 to 150 in 2003; and the portion of budget allocated per budget examiner increased from 1.0 trillion won in 1994 to 4.6 trillion won in 2003 (MPB, 2003, p.8).

sectors and secondly, they will have flexibility in implementing policy and executing budget. There will be a learning curve when introducing these changes which will further allow line ministries to build up capacity to deal with their new role. The timeline for granting discretion may need to be done gradually to plan a path for granting discretion over to line ministries.

Besides, gaining greater discretion over budgetary decisions can also increase the legitimacy of holding line ministries accountable for the performance of their output. Under the new system, unlike the current situation where line ministries are sometimes held accountable even though they don't have any control over resources and decision-makings, line ministries should be accountable for the decisions they make and their performance only.

### 3.5. Performance and accountability

In an effort to enhance performance, the Korean government launched a pilot project in 1999 to implant performance-based budgeting (PBB). Under this project 39 participating agencies prepared and submitted performance plans to the MPB specifying objectives, strategies, and indicators. They also compiled an *ex post* performance report for comparison against the original plan. The impact of this pilot project between 1999 and 2002, however, was analysed as falling short of expectation.

The MPB, recognizing that it may have been too ambitious to link performance and budgeting, is in the process of designing an alternative, applicable management system. In the new system, line ministries are asked to develop objectives, indicators, and measurement methods for certain projects under the guidelines provided by the MPB.<sup>42</sup> In this way, line ministries will have strong sense of ownership and the MPB can ensure performance indicators are appropriate and consistent over all ministries.

The new performance management system should ideally follow a long-term phased approach. Since this can be a daunting task, it may be beneficial to formulate a viable, short-term plan, which sets reasonable goals and fits within the broader program, to facilitate early and successful implementation. Pilot projects to develop and introduce output-based indicators would be a preliminary step followed by expanding into all programs and developing outcome-based indicators.

Expectations are high regarding the latest tools and techniques for performance management. Evidence from international experience, however, indicates that performance management or PBB adds value only when the existing institutional arrangement in the public sector is conducive to support performance orientation. Therefore, the Korean government would need to foster an environment which supports performance orientation while fully introducing PBB or outcome budgeting. For example, personnel management and organizational structures that provide incentives for improving performance should be in place along with a performance management device.

The *quid pro quo* for the increase in discretion is that the line ministries be held accountable for results. The new system should bring a fundamental change in terms of accountability. It should make the MPB and line ministries more responsible for their results, and not their processes. Thus, instead of input control, the focus should be on what they achieved.

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<sup>42</sup> According to the MPB's plan, a certain number of projects, amounting to 30 percent of the total ministerial budget, will be evaluated.

The first step to enhance accountability is to emphasize that ministers should hold ultimate responsibility for programs operated under their discretion.<sup>43</sup> Presently, the Korean government has little *ex post* evaluation, although it has introduced some *ex ante* evaluation systems, including the preliminary feasibility study. To move further along this path, the MPB should embrace the role of watchdog by performing more comprehensive monitoring and evaluation of projects. Setting up policy objectives for the cabinet meeting and discussing projects objectives with line ministries during the budget review stage will be a sound basis for this process. To further contribute to this mechanism, budgeting and accounting systems should be linked and information exchange between the MPB, the MoFE, line ministries, and the Board of Audit and Inspection integrated.

### 3.6. Budget structure, classification, and scope

Another lesson from international experiences with MTEF is that success of fiscal reform largely depends upon 'budgetary basics' such as budget structure, scope, classification, accounting, information, evaluating, and auditing. Unless these basics are firmly set up, introducing MTEF may not generate anticipated benefits due to a weak public expenditure management environment.

Unfortunately, many weaknesses exist in the Korean PEM system. First, the budget structure is too complicated; a fragmented assortment comprising one General Account, 22 Special Accounts, and 45 Funds. Second, its expenditure classification is far too subdivided; consisting of more than 2,200 appropriation accounts (*Se-Hang*) and more than 6,000 sub-accounts (*Se-se-Hang*). Each of them is subject to negotiation between the MPB and line ministries. Third, the coverage of the budget is limited; excluding some important fiscal activities of the government, like the National Health Insurance and quasi-government activities.<sup>44</sup> Current coverage of the budget is not consistent with Government Finance Statistics (GFS), an international standard for public expenditure statistics issued by the IMF.<sup>45</sup>

The fragmented budget structure, complex classification, and limited budget coverage cause several problems. First, it is difficult to control public financial resources, which impedes allocative efficiency. Second, the inherent opaqueness of the system leads to transparency and accountability issues. Third, these budgetary basics problems also contribute to managerial inflexibility and make results orientation more difficult to attain. These problems, all together, make it technically prohibitive to allocate resources within sectoral limits down at the level of sub-accounts, and this would hold even if the Korean government introduces a new system incorporating sectoral ceilings.

Much effort to realign the budget structure, classification, and coverage are needed. The Korean government should make all the special accounts and funds subject to the same level of scrutiny as budgetary expenditure. And, extra-budgetary funds should be discouraged unless very strong justification exists. The budget subdivisions, currently classified by line items with its heavy emphasis on input control, should be more

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<sup>43</sup> A serious problem is that the tenure of ministers has been notoriously short with the average term of a minister being less than one year, during 1993-2002 (Maeil Economic Newspaper, March 10, 2003).

<sup>44</sup> For more details, see Koh (2003), pp.29-31.

<sup>45</sup> It is however important to note that GFS is for statistical purposes rather than budgetary management purposes. IMF acknowledges that countries are not obliged to prepare an annual budget completely in line with GFS. Rather, it requires a country to *ex-post* prepare and rearrange expenditure according to GFS.

simplified and, in the long run, managed with expenditure classification on a functional and program basis. Also, the consolidated budget report should embrace all activities that fall into public spending.

There also exists an urgent need to improve the information base and establish efficient information flows to facilitate strategic decision-making. Core functions of a financial management system like budgeting, accounting, cash-debt management, and auditing-reporting need to work as one entity even though it consists of multiple, geographically dispersed organizations. The information outflow from one component should be an inflow to all other related components so all components share a common financial evaluation and measurement base and decision makers can make timely and informed decisions.<sup>46</sup> For example, as line ministries would have more discretion in preparing their budget, the MPB needs to verify that each ministry uses the same set of macroeconomic indicators such as the unemployment rate and inflation rate.<sup>47</sup> Another important benefit from the integration of financial information is enhanced transparency of financial management procedures. Increased information flows and accuracy strengthens the checks and balance system within administrations, between the MPB and line ministries, and between the public sector and citizens.

#### 4. Some suggestions for implementation strategy

For the successful implementation of MTEF, it is important to acknowledge the unique public sector environment of a country. Consideration of country context is all the more important for Korea, because Korea's public sector has very distinctive features from western countries where MTEF was originally developed and practiced. This section first briefly discusses a few aspects of Korea's public sector which may require special attention when developing an MTEF implementation strategy. Following this, some selected observations and suggestions regarding Korea's path to implement MTEF and top-down budgeting are provided.

First, Korea has shown a strong track record in linking planning and budgeting in the past. Korea's Economic Planning Board (EPB), a super-ministerial economic agency in Korea in 1961-1994, was empowered to handle both planning and budgeting functions under one roof for better directing economic growth. It is regarded that the EPB played an important role in directing economic development and was a crucial player in Korea's economic success story. The minister of the EPB was Deputy Prime Minister and enjoyed strong political support through visible Presidential involvement. In retrospect, Korea has, in substance, exercised MTEF without calling it MTEF.

Second, it is important to note that the current reform initiative is initiated within the executive branch and led by a number of technocrat 'champions.' This creates a strong sense of ownership within the government and helps to design workable features of reform and to implement it. Traditionally, technocrats have played very

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<sup>46</sup> An integrated information system becomes a more vital issues under Korea's divided organizational structure where treasury management and budget execution reporting is under the MoFE and budget formulation and execution is under the MPB. The current two stand-alone information systems in the two ministries need to be seamlessly linked to each other.

<sup>47</sup> This is not to say that the MPB should handle macroeconomic conditions for all purposes. Rather, the MoFE should be in charge of monitoring and setting macroeconomic conditions for general purpose and the MPB's concern should be limited to those related to budget formulation.

strong roles in Korea's public sector.<sup>48</sup> Among the reasons to explain this predominance of career technocrats are historical and social respects for government officials. This has attracted many well-educated and highly trained people to join the public sector and become career technocrats. This also means that technocrats relatively distance themselves from political pressures. At the same time, the executive body and technocrats need to draw together to present a broad and united front of political support for its reforms as demands of various interests increasingly enter into the decision-making process.

Past experience of linking planning closely with budget during the EPB period and strong sense of ownership for the reform within the government and technocrats creates a favorable environment for MTEF to be successful. But that is not to say that the path of this reform will be easy. Challenges and obstacles lie ahead making the successful implementation of the new system no guarantee. In order to overcome these obstacles, the key issues outlined in the previous chapter need to be carefully addressed and detailed plans prepared. Besides these key questions, below are some observations and suggestions regarding Korea's path for implementing MTEF and top-down approach.

#### *Pre-conditions*

There are several important pre-conditions for successful implementation of MTEF in Korea. Among these are strong political support, the MPB's willingness and commitment to the new system, compliance of line ministries, capacity building for the MPB and line ministries, and development of a legal framework for the new system. Some have been met but not all. Although not all the pre-conditions are in place, the Korean government, rather than delay reform, should focus on putting them in place in parallel with proceeding with reforms. Most OECD countries also had, and still have, some shortcomings in their expenditure management. Instead of waiting till everything becomes impeccable, they used MTEF as an instrument to alter the *status quo* and improve along with strengthening policy linkage with budget. Considering its highly skilled civil service, Korea may opt to introduce MTEF while simultaneously striving to improve these pre-conditions.

#### *Bureaucracy and organizational culture*

Central to success of the proposed reform will be the evolution of Korea's bureaucracy and organizational culture. Korea's civil service system is characterized by life-long job security, seniority-based systems for promotion and non-merit based salary, short-term tenure of high level policy makers, and lack of performance-oriented culture, all of which leave little incentive for bureaucrats to accommodate change. These characteristics have contributed in part to the failure of past public sector reforms which government ambitiously tried to implement and ended up only causing superficial changes and limited tangible results.

Fiscal reform, due to its potential impact on resource allocation, can be a strong driving force in broader public sector reforms. However, fiscal reform is a type of reform that requires a holistic approach; as public expenditure touches almost all realms of public sector, meaningful change in PEM must be complemented with other public sector reforms. Therefore, it is important to reignite various public sector reform efforts that were initiated at the time of the Asian financial crisis but remain

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<sup>48</sup> It is indicative to point out that most political appointees in economic policy-related ministries, particularly the MPB and MoFE, have been actually awarded to career technocrats over the last four decades.



incomplete. It will not only create a favorable environment for MTEF to be introduced, but also will create a synergy effect for building a more effective and transparent public sector.

### ***Leadership and capacity***

Strong leadership is essential in any reform. For MTEF and top-down budgeting, direct involvement of the President and active engagement of cabinet are necessary. Also, the MPB's strong leadership is crucial to initiate the reform. It will be particularly essential to have key individuals in the ministry to "champion" change both initially and to sustain the momentum. Expanding from this initial step, a core group should be identified to lead and promote the initiative throughout the ministry.<sup>49</sup>

Capacity building is another important element to implant this new system. For the MPB staff, skills in macroeconomic and policy analysis, policy prioritization, coordination and conflict resolution, and problem-solving abilities should be built up. Line ministries should develop capacity in planning and policy analysis, development of implementation strategy and tools, and problem-solving abilities.

The MPB and line ministries can build up capacity through job training and seminars for all levels of MPB and line ministry staff. Not just the technical features of MTEF but the benefits of MTEF should be conveyed to all staff levels. More important, however, is to create an incentive system that motivates self-development and capacity building. Once sufficiently motivated, the MPB and line ministry staff will benefit from the learning curve as they internalize the MTEF process.

### ***Big bang and gradual approach***

Devising a specific implementation strategy will increase the likelihood of success of the reform. Reform can be implemented via a big bang or gradual approach, *i.e.* introducing the whole plan at once or on a piecemeal basis. For Korea, a combination of a big bang approach and gradual approach together would be more desirable. Top-down decision-making may be adopted via a big bang approach and should see strategic decision-making for budget aggregate and sectoral ceiling introduced together with resource allocation policy making. However, in areas not covered in strategic decision-making, a more gradual approach should be adopted. This includes various budget stages, such as budget proposal preparation, review, monitoring, and evaluation. A comprehensive long-run plan should map out smaller steps designed to realize the gradual approach. In the process of implementation, attention should continually be paid to meeting the pre-conditions referred to above.

### ***Performance-orientation***

Improvement of PEM requires serious focus on results achievement or performance from government expenditures. Accordingly, MTEF and performance management represent two sides of the same coin. Even if MTEF is successfully introduced, it may be vulnerable unless performance-oriented management is implemented correspondingly.

International experience shows that nurturing a performance-oriented environment is of central importance before new tools and techniques for performance management or PBB can be fully introduced. In the case of Korea, performance orientation in the public sector is considerably under-developed. In the current system, life-long tenure, seniority-based promotion and salaries are the norm. There is little

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<sup>49</sup> Muggeridge (1997), p.32.

managerial flexibility, to the extent that even ministers cannot make changes in the organizational structure, nor do they have the discretion to hire career officials. Thus, it is at least equally important for Korea to make efforts to realign the public sector environment, especially the civil service system, to fit into performance-oriented management while efforts to introduce performance management system needs to continue.

A suggestion to exemplify the advantages of such a culture would be to select one or two government ministries/agencies and designate them as regulation-free organizations. All regulations would be removed, allowing ministers/CEOs full discretion over personnel, organizational structure, management, etc.<sup>50</sup> At the same time, the chosen agencies would have clear assignments and a vision to achieve the objectives. In such an organization, performance would be a key driver for the minister and senior officials because they would be judged on *what was achieved* rather than *how things were done*. This should also lead to positive spill-over effects. Through this pilot project a performance-oriented culture could spread out in the public sector.

Korea's PEM is currently in transition, having already begun some reforms to move forward, but still many more issues remain to be addressed. Many challenges lie ahead that must be confronted, but there is also cause for optimism. The Korean government is dedicated to reform, initiatives have been derived and pushed from the inside, and there are positive dynamics for change. A budget system is a communication system, conveying symbols and signals about behavior, priorities, intentions, commitment, and price. The new PEM system, thus, is much more than simply fiscal reform; it's about creating new value and changing behavior, making public sector more performance-oriented, accountable, and transparent.

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<sup>50</sup> This idea is borrowed from Special Economic Zones, which are designated areas dispensed of regulations in order to boost investment and create a free and competitive business environment for economic activities.

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## CHAPTER 4

# Successful Installation of MTEF to the Korean Fiscal System

by

*Seok-Kyun Hur, Korea Development Institute*

### 1. Introduction

The budget process in Korea begins in March when the Ministry of Planning and Budget (MPB) transmits the Guide to Budget Compilation to the ministries. After negotiations between concerned parties, the budget draft is approved by the President and then presented to the National Assembly by October 2<sup>nd</sup>. The latter is supposed to approve the budget no later than December 2<sup>nd</sup>, well ahead of the new fiscal year that starts on January 1<sup>st</sup> of next year.

The current budgeting process in Korea is characterized by a lack of medium-term strategic perspectives on financial management. Macroeconomic forecasts contained in the Guide to Budget Compilation cover the next budget year only and no mention is made of the out-years. A medium-term fiscal plan was published in 1999, which included projections of fiscal aggregates and outlined priorities among the 12 broad spending categories between 1999 and 2002. It was subsequently revised in 2001. However, the plan remained largely indicative and, in practice, there was little formal connection between the plan and the annual budgeting process.

Another characteristic of the Korean budgeting process is the excessive reliance on the bottom-up approach. The Guide to Budget Compilation contains a very rough ceiling on the aggregate spending level (for example, one-digit increase in total). It does not provide a sectoral or ministerial allocation of the budget. As a result, budget requests for the next year across all line ministries tend to be unrealistically large, often implying a 20-30 percent growth from the current year's budget. The MPB then enters into a laborious period of negotiation with line ministries. The process becomes more painful because of the extremely segmented appropriation accounts - there are over 2,200 accounts (*Se-Hang*) and the MPB often negotiates with line ministries on sub-accounts (*Se-Se-Hang*) which total more than 6,000.

The current approach has certain merits. The budget authorities have large discretion over the total size of the annual budget and have used the power to contain and adjust expenditure growth to changing revenue conditions. To some degree, such myopia is inevitable in Korea where the socio-economic environment changes quite rapidly and unexpectedly. In addition, by emphasizing input control and regularity of budget execution, we find few cases of abuse or misuse of tax money.

On the other hand, the weaknesses of the current approach should not be overlooked. Without a long-term view on the appropriate level of tax burden, it can induce an ever-increasing expenditure to accommodate rising demands from various sectors. It also fosters gradualism in budgeting and can hinder a strategic reprioritization of spending, exactly when the strengthened control on aggregate expenditure generates greater necessity for such reprioritization. Line ministries have

little information on the availability of resources in the future and their planning function is severely limited. Limited planning function in turn reduces the effectiveness and efficiency of overall public spending.

Recognizing these shortcomings, the MPB is moving toward a medium-term expenditure framework (MTEF) and a top-down approach in budgeting. In 2003, it specified the aggregate level of the general account for fiscal year 2004, which takes up the largest part of central government spending. It also asked line ministries to provide out-year projections of major program expenditures for fiscal years 2004 and 2005 together with the budget requests for fiscal year 2003. In addition, the MPB designated a few organizations for a pilot study on top-down budgeting.

These are desirable developments, but we still have a long way to go before seeing the successful installation of an MTEF in Korea. The MPB did not set medium-term expenditure targets and did not provide line ministries with a sectoral allocation of the budget and medium-term forecasts on economic variables necessary to project out-year spending. Nor were there concrete guidelines on expenditure projections. For example, dividing the projection into three parts – for existing policies, for savings options, and for new policy initiatives – would be useful in identifying line ministries' spending priorities, but it was not attempted.

One big challenge is the extreme compartmentalization and fragmentation of the budget, which is comprised of one general account, 22 special accounts, and 45 public funds. These accounts and funds are intricately inter-related with each other through complicated flow of grants and loans. Even when a sectoral allocation of the budget is set up, it will be technically very difficult to allocate the sectoral budget to accounts and funds.

Key questions in setting up an MTEF and introducing a top-down budgeting process include the following: How can we produce unbiased and credible medium-term macroeconomic forecasts? How can we overcome shortcomings of a compartmentalized budget structure, and establish an aggregate fiscal discipline? What are the guiding principles in setting up a medium-term aggregate expenditure level and allocating it across sectors and/or ministries? How can we minimize resistance and objections from line ministries to pre-determined sectoral allocation of spending? What are the technical details needed in out-year projections of spending? How much autonomy should be reserved for line ministries in top-down budgeting? What will be the redefined roles of the budget authorities?

The present study aims to answer these questions and produce operational plans to introduce an MTEF and top-down budgeting. It will first discuss general issues in budgeting, overview MTEF as recommended by international organizations and as practiced in foreign countries, and compare it with the current budgeting process in Korea. It will then propose an appropriate system for Korea.

The contents of the paper are construed as follows: Section 2 discusses motivational aspects of introducing MTEF and explores the requisites for successful installation of MTEF in Korea while comparing the current single year budgeting system with MTEF. Section 3 explores common pillars of MTEF system and provides suggestions for successful installation of MTEF in Korea. Finally, section 4 concludes.

## 2. General features of MTEF

### 2.1. Objectives and means of MTEF

The pursuit of MTEF is multi-purposed: First, it aims to maintain fiscal sustainability by reigning in excessive expansion of public expenditures<sup>51</sup>. Under the current bottom-up budgeting system, conflicting interests among line ministries are often resolved by aggregate budget expansion beyond what is optimal. In contrast, under MTEF, there are two different types of ceilings – a global ceiling and sectoral ceilings. These ceilings are determined interdependently by considering medium-term economic forecasts and sectoral demand estimates for public expenditures over the matching period. By requiring that the global ceiling be stricter than the sectoral ceilings, such a two-tier ceiling system can accommodate fiscal sustainability as well as flexibility of moving public resources across sectors.

Second, MTEF enhances the efficiency of public spending by setting national priorities. The public sector produces various kinds of public goods in an economy. Accordingly, a reprioritization procedure is very critical in determining a production portfolio of diverse public goods within the limited resources. Accompanied with a top-down allocation system, MTEF enables each line ministry to make a self-motivated sectoral budget plan based on a longer time horizon. This in turn ensures the time consistency and effectiveness of government expenditure programs and enhances the possibility of these programs contributing to long-run economic growth. In this context, the role of top-down resource allocation cannot be emphasized enough. However, the importance and complementary role of top-down allocation with respect to MTEF does not necessarily imply that top-down allocation is the only means of MTEF and the bottom-up approach is an absolute vice to avoid. Rather, a successful MTEF relies on both approaches of allocation. Of course, physical resources and information on macro economic forecasting should be delivered from top to bottom. In contrast, critical information for allocation of fiscal resources, such as production efficiency and demand quantity of specific public goods (or projects), should be transferred from bottom to top. Thus, a key to successful introduction of MTEF lies in finding harmony between top-down and bottom-up allocations.

Third, MTEF strengthens the function of the fiscal management system as an automatic stabilizer. According to traditional public finance theory, one of the roles of the public sector is the stabilization of an economy. The role of automatic stabilizers is critical in that it smoothes out the production stream of public goods and reduces swings in business cycles by absorbing shocks, which otherwise would be directly born by private entities. Figure 4-1 shows how a well-designed MTEF reflecting the medium term economic prospect can provide insurance to the economy by changing fiscal positions (deficit->surplus in the figure) in the course of a business cycle<sup>52</sup>. However, the power of stabilizers is limited because most of the aggregate shocks arising in the economy cannot be hedged. In other words, it means that complete stabilization is not achievable without affecting the fiscal balance.

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<sup>51</sup> The idea of MTEF was devised originally in countries (e.g. Sweden and UK) suffering from heavy government debt. However, due to the heterogeneity of the situation each country is faced with, the implementation of MTEF in practice varies from a country to another.

<sup>52</sup> Even though a result differs by the time spans of data, the current year-by-year system is shown to be pro-cyclical. We suspect that the combination of the year-by-year system and the strong emphasis on fiscal consolidation causes the pro-cyclical feature.

Figure 4-1. Business cycle and fiscal balance

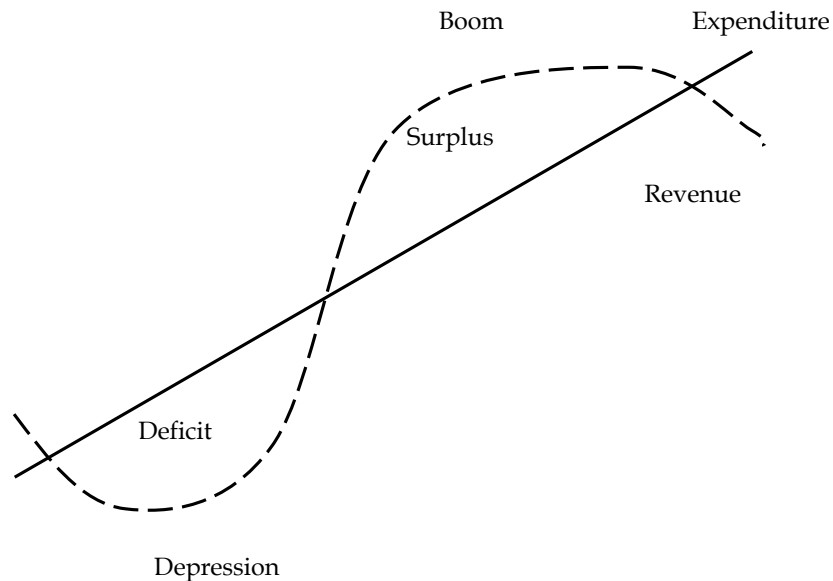


Table 4-1 describes the objectives of MTEF and matches them with relevant policy components in MTEF. In addition we provide analogies of MTEF to a consumer's intertemporal maximization program under uncertainty. Despite fundamental differences between the two, there are enough existing similarities to deepen our understanding about the MTEF.

Suppose a consumer with certain duration of life lives in a world full of uncertainties. Then, evidently his/her economic decisions should concern the following three dimensions: time, states, and sectors. To rephrase, he/she has to choose (1) how much to consume today instead of consuming tomorrow, (2) how many apples to consume instead of pears today, and (3) how much more to consume tomorrow in case of an event in comparison with the case of another event. Interestingly, each combination of an objective and a policy tool is analogous to each dimension of the consumer's decisions.

Likewise, MTEF defines the functions of fiscal activities in a multi-dimensional space: First, MTEF is a mechanism through which subsidiaries of a government are encouraged to compete with others by demonstrating cost efficiency and social need for public goods or services they produce. Second, MTEF provides insurance not only to subsidiary organizations but also to the aggregate economy. Budget allocation in consideration of long-term fiscal sustainability will induce precautionary fiscal savings for a rainy day. Third, budget planning based on the longer term prospect contributes to improvement in growth potentials through rational allocation of public resources.



Table 4-1. The objectives and their matching policy tools of MTEF

Objectives	Policy tools in MTEF and their analogies
Fiscal Consolidation (Cross-time substitution)	<ul style="list-style-type: none"> <li>● Setting a global ceiling and sectoral ceilings on the budget plan based on medium-term economic forecasts</li> <li>● Analogous to consumption-savings decision by a private entity</li> </ul>
Enhancing Efficiency in Public Spending (Cross-sectional substitution)	<ul style="list-style-type: none"> <li>● Assigning sectoral ceilings based on national priorities and encouraging line ministries to allocate resources within their sectoral ceilings</li> <li>● Analogous to consumption bundle decision by a private entity</li> </ul>
Automatic Stabilization Mechanism (Cross-state substitution)	<ul style="list-style-type: none"> <li>● Smoothing public expenditures across time (in a business cycle) by assigning public expenditures within a medium- (or long-) term framework</li> <li>● Analogous to precautionary savings by a private entity</li> </ul>

Table 4-2. Comparison of single year budgeting and MTEF

	Traditional Budget (at Ministry level)	MTEF (3-year-rolling program at Sector level)
AGGREGATE FISCAL DISCIPLINE (to keep expenditure within the means)	Focused on short-term macro-economic concerns (with international agencies providing the discipline in many countries).	Situates short-term macro-economic concerns within a medium-term macro-economic and sector perspective. Involves building domestic macro-economic modeling capacity.
LINK BETWEEN POLICY, PLANNING, AND BUDGETING (Reflecting the government's capacity and willingness to prioritize expenditure programs)	Very weak because policy choices are made independent of resource realities. Thus policy is not sustainable and spending patterns may not reflect the priorities articulated by government.	Policy-making tightly disciplined by resource realities. Thus a much stronger link exists between policy-making, planning, and budgeting. Spending reflects the stated priorities of Government.
PERFORMANCE AND SERVICE DELIVERY (Relating to operational performance of all resources human as well as financial)	Incentives for results in terms of outputs and outcomes are generally low because emphasis is on input control. Little attention to the predictability of budget funding.	Emphasis is on the delivery of agreed outputs and outcomes with available resources. Incentives are structured to increase the demand for evidence of good performance (accountability for sector managers for results). Consequently, service delivery should improve.
AUTONOMY OF CREDIT MANAGERS	Generally low, because lack of discipline within the traditional budget framework is translated into detailed input controls	Generally high because of greater discipline in setting and enforcing hard budget constraints plus accountability mechanisms that makes it possible for managers to be given more authority to determine how agreed outputs and outcomes should be achieved.

In contrast with the current single year budgeting system, the potential advantages of adopting MTEF are highlighted in Table 4-2. In an ideal situation, in which there is no information asymmetry, single year budgeting may produce the same level of outcome as MTEF. However, reality is that information asymmetry combined with various socio-economic uncertainties persists within a government as well as between the government (as a whole) and the public. Furthermore, generational inequity cannot be restrained due to dynamic inefficiency under the current single year budgeting.

Unlike other countries, which have already adopted MTEF, Korea does not have an apparent fiscal problem at the present. The annual budget is more or less maintained in balance and the ratio of government debt to GDP is smaller than in other OECD countries. Inefficiency arising in the process of allocating fiscal resources exists but is not big enough to attract the public's attention. In such a situation, it would be very difficult to address the need for introducing MTEF not only to the public but also to public officials. However, anticipating increasing social welfare spending following the rapidly aging demographic structure, we have to be reminded that MTEF serves as a precautionary measure. By taking precautionary measures before symptoms arise, unnecessary turmoil in the economy could be avoided.

## 2.2. Requisites and key processes of a well-designed MTEF

In discussing the optimal design of MTEF, the following policy environments should be taken into account: First, the major participants in this setup encompass the budgeting authority, legislative body, line ministries (including local governments), and the public. Among them, most of our discussion focuses on the relationships between the budgeting authority and line ministries as well as the relationships among the line ministries. Second, each participant has a heterogeneous motive. For example, each line ministry has an objective of maximizing the production of (a) public good(s), which it is assigned to produce.<sup>53</sup> On the other hand, the budgeting authority has an incentive to promote the nation's welfare across time and across states. Accordingly, the budgeting authority tries to enhance the production efficiency of public goods and find an optimal composition of various public goods to satiate the public's needs. In such an environment, a Pareto-efficient allocation would be reached in the absence of information asymmetry and other frictions. However, the reality confirms their existence. MTEF is a trial to overcome information asymmetry arising in the budgeting process. In this sense, we have to consider what elements should be included in MTEF in order to reduce social welfare loss due to information asymmetry.

Government budgets are prepared according to an annual cycle, but to be well formulated and to contribute to high-quality and sustainable services, they must take into account events outside the annual cycle; particularly macro-economic realities, expected revenues, and longer-term needs of programs and of government's spending policies. This is why annual budgeting cannot be performed properly in isolation but has to be linked to planning, in the context of a multiyear framework.

A medium-term expenditure framework consists of a top-down estimate of aggregate resources available for public expenditure consistent with macro-economic stability; bottom-up cost estimates of carrying out policies, both existing and new; and a framework that reconciles these costs with aggregate resources. It is called "medium-

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<sup>53</sup> In a principal-agent context, the objective of the line ministry would be assumed to maximize the size of budget allocated to the ministry rather than the size of production.

term” because it provides data on a prospective basis, for the budget year  $t$  and for following years  $t+1$  and  $t+2$ .

MTEF is a rolling process repeated every year and aims at reducing the imbalance between what is affordable and what are demanded by line ministries. MTEF does this by bringing together policy-making, planning, and budgeting early in the budgeting cycle, with adjustments taking place through policy changes. It involves building domestic macro-economic and sector modeling capacity. Also, even if the whole of the Government’s budgeting system is not working well, each sector is better off managing itself with a medium-term perspective.

A well implemented MTEF should: (i) link the Government’s priorities with a budget within a sustainable spending envelope; (ii) highlight the tradeoffs between the competing objectives of the Government; (iii) link budgets with the policy choices made; and (iv) improve outcomes by increasing transparency, accountability, and the predictability of funding.

In detail, seven major requirements must be considered for MTEF implementation:

- **Good macro-economic policies and reliable forecasting:** Good macro-economic analysis and forecasts are needed as a basis for a MTEF. Inaccurate macro-economic forecasting dilutes the credibility and feasibility of MTEF.
- **Adaptable fiscal policy and instruments:** The MTEF approach is based on a strong link between macro-economic and fiscal policy. Plans for future expenditure must be based on reasonable estimates of prospective resources.
- **Reprioritization and reallocation:** Behind the move to MTEF is a conviction that the annual budget by itself is a poor mechanism for shifting resources from lower to higher priority use. A major function of an MTEF is to provide a better mechanism for aligning budgets with policies.
- **Budgetary discipline:** Budget allocations must be based on a hard aggregate budget constraint derived from what is affordable, and line ministries must live with their budget allocations.
- **Institutional conformity and absence of bias:** An MTEF requires a supportive institutional base; that is to say, one in which the various actors use the MTEF as a framework within which expenditure decisions are made. In particular, political decision makers must accept the MTEF as the means by which resources are allocated.
- **Appropriate parameters:** Designing an MTEF requires that its parameters be set. These parameters include the following: the definition of aggregate expenditure to be used, the relationship between the sectoral breakdown and the organizational structure of the government, the content of expenditure envelopes, the appropriate price basis for estimating future expenditures, the mechanism for its coordination with the annual budget process, and the degree to which it is to be flexed for different scenarios.
- **Transparency:** Fiscal transparency and policy transparency improve the accountability of actors engaged in the MTEF process. Fiscal transparency means being open to the public about the structure and functions of government, fiscal policy intentions, public sector accounts, and fiscal

projections. Policy transparency means being open to the public about what Government intentions are in a particular policy area, which outcomes are to be achieved, and the costs of achieving these outcomes. Also, transparency means reporting actual performance with quality of outputs and results achieved.

An MTEF cannot be achieved without the operation of key government processes on which it will depend upon. For the MTEF to work, key supporting processes have to function as in Table 4-3.

Table 4-3. Annual procedure of MTEF

CORE PROCESSES	SUPPORTING PROCESSES	PURPOSE
<b>Define the aggregate resources</b>	Macro-economic analysis, revenue forecasting, and definition of sustainable fiscal policy.	To provide a realistic estimate of the total resources available in the medium-term to allocate to spending programs.
<b>Formulate and cost sectoral spending plans</b>	Spending ministries formulate sectoral expenditure programs (SEPs)	To show sectoral objectives, programs and activities, and their costs.
<b>Reconcile available resources with sectoral spending plans</b>	Politicians and other decision-makers reconcile top-down constraints with bottom-up spending demands.	To reach agreement on medium term expenditure programs.
<b>Set medium-term sectoral allocations</b>	On the basis of relevant data, decision-makers allocate the aggregate resources to sectors.	To communicate to ministries a sectoral expenditure policy constrained by aggregate resources.
<b>Announce sectoral expenditure limits for year one of the MTEF</b>	Formulation of annual budget.	To ensure that the budgets prepared by ministries reflect agreed sectoral expenditure programs.
<b>Ensure that budget execution is in line with budget intentions</b>	Accounting, reporting, and expenditure controls are used during the execution of the annual budget.	To prevent excessive deviation from the annual budget and MTEF
<b>Ensure that desired results are achieved</b>	Incentives for civil workers to perform. Ex-post audit and evaluation;	To align civil workers' and politicians' incentives with public goals.

An MTEF involves a radical change in the business of budgeting. Consequently, without political commitment, it has little chance of succeeding. Evidence also suggests that a comprehensive approach (entire government) is preferable to introducing an MTEF incrementally, starting with select sectors and then expanding coverage for the entire government. This is partly a question of data gathering, analysis, and reporting; and partly of people who can both supply and use the information, and the institutional mechanisms for coordinating the efforts of participants.

Most of the necessary changes for successful MTEF do not require high-tech solutions, but rather common sense and perseverance. In this sense, political support

would be critical in order to succeed in introducing MTEF once and for all. The lack of political support is of concern because budgeting is still seen as a technical exercise mainly driven by the Ministry of Planning and Budget (MPB). Another reason is that politicians seem unaware of the benefits of the new process, and still rely to a large extent on the old, incremental methods to obtain funding. Finally, the incentive for good budget preparation remains limited, because much is lost in the implementation, which is still driven by cash rationing.

### **2.3. Anticipated outcomes from MTEF**

The MTEF approach stresses that expenditure management is about appropriate policies in the medium-term, rather than about cash management in the short-term. Where the available cash is the strongest influence on expenditure, management in the normal meaning of the term becomes impossible. MTEF provides more predictable program funding and therefore better management. From the adoption of MTEF, we expect the following outcomes:

- (1) Improve macro-economic balance by developing a consistent and realistic resource framework.
- (2) Improve the allocation of resources to strategic priorities among and within sectors.
- (3) Increase the commitment to predictability of both policy and funding so that ministries can plan ahead and programs can be sustained.
- (4) Provide line agencies with a hard budget constraint and increased autonomy, and increasing incentives for efficient and effective use of funds.

Implicit in the above are two further gains: (i) to improve the linkage between annual budgeting and medium-term considerations, such as investment plans, borrowing capacity, changing spending policies, and priorities, and (ii) to provide relevant information to political decision-makers on cost implications of expenditure policies.

## **3. Specific issues for the implementation of MTEF in Korea**

In the previous sections we discussed the rationales for the adoption of MTEF and its general working mechanism. Thus, most of the claims suggested there are valid for any countries. This section covers “specific” issues regarding the design of MTEF for Korea. We emphasize the word “specific” for the following reasons. First, a more detailed description of MTEF system is necessary. Second, country specific factors (Korean factors) should be counted.

### **3.1. Coverage of MTEF**

MTEF should cover the entire consolidated budget in GFS. It means that all the resources under the discretion of the government need to be reviewed and prioritized for spending. This comprehensive budget coverage is particularly important considering that MTEF tries to improve resource allocation in line with the government’s priority.

### 3.2. Time horizon of MTEF

Usually, the time horizon of MTEF ranges from 3 to 4 years. The longer the horizon, the less responsive the annual budgeting is to changes in the socio-economic environments. In contrast, a shorter time horizon is not consistent with the basic motive of MTEF, the provision of insurance to line ministries. Accordingly, an optimal time horizon should be determined which lies in-between. In addition, the Korean economy is exposed to various risk factors, internal and external, as evidenced in the past. Therefore, it is recommended that MTEF of Korea cover a three-year time horizon.

Table 4-4. Time coverage of MTEF

Time Horizon	2-year	3-year	4-year	5-year
Country	Italy	Canada, Czech, France, Germany, Sweden, UK	Netherlands, New Zealand, Mexico	USA

### 3.3. Macroeconomic forecasting

#### 3.3.1. Horizon of macro-economic forecasting

The time horizon of macro economic forecasts should not be shorter than the time horizon of MTEF. In cases of other countries, forecast horizons are usually longer than the time horizon of MTEF, even though officially, the budgeting authority announces macro forecasts only for the time horizon of MTEF. Under the premise of a 3-year MTEF, macro forecasting 4 to 5 years ahead would be appropriate.

#### 3.3.2. Who forecasts macro variables?

In case of US, the Office of Management and Budget (OMB) is mainly responsible for forecasting, which OMB has a separate division for. The forecasting figures are cross-checked by the Department of Treasury and Council of Economic Advisors. In contrast, the Department of Finance in Canada collects economic prospects from credible private entities and takes arithmetic averages of the numbers reported.

Considering that MPB of Korea does not have an in-house macro-economic research division whereas there are many publicly-funded research institutes, the adoption of a Canadian style approach depending on government funded research institutes would be preferable.

#### 3.3.3. How should the forecasts be reflected on MTEF?

Conservatism prevails. At the stage of making a medium-term expenditure plan, conservatively discounted economic forecasts should be used. Cautioning on the side of prudence would provide a buffer zone to the fiscal system.

### 3.4. Harmony of Top-down and Bottom-up in MTEF

As mentioned earlier, top-down and bottom-up approaches do not conflict each other within MTEF. An optimal mix of top-down and bottom-up approaches should include the following transfer processes of information and physical resources.

- (1) Top-Down: information flows on macroeconomic forecasts and national priorities, broadly itemized budget allocation and risks of performance
- (2) Bottom-up: information flows on performance measurement and demand or social need for specific public good and risk of budgeting and debt management
- (3) These duplex exchanges of information and resources are made at legally set (or publicly guaranteed) opportunities.

### 3.5. Categories of Spending in MTEF

It is recommended that classification and presentation of budget estimates under MTEF be presented in a way to link expenditures to objectives, outputs and activities clearly. This result-oriented budget structure is, however, not a necessary condition to introduce MTEF. A country may opt to apply existing budget classification and charts of accounts for better sectoral allocation. Once this stage of MTEF is internalized, the government can move on to improve budget classification and charts of accounts to produce sufficient information in determining policy and program costs, which will further the benefits of efficient resource allocation and financial operation.

MTEF, in its full-fledged form, should provide information on the cost of individual programs and, ultimately, its overall impact. Under this situation, it will serve as a basis for decision-making when programs compete for funding and aggregating all selected program expenditure to make a sectoral budget proposal.

In many countries, including Korea, existing budget classification structures, chart of accounts and legal requirement may not allow line ministries to be privy to this information. If so, sectoral ceilings are set first by the central budget office using a macroeconomic framework, and then line ministries decide on how to allocate resources to their programs.

It is recommended that if the initial MTEF exercise becomes internalized, the government should consider improving/modifying the budget structure and the chart of accounts in order to build a stronger link between resources and priorities.

### 3.6. Rules for Selecting a Global Ceiling and Sectoral Ceilings.

#### 3.6.1. Who sets the ceilings?

Ultimately, overall size of expenditure and sectoral/ministerial limit should be decided/agreed at a ministerial level meeting, where the central budget office provides a medium-term expenditure plan, usually considering multiple scenarios for different economic and social factors.

It is important to recognize that the medium-term expenditure plan, most likely in a multiple number of (contingency) scenarios, are technical inputs to decisions that need to be made at the cabinet meeting on allocation between sectors. Thus, the expenditure framework and scenarios are not the end themselves, but are tools for improving decision making.

#### 3.6.2. What factors determine ceilings?

As for the global ceiling, the potential GDP growth rate would be the most reasonable guideline. However, precise estimation of the potential GDP is not an easy task. Thus, the government revenue forecast is recommended as its proxy.

For the measurement of fiscal affordability (sustainability), the current government debt structure should be considered as well as the revenue forecast. Most commonly used measures for fiscal sustainability are ratios of government debts/GDP and fiscal

deficit/GDP. Since the integration of fiscal deficit over time is equal to government deficit, these two ratios encompass the same amount of information mathematically.

According to the IMF, government debt is defined as follows:

$$\text{Government debt} = \text{Central government liabilities} + \text{Local government liabilities} \\ - \text{Local liabilities to the central government}$$

The above definition of government debt does not include de facto government liabilities such as contingent ones. A true indicator of government debt should be the sum of the above IMF definition and the following:

$$\text{Non-government debt} = \text{Guarantee of Payment} + \text{Central bank debt} \\ + \text{State owned companies} + \text{Public pension}$$

The national budget accounting system varies from country to country. Accordingly, it is very difficult to maintain comparability among data provided by governments. For this reason, the IMF measure of government debt is widely used for cross-country comparison, though it may underestimate the actual amount.

As an extra precaution, MTEF of Korea should adopt the measure of fiscal sustainability that includes non-government debt going beyond the IMF criterion. In addition, the duration of revenue forecasts and government debt structure should be matched in order to hedge against interest rate and liquidity risks. After undergoing a thorough examination of the revenue forecast and current government debt structure, the MPB could determine global ceilings for the next three years.

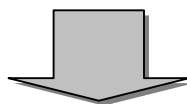
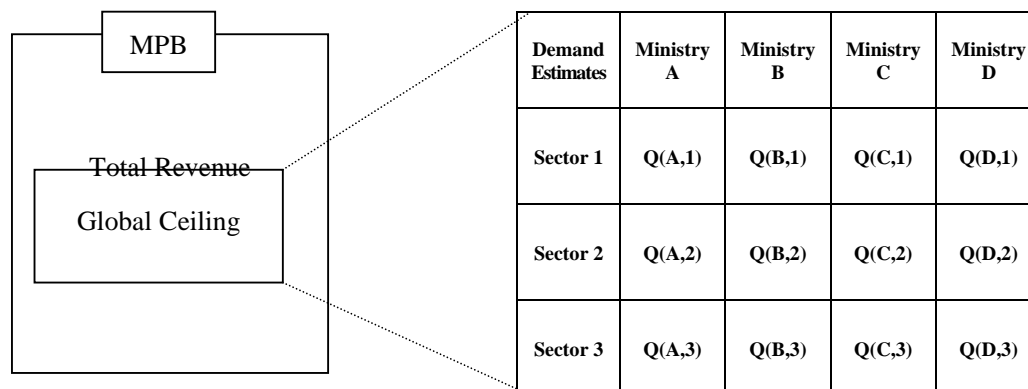
Also, determining sectoral ceilings is not independent of the factors influencing the global ceiling. In addition to such macro economic factors, sectoral ceilings should reflect national priorities and information on sectoral production efficiency.

In regard to the procedures on determining sectoral ceilings, the timing and number of communications between the budgeting authority and line ministries is important. These procedural issues do not have a right or wrong answer. Depending on the country specific characteristics (e.g., schedules for congressional sessions, the organization of a government body, and its relation to the legislative body), the types of communication or negotiating channels within the government should be defined. Instead, more important is what information the involved parties should be equipped with at the time of discussions over sectoral ceilings. Frictionless flow of information should be encouraged and, at the same, conflicting demands among the line ministries should be reconciled through the voluntary demonstration of social worthiness and efficiency.

In regard to the enforceability of the ceilings, we recommend that global ceilings be binding at least for the coming fiscal year while the sectoral ceilings may be indicative. In other words, this implies that voluntary exchanges of sectoral budget allocations among line ministries with/without mediation of the budgeting authority. There might be concerns that allowing voluntary exchanges among the line ministries will make the process of budget allocation deviate from national priorities. However, if it is complemented by Performance Based Budgeting (PBB), which assigns more weight to a program with higher national priority, the exchange scheme will ensure more dynamic flexibility of line ministries.



Figure 4-2. Cross-sectoral procedure for MTEF



Sectoral Ceilings	Ministry A	Ministry B	Ministry C	Ministry D
Sector1	R(A,1)	R(B,1)	R(C,1)	R(D,1)
Sector2	R(A,2)	R(B,2)	R(C,2)	R(D,2)
Sector3	R(A,3)	R(B,3)	R(C,3)	R(D,3)

### 3.7. Time consistency of ceilings – changeable or unchangeable

Under the assumption that the annual budget is prepared through MTEF process, the previous year's MTEF plan (t) does not necessarily bind the annual budget or the MTEF of this year (t+1).<sup>54</sup> Expenditure perspectives of two or three years included in MTEF should be seen as guidance. Since situations almost always occur unexpectedly, it would be optimal to adjust the original plan following the track of events. For

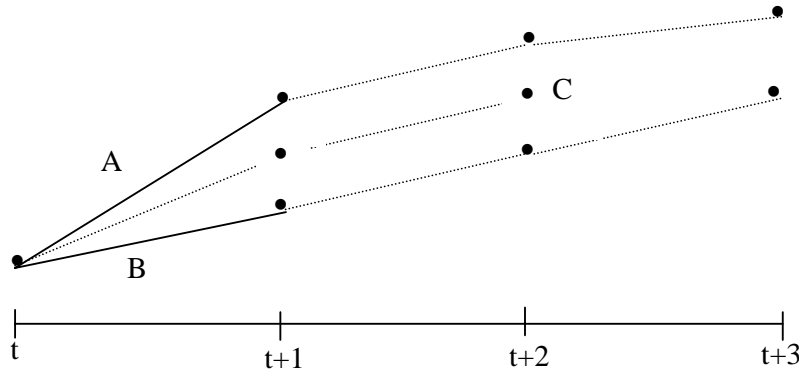
<sup>54</sup> In our prior knowledge, Brazil is the only country, which strictly keeps the ceilings set by MTEF for the whole matching time horizon.

example, in the event of a natural disaster such as a typhoon, there would be a huge amount of unexpected public expenditures.

On the other hand, if a change in the ceiling is permitted frequently and flexibly, the time consistency or credibility of MTEF would be affected bringing about a similar outcome to that of the year-by-year approach.

Figure 4-3 describes the multi-year process of MTEF. C represents the MTEF ceilings determined for the periods  $(t, t+1, t+2)$  at  $t-1$  whereas A and B are the MTEF ceilings determined for the periods  $(t+1, t+2, t+3)$  at  $t$ . A and B differ by the state of an economy from period  $t$  to  $t+1$ . Realization of different paths makes A and B deviate from the original plan C. In order to maintain balance between flexibility and consistency, we have to determine an acceptable degree of variation, which sets a boundary separated by space between A and C or B and C.

Figure 4-3. Cross-time procedures of MTEF



In practice, there are several ways to maintaining balance between flexibility and consistency: (1) to allow adjustments among the sectoral ceilings while maintaining the global ceiling, (2) to assign different margins of adjustment between the global ceiling and the sectoral ceilings or among the sectoral ceilings, and (3) to decompose the budget items into mandatory spending and discretionary spending and allow different margins of adjustment to them. Each of the above alterations has pros and cons in comparison with others. Hence, it is in the hands of political decision-makers to choose one of them.

Table 4-5. Fixed vs. flexible MTEF

	Fixed MTEF	Flexible MTEF
Country	UK, US (till 2002), Sweden, Netherlands	Canada, France, Germany, New Zealand Czech, Mexico

Source: OECD (2003).

### 3.8. Performance Based Budgeting and MTEF

One of most important modules in MTEF is the provision of diverse channels for information flow, the usefulness of which depends on its precision. Accordingly, a

logical tool for justifying a certain program, such as performance evaluation, would be essential in MTEF. However, heterogeneity (or diversity) of public programs and unaccountability of their hidden or intangible effects makes inter-program performance comparison impossible.

### 3.9. Performance Measures for MTEF

MTEF itself is a fiscal program and is an object of performance. The two biggest objectives of MTEF are (1) to maintain fiscal sustainability and (2) to enhance the allocative efficiency among various sectors. However, due to the difficulty of finding a right performance measure for inter-program comparison, in practice, performance evaluation for MTEF is limited in checking fiscal sustainability. MTEF is not a legal code to keep, once put into practice. Rather, MTEF is an apparatus to be evolved reflecting past track records. The provision of performance measures for MTEF will complete the evolutionary cycle of MTEF.

## 4. Concluding Remarks

The budgeting process is a collective action game. Various agents participate in the process in the name of social welfare with hidden heterogeneous incentives. From the standpoint of a principal, who devolves his/her decision right to the agents, optimal mechanisms designed to coordinate interactions and conflicts among the agents would be very critical. However, at the implementation stage informational asymmetry may work against achieving social optimum.

The purpose of our research is to introduce a Medium-Term Expenditure Framework and evaluate the pros and cons following its adoption to Korea's current budgeting process. MTEF is not a perfect solution guaranteeing the efficiency of the public sector. However, compared with the current system, MTEF is advantageous in the following sense:

- (1) MTEF is less reliant on discretionary factors and is rather rule-based. Rule-based allocation of public resources ensures system predictability to participants. Accordingly, the participants can pursue fiscal programs in a more consistent way.
- (2) MTEF system encourages efficiency-based competition among the conflicting agents leading to a pseudo-market allocation. In contrast, allocation under the current system does not provide a formal channel, through which the agents can compete against others.

For the successful installation of MTEF in Korea, there are several points to ponder. A substantial portion of this paper is devoted to the examination of various issues, especially procedural ones. References to foreign country cases makes us realize that at the stage of implementation MTEF should adapt the socio-economic environments of an economy it is applied to. Accordingly, different schemes can be adopted from country to country depending on the country-specific factors. Though seemingly heterogeneous, diverse types of MTEF are designed to attain a common goal, the provision of information channels and mechanism for early resolution of uncertainty within a government, which is a necessary condition for Pareto efficiency in Welfare Economics. Therefore, in designing an optimal MTEF for Korea, we have to always ask ourselves whether a certain feature or a procedure under consideration will contribute to reaching a pseudo market allocation of the annual budget.

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CHAPTER 5  
**MTEF in Sweden**

*by*  
*Allan Gustafsson, Sweden*

## **1. Background**

### **1.1. Constitutional arrangements**

Sweden is a constitutional monarchy and the King is the Head of State. His duties are, however, mainly of a representative and ceremonial nature. The Constitution, based on the principles of popular sovereignty, representative democracy, and parliamentarism, thus begins by stating that “all public power in Sweden proceeds from the people.”

Sweden has a unicameral parliament, the Riksdag, with 349 seats. Elections are by proportional representation. The electoral system is designed to ensure a distribution of seats between the parties in proportion to the votes cast for them nationally. A party must gain at least 4 percent of the national vote to qualify for representation. Elections are held every four years. The Riksdag, upon a proposal by the speaker of the Riksdag, appoints a Prime Minister who is given the task of forming a government. The Prime Minister chooses his/her ministers and together they make up the Swedish Government. The Government is accountable to the Riksdag.

The Swedish Constitution consists of four separate documents. Of those, the Instrument of Government (*Regeringsformen*), together with the Riksdag Act (*Riksdagsordningen*), which occupies a position midway between constitutional and regular statute law, set the overall framework for the budget and the budget process. The structure of the budget and the budget work is regulated by a Budget Act which is a regular statute law.

### **1.2. Reforms**

The present structure and the procedures for preparing and deciding on the budget are the result of a series of reforms initiated and implemented in a very short time in the middle of the 1990s. The impetus to the reform came from the very deep crises affecting the national economy and the government finances at the beginning of the 1990s.

When analyzing the crises, it was found that one of the contributing factors to the crises was a very lax budget process. One of its consequences was a seemingly unstoppable growth in the relative size of the public sector and thus the tax burden. Furthermore the Swedish public finances had become extremely sensitive to the swings of the business cycle because of the dominant role of transfers to households in government expenditure. As long as these swings were moderate, the opposing effects on government revenue and expenditure served as automatic stabilizers. External shocks of the magnitude experienced in the early 1990s, however, took the economy

“out of bounds.” The central government deficit exploded and reached 12 percent of GNP in 1993. The gross financial debt peaked at 77 percent of GNP in 1996.

In order to reduce the swings in the budget balance but also – and perhaps more importantly – to create a semi-automatic mechanism for containing the growth and eventually reducing the size of the central government, the traditional incremental bottom-up approach to budgeting was replaced by a very strict top-down process.

### **1.3. General characteristics of the Swedish public financial management**

Subsequent to the reforms of the mid-1990s, public financial management now has a three-year perspective within a top-down framework. This three-year perspective and the top-down approach apply to budget preparation as well as to the decision-making process in the Riksdag.

Execution of the budget is fully decentralized to the agencies responsible for executing the some 500 appropriations. Appropriations for the administration of the agencies are given as block appropriations, i.e. the agencies are completely free to decide on the input-mix required to achieve the objectives established for its operations. Objectives, targets and general reporting requirements are stated in the yearly “letter of appropriation” (see further below) .

For many agencies, central financing from the Treasury is supplemented by or, in some cases, completely made up of revenue accruing directly to them in the form of fees and sales revenue. To give additional financial flexibility, the agencies have the right, up to a limit, to carry over unused appropriations to the following year. They can also, within limits, borrow against next year’s appropriation. Investment is financed by internal loans issued by the Swedish National Debt Office. Payments are made directly by the agencies and the accounts are kept according to generally accepted accounting practice i.e. the type of accounting used private enterprises. The main instrument against overspending is agency self-discipline. The accounts of every agency are audited by the Swedish National Audit Office (Riksrevisionen). The audited accounts are presented in a yearly report together with a review of activities of the past year put in relation to the objectives and targets set in the letter of appropriation.

## **2. Foundations of budget preparation: level 1**

### **2.1. Actors in budget formulation**

Budget formulation involves, in one way or another: the Riksdag, the Office of the Prime-Minister, the Ministry of Finance, the line ministries<sup>55</sup> and the agencies.

### **2.2. Macro-forecasting**

Macro-forecasting is mainly carried out by the Department for Economic Affairs (DEA) at the Ministry of Finance. The work carried out in this department builds on work by and material from the National Institute for Economic Research (NIER), the Department for National Accounts at Statistics Sweden, the National Tax Board, the OECD and other international institutions. For the component that refers to public sector consumption, DEA receives input from agencies and line ministries channeled

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<sup>55</sup> The Office of the Prime Minister and the Ministries together make up the “Government Offices.”

through the Budget Department. The Financial Markets Department within the Ministry of Finance provides input on financial variables, notably interest rates.

Besides providing input to the forecasting work of the DEA, NIER produces its own independent macro-economic forecasts. Macro-economic forecasts are also produced by the major banks and other private sector institutions. The existence of multiple forecasters serves as a check on the forecasts made by the DEA.

Short-term macro-forecasts are based on a set of partial simulation models but outcomes of those are adjusted on the basis of judgment backed up by a set of quick indicators. Medium-term models rely more heavily on models. DEA uses a stripped-down version of a partial equilibrium model developed by the NIER. Work is on-going at the NIER to develop a more sophisticated scenario-type model.

The process at DEA generates forecasts for a number of variables that are subsequently used as inputs in the forecasting of government expenditure, for example: nominal GNP, nominal GNI, household consumption, CPI, interest rates and employment.

DEA produces four to six complete forecasts during a year. Two of those are published – those on which the Spring Finance Bill and the Budget Bill are based.

The ambition is to produce as accurate forecasts as possible. The political level at the Ministry of Finance has largely refrained from trying to influence the forecasts knowing well that any manipulation would jeopardize its credibility. The existence of alternative forecasts – those of the NIER and private sector institutions – also serve as a check on the official ones. Contrary to what is done in some other countries, for example Canada, there is no systematic conservative bias introduced into the forecasts. The need for a buffer to absorb external shocks is instead met by an explicit budget margin on the expenditure side of the budget.

### **2.3. Revenue forecasting**

Revenue forecasting is primarily the responsibility of the Fiscal Affairs Department at the Ministry of Finance. In-year revenue forecasting is also done by the National Financial Management Authority (ESV). Detailed information on debited taxes and tax payments is provided by the National Tax Board.

Forecasts are made in accruals as well as in cash terms. The forecasts are made with the help of a set of partial models – one for every type of tax.

### **2.4. Debt policy**

The management of the central government debt is the responsibility of an independent agency, the Swedish National Debt Office (SNDO). Its objective is to borrow at the lowest possible cost, taking into account risk. General guidelines for the management are established by the Government on the basis of proposals by the SNDO. Proposals for the coming year are presented to the Government in October every year. The proposal covers a three-year period, year two and three being preliminary. Once decided, the Board of the Debt Office sets detailed guidelines for next year's work.

For 2004, for example, the Government reiterates its long-term aim to reduce foreign currency debt as a percentage of total central government debt. The medium target is for foreign denominated debt to amount to no more than 20 percent at the end of 2006. For 2004 the target for amortization of foreign debt is SEK 25 billion. However, the Debt Office has the mandate to deviate from this target by +/- 15 billion should conditions in the market change. The Debt Office is furthermore instructed to increase

the proportion of inflation-linked krona-denominated loans. The benchmark for the average duration of the nominal krona and foreign-currency debt is to remain unchanged at 2.7 years.

## **2.5. Expenditure forecasting and fiscal envelope**

As a starting point for every budget round, a baseline is estimated. The base-line, termed “consequence assessment,” is an estimate of what would be the outlay for every single appropriation and, thus, for the aggregate budget. The baseline presumes no change in policy and no change in activity volumes except for those that follow from decisions made in earlier budget rounds. The baseline thus only takes into consideration changes in factors that are beyond the immediate control of government, such as changes in prices, wages, exchange rates, and interest rates. To increase accuracy and fairness, a number of more focused price indices – not just CPI – are used. For the appropriations for normal administrative costs of agencies, three indices are used: for wages, for rents and for other operational costs. From the thus reflatd initial baseline estimate is then deducted a variable percentage to reflect presumed efficiency gains. The efficiency factor, which is based on national accounts statistics, concretely a moving average for the preceding ten years, has in recent years hovered around 1.5 percent.

For appropriations like defense and infrastructural investment other types of specialized indices are used.

The models used to produce the baseline estimates vary a great deal in complexity. Some are quite simple doing nothing more than reflatd last year’s appropriation – adjusted for presumed efficiency gains. Other models, in particular those referring to some of the entitlement programs, are more complex. Some simulations use a sample of individual household data as its basis; others more aggregate data. All models are partial but estimated feed-back effects are incorporated into successive forecasting rounds.

At present, the responsibility for the different models is largely decentralized to line ministries and sometimes to the responsible agencies. At the beginning of the exercise, Ministry of Finance, however, makes available a set of parameters – assumptions regarding the evolution of the different price indices, GDP growth rates, unemployment etc. – to the forecasting institutions. Sometime in the future, the models will be incorporated into the government-wide budgeting and reporting system that is in the process of being developed.

## **3. Allocation: level 2**

### **3.1. Global expenditure ceiling**

Global expenditure ceilings are set for three years on a rolling basis. That is, every year a global ceiling for year  $t+3$  is established. Beginning 2002, the Government’s firm proposal is presented in the Budget Bill and voted on by the Riksdag in the fall.<sup>56</sup>

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<sup>56</sup> During the first years after the introduction of the new budget process, it was presented in the Spring Finance Bill and voted on separately. The rationale for presenting and voting on the global expenditure ceiling separately in the spring was to put focus on the longer-term fiscal issues. However, it, in practice, led to two budget processes – leaving very little time for follow-up of government programs – and the proposal and the



The Riksdag's decision on the expenditure ceilings are, strictly speaking, not legally binding but in practice they have held firm.<sup>57</sup> The over-all ceiling has become almost sacrosanct, while its break-down into expenditure ceilings is more indicative and finds its final form only for the up-coming year.

The process in which the global expenditure ceiling for year  $t+3$  is set is not entirely straight-forward, being partly technical, partly political. The starting point is a forecast of central government revenue based on the existing tax structure and existing tax rates plus any already decided on changes in the latter. From this revenue estimate is deducted the business-cycle adjusted surplus target and the target budget margin in order to arrive at the global expenditure ceiling. The present surplus target is an average of 2 percent of GDP over the business cycle and the target budget margin for year  $t+3$  is 1.5 percent of total expenditure. If year  $t+3$  is forecasted to be a boom year, the surplus target should in principle be adjusted upwards - and vice versa. In mathematical notation:

$$C_{t+3} = R_{t+3} + \Delta T_{t+3} - \hat{S}_{t+3}$$

where  $C$  = ceiling,  $R$  = revenue,  $T$  = taxes, and  $\hat{S}$  = surplus target.

Underlying this approach to the expenditure ceiling - coming in from the revenue side - is, or at least was, a concern about the tax burden in general and the marginal effects in particular. The concrete effect was, as the Swedish economy recovered from the crises of the early-mid nineties, a dramatic lowering of the proportion taken up by general government in the economy: from 70 percent to 55 percent measured on the expenditure side. In the last three years, this downward trend has, however, leveled off at about 55 percent.

The revenue projections are, however, not end of story. Expenditure is also forecasted making in effect  $\Delta T_{t+3}$  in the formula above to some extent endogenous. Should the projections of growth in the economy, and thus of revenue, point to a surplus beyond the desired surplus target and the target budget margin, the Government can decide to lower taxes and/or increase expenditure. If the opposite would obtain, expenditure will have to be curtailed and/or taxes increased.

The budget department prepares a number of scenarios which are presented to the Minister of Finance and the Prime Minister who in the end make a political choice as to the exact level of the expenditure ceiling.

One technical aspect of the expenditure ceilings is worth pointing out; they are expressed in nominal terms. A nominal ceiling on government expenditure adds credibility to the inflation ceiling established by the central bank. It is particularly important in a country, like Sweden, where the public sector occupies such a large share of the national economy.

The total expenditure ceiling for year  $t+2$  may, in principle, be altered but the Government has so far chosen to confirm the one established the year before, save for any adjustments for technical reasons.

### 3.2. Expenditure area ceilings

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discussion on the global expenditure ceilings have now been shifted to the fall.

<sup>57</sup> Contrary to the Latin tradition, budgets in Sweden do not have the status of laws.

The ceiling for t+2 becomes the starting point for the process of preparing the detailed budget the subsequent year. During the first years after the budget reform, the Government prepared and Parliament decided on indicative expenditure ceilings in the spring. This is no longer the case. Nevertheless, the Government, in its March retreat, decides internally on the expenditure area allocations and those allocations serve as guidelines for the preparation of the detailed budget proposal, i.e. the proposed allocation to the approximately 500 appropriations.

The starting point for the allocations between the expenditure areas is the baseline calculations or consequence assessments described above. The line ministries also present budget requests on the basis of requests prepared by the agencies under their jurisdiction. In these requests the ministries may argue for higher allocations to particular areas and they are not, at least not in practice, constrained by the expenditure area ceilings decided on by Parliament in the previous fall. What ensues is a rather intensive negotiations process involving the line ministry and the Budget Department within the Ministry of Finance – and to the extent necessary the Minister of Finance and even the Prime Minister. However, once the expenditure ceilings are set by the Cabinet in March, they, in principle, have to be respected when making the final allocation to individual appropriations presented in the Budget Bill. Some adjustment may have to be made for technical reasons or because some fundamental assumption, for example, on employment/unemployment, has to be revised.

The budgeting process is thus fundamentally incremental, albeit within the confines of the global and the expenditure area ceilings. There is definitely no zero-based budgeting taking place and there is no systematic attempt at estimating the return on government spending in different areas. Nor is there really any systematic use of information on results and of all other types of information that agencies are required to feed back to the Government Offices and to Parliament.

Attempts at basing the budget process on and around a more streamlined programmatic structure for the budget, allowing a systematic feed-back and analysis of outputs and outcomes, have, at least for the time being, got bogged down; a new programmatic structure has been introduced and should, in principle, be used for reporting, but budgeting and the allocation of resources is still made in the old structure severely limiting the usefulness of the reform.<sup>58</sup>

### **3.3. Conflict resolution and consensus building**

One important factor which facilitates decision-making in Government is that all decisions are taken by the Cabinet as a collective body. There is thus less scope for bilateral negotiations between line ministers and the Minister of Finance. Just as obtains for the decision-making process in Parliament, any minister arguing for an increase of spending in his or her area must be ready to confront his or her fellow ministers with proposals for where the funding for it – in the form of reducing spending in competing areas – should be found.

Most decisions of a more detailed nature are taken at a lower level in the Government Offices, either within line ministries or in negotiations between the Budget Department and the line ministries. Despite the new top-down process, the

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<sup>58</sup> The duplication of structures will undoubtedly prove untenable and in time a replacement of one for the other or some type of merger of the two will necessarily have to be engineered. As a trial balloon an accrual-based shadow budget for 2004 will be presented for information purposes. The shadow budget will be broken down by policy areas rather than by expenditure areas.

Budget Department has a tendency to get involved in rather low-level issues, issues that presumably, given the existence of expenditure areas ceilings, could be handled within the respective line ministries. However, well established procedures for handling differences of position do exist; outstanding issues are raised to successively hierarchically higher levels – if need be to the Prime Minister – until they are resolved.

### **3.4. Effect of ceilings**

The top-down approach to budgeting has not completely closed the window for intra-governmental negotiations. Although line ministries, in principle, ought to respect the ceilings established by the Riksdag, they often do use their budget proposal as a vehicle for demands for additional funding. These proposals can, however, not be wildly out of line or they would not be taken seriously. The ceilings thus act as a restraint but not as an absolute constraint on the agency and line ministry proposals. One could also argue that, for want of a more systematic and structured way of assessing the effectiveness of government spending, in particular of larger programmatic aggregates, agencies and line ministries should have at least one formal channel for arguing their case.

### **3.5. Final budget allocation**

The proposed allocation between expenditure areas and within expenditure areas is finally established in the Budget Bill. The final inter-expenditure area allocations correspond very closely to those decided on in the March retreat by the Cabinet. The difference between the two has, in recent years, been less than one percent and almost solely in entitlement programs where changes in the macro environment and/or in other external factors have necessitated a review of the forecasts. In principle these changes – normally increases – should be absorbed by a reallocation within or between expenditure areas. In practice they have, in most cases, led to a reduction of the budget margin.

The differences between the provisional inter-expenditure allocations presented for t+2 in the Budget Bill one year earlier and the eventual final allocations have tended to be considerably bigger. In the two most recent Budget Bills, the importance of the expenditure area breakdowns for t+2 and for t+3 have been downplayed by only requesting the Riksdag to “approve the forecasted consequence assessments” rather than to set firm ceilings. In next year’s budget round, the allocations for t+2 may again be given a more definite status while those for t+3 are likely to continue to be only indicative and based on the presumption of no substantive changes.

### **3.6. Roles within the administration**

#### ***3.6.1. The division of responsibilities within the Government Offices***

The introduction of the top-down budgeting model has, on the one hand strengthened the role of the Ministry of Finance in regard to the major allocative decisions. At the same time it has given the line ministries greater responsibilities for the allocation of budgetary resources within the different expenditure areas.

In principle, one could conceive of the responsibilities for deciding on individual appropriations being fully delegated to the line ministries. This, however, has not happened. The Budget Department, for good or bad, still tends to get involved in many detailed decision at intra-expenditure area level. The justification for this is a blanket rule that the Budget Department should be involved in any decision that has financial

consequences. Generously interpreted that could mean that the Budget Department ought to get involved in just about every single decision on the budget. On the other hand, with the top-down decision-making mechanism in place, any effects on aggregate spending are already effectively blocked. The department's involvement in the details is really more a question of old habits taking a while to die. The present culture at the Department was also very much set during the days of the financial crises when the Department's singly most important task was to scour the budget for potential expenditure reductions.

The Department is still largely staffed with relatively young professionals for whom a couple years at the Budget Department traditionally have served as a catapult to good careers in other parts of the public sector.<sup>59</sup> The increased responsibility for the allocation of resources between expenditure areas has not yet led to any noticeable changes in staff composition or any systematic up-grading of staff skills, although it ought to have.

In the line ministries, the units responsible for the coordination of budget work have come to play a more important role. It is difficult to say whether there has been any systematic up-grading of staff skills.

### ***3.6.2. The role of the politically appointed officials***

The Budget Bill, which consists of some 2,500 pages, is prepared by the technical staff of the Government Offices. The political appointees in the form of Ministers, State Secretaries, and their political advisers are, however, more or less heavily involved in any policy issues reflected in the budget - for example the allocation of resources between expenditure areas. The Finance Minister is obviously interested in taxation issues and he follows very closely the financial execution of the budget, given the very substantial political capital invested in the global expenditure ceiling. In recent years he has, because of insufficient budget margins, been forced to decide on more or less transparent ways of slipping under the ceiling. The most important trick in volume terms has been to transform straight expenditure into tax expenditure, i.e. tax exemptions tied to specific activities. Common year-end measures have been to postpone payments to the following year. In total volume terms these maneuverings have, however, been quite limited, never surpassing one percent of the total budget. Their cost has been more political than economic.

## **4. From formulation to enactment**

The top-down multi-year budget introduced in the middle of the nineties stands on two equally important legs: the top-down budget preparation process and the top-down decision-making process in the Riksdag. The ever-increasing size of the public sector had to do as much with the decision-making process in parliament as it did with conscious political choices by the party that has been in power for most of the time since the 1930s, the Swedish Social Democratic Party. It was very easy for a coalition of parties or even of individual MPs to propose and gain acceptance for proposals for increased spending in particular pet areas. They could do this without having to take any responsibility for how the proposed increased spending was to be financed. The importance of this type of dynamics became evident in the early nineties when a coalition of presumably more fiscally conservative parties in practice was held together

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<sup>59</sup> There are signs that that may now be changing with a general tightening of the public sector job market.

largely by accommodating each single partner's spending preferences – at the expense of the advocated budget discipline.

With the new process, no new proposal for spending can be put forth by members of parliament without a matching proposal for how it is to be financed – in concrete terms what other spending is to be reduced since the global ceiling is fixed by an earlier decision.

As explained above, the global expenditure is set on a rolling basis for three years. Each year a new year is added and the ceiling for year  $t+2$  is reconfirmed, possibly with some changes mainly for technical reasons.

The decision process on next year's budget begins with a new decision on the global ceiling. This decision is taken as a package together with the allocation to the 27 expenditure areas and any changes in taxation that will affect the revenues of the government's. The decision also includes an acknowledgment of the revenue estimates prepared by the Government.

The package proposal is prepared by the Finance Committee and voted on by the full house. The composition of the Finance Committee reflects that of the house, thus, in practice, the proposal prepared by the Finance Committee corresponds to that of the Government's – except possibly for some minor details.

Once the global ceiling and the expenditure area ceilings are established, proposals for the break-down of the expenditure ceilings into a total of some 500 appropriations are prepared by the committees responsible for the different areas. These proposals again, largely, correspond to those of the Government's. The detailed allocations are voted on as a package, expenditure area by expenditure area.

In principle, the Riksdag is supreme in relation to the budget. However, the rules of the voting in the Riksdag on the budget are such that in order for the proposals prepared – by the Finance Committee for the area ceilings and by the other standing committees for appropriations – to be overthrown, the opposition will need to agree on one single package to be put up against that of the government's. In proportional electoral systems, such as the Swedish one, this type of voting arrangements strengthens the hand of the government's considerably – making it possible for minority governments to govern. In recent years, the Social Democrats have nonetheless chosen to routinely engage in a dialogue with two opposition parties, the Greens and the Leftist Party, in order to ensure their prior support for the budget proposal although, arithmetically speaking, they do not need to.

Once the budget proposal is finished and transmitted to the legislature, the executive has a very limited role as regards its enactment. The decision on the final proposal, i.e. what is reflected in the Budget Bill, is taken as a collective decision by the Cabinet. All ministers are thus bound by it and would not conceive of arguing against it, at least not publicly.

As soon as all decisions on the budget are taken by the Riksdag, the line ministries, in close collaboration with the Budget Department, prepare Letters of Appropriation through which the agencies are formally informed of the appropriations for which they are responsible and of the conditions, objectives, and reporting requirements associated with those appropriations. Letters of appropriation may be prepared for single appropriation or for a set of appropriations under the jurisdiction of one agency. The letters of appropriation may vary a bit in character depending on the nature of the appropriation, but when it concerns the operation of an agency, they will contain a section on objectives, results indicators and special reporting requirements, a section on assignments (tasks) for the coming year, and a section on the financing of the activities of the agency. The latter includes: a) the appropriation for the year, b) an indication of any planned use of carried-over appropriations, c) a ceiling on the appropriation credit,

i.e. the right to borrow against next year's appropriation, d) an estimate of fee revenue that will be under the control of the agency, e) a ceiling on borrowing for investment in fixed assets, f) a ceiling on credit to meet short-term cash-flow needs, and g) any explicitly authorized, special, longer-term or multi-year commitments.

In parallel with the preparation of the letters of appropriation by the Government, the Riksdag compiles the final central government budget and hands it over to the Government a few days before Christmas.

## 5. Execution

Once the budget is enacted and the letters of appropriation issued, the execution of the budget is fully delegated to the agencies. For the framework appropriations financing the administrative expenses of agencies, one twelfth of the yearly appropriation is transferred monthly to interest-bearing accounts within the government group account held in one of the commercial banks.<sup>60</sup> Payments are executed by the agencies themselves without the intervention of any central government treasury. Should the need for liquidity exceed what is available, it is met by a credit facility attached to the bank accounts.<sup>61</sup>

The strict annuality of traditional budgetary principles is, thus, done away with and all control of execution is *ex post*. Within the more flexible framework created by block appropriations, carry-overs, appropriation credits, loan and credit facilities, the agencies are expected to, and in fact generally do, behave responsibly.

The accounting is decentralized to the agencies and the accounting is done according to generally accepted accounting principles, i.e. the principles that are used in the private sector world wide. The general accounts are complete, i.e. they, besides the central funding, include all other revenue such as sales income and fees, all expenses, and assets and liabilities. The follow-up against the appropriations – sometimes called the budgetary accounting – is integrated into the general accounts.<sup>62</sup> Information from the budgetary accounts is transferred monthly to the central government financial management information system. Complete, accrual-based accounts for all individual agencies are prepared twice a year and consolidated into aggregate accounts for the entire central government. This is done by the National Financial Management Authority.

All agencies are subject to financial audits every year and performance audits are carried out as necessary. With the creation of the new Swedish National Audit Office under the Riksdag, the consolidated accounts will also be audited. Another mechanism to stimulate good and responsible financial management is a yearly rating of the agencies done by the National Financial Management Authority.

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<sup>60</sup> In the near future, the Government will tender for payments and group account services from several banks. The Swedish National Debt Office is responsible for the oversight of government payments and is responsible for the over-night clearing of the group-account(s).

<sup>61</sup> As regards transfer payments, they are also channeled through sub-accounts of the government group account but are replenished on the day of payment from the general government account controlled by the National Debt Office.

<sup>62</sup> This integration is, however, not entirely straightforward and transparent because the budgetary accounts follow different principles than those of the general accounts. Efforts to fully integrate budget follow-up into the general accounts by defining the appropriations in terms that are fully compatible with those of accrual accounting have got bogged down.

## **6. In-year changes in the budget**

Supplementary estimates are prepared and presented to the Riksdag twice a year in connection with the Spring Financial Bill and with the normal Budget Bill in September. Any proposal for new spending must be accommodated within the global expenditure ceiling – normally within the relevant expenditure area ceiling – i.e. it must be accompanied by a proposal for reductions in other areas. Nothing else would be acceptable. The costing for any new proposals is done in the same way as for a regular proposal presented in the Budget Bill. The number and volume of new proposals is, however, quite limited. Rather than vehicles for new proposals, supplementary estimates have, in recent years, been necessary to handle unexpected volume increases in entitlement programs.

## **7. Problems and outstanding issues**

### **7.1. Budget margin**

Although the new process has transformed the dynamics of preparing and deciding on the budget, it takes a while for bad old habits to die completely. And what Swedish politics traditionally has been made of is promising the electorate additional social benefits under the name of “reforms.” However, with the ceiling effectively set three years earlier, the one seemingly remaining opportunity for politicians wanting to squeeze in yet one more “reform” has been to eat away at the budget margin. For that they have had to bet on being no unexpected cost increases in other areas. Unfortunately this has invariably proven to be an overly optimistic assumption and the price to be paid has been painful decisions and maneuverings at year-end to squeeze under the ceiling – and a concomitant loss of credibility.

### **7.2. Overall sector priorities**

The top-down budgeting process, together with the increased focus on results, has created an opportunity for pondering, in a more thorough and systematic way, the overall composition of the budget. This opportunity has not really been seized.

It must, of course, be acknowledged that it is impossible to scientifically calculate and in any definitive way decide what would be the optimal sector allocation of government resources. There are too many imponderables, potential synergies and external effects for that ever to be conceivable.

It could still be argued that a lot more could be done in the way of analyzing the effectiveness and efficiency of programs – even at a more aggregate level – and seeing to it that the outcomes of those analytical endeavors are fed into the political process. For that to happen, the roles of the different actors in the budget process would need to be reviewed in order to achieve a clearer division of labor and responsibilities. One obstacle has previously also been the limited IT support for the budget process. That is now changing with the building up of an internet-based FMIS that will soon service all ministries and agencies. However, better IT support is a necessary but not a sufficient condition for a division of responsibilities better in keeping with the new top-down

approach. A cultural revolution and new capabilities will be needed at all levels within the Cabinet Office.

### 7.3. Long-term structural problems

The new multi-year top-down budget process has extended the budget horizon beyond the immediately coming year. It has not, however, automatically led to a systematic factoring in of the longer-term – beyond the three-year horizon of the expenditure ceilings. For Sweden, as for many other European countries, the fiscal perspective for the period beyond 2008 is quite problematic because of the aging population. Sweden does have a target for the budget balance that is higher than that of most other countries within the European Union. Still it is probably not ambitious enough to build the buffers that will be needed if the next generation is not to bear the entire burden of the aging population. The problem is a specific and acute one for Sweden, but a generic one for all MTEF type efforts; in incorporating the medium-term into the budget process, one must not lose sight of the long-term!

The challenge is to create a framework for political decision-making that, just as the new top-down budgeting process in Sweden, conditions the outcome in favor of long-term collective rationality at the expense of short-term vested interests and vote maximization.

### 7.4. Technical issues

Global, hard budget constraints are essential to fiscal discipline; but it makes a difference how they are defined. There are several different dimensions to this issue.

For example, what should be the accounting basis for the constraints? In Sweden, the accounting basis for the volume constraint (to use a generic term for the expenditure ceiling) is the budgetary accounts, and they are expenditure-based. An alternative would be to base the volume constraint on the general accounts which are accrual-based. One important difference between the two sets of accounts is the treatment of investment. In the budgetary accounts, the full outlay for investments is included while in the accrual-based accounts only depreciation appears. The treatment of investment in the expenditure-based budgetary accounts means that, in relation to the global constraint, outlays for investments compete, krona for krona, with recurrent expenditure. One effect is that, in a tight fiscal situation, reductions in the budget are likely to focus on investment, simply because the government has more discretionary power over it.

A second important issue as regards the global volume ceiling is what should be included: total expenditure/cost for the entire general government or only central government? If the constraint should cover only central government, should it constrain total expenditure/cost or only that financed by central funds?<sup>63</sup>

Furthermore, should all types of expenditure/cost be included, or should some be excluded because the government has very little control over it in the short term? In the case of Sweden, interest payments on the central government debt are excluded. They

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<sup>63</sup> A technical question in that respect is whether it is possible, in situations where central funds are pooled with other types of revenue, to attribute an expenditure/cost to a particular source of finance – at least in a credible way. And if one can not credibly follow it in the accounts, should one design a constraint that presumes just that?



were with good reason excluded during the turbulent years of the 1990s when interest rates were very volatile and even the slightest suspicion that the Swedish Government would default on its loans – for example because of putting interest payments under the ceiling – would have pushed interest rates even higher. In a more stable situation, like today, the choice is not quite as obvious. Interest payments are largely exogenous in the short term but in the medium- and long-term the Government can certainly influence them through its debt policy. Including interest payments under the ceiling would increase the incentives to reduce debt for the benefit of future generations.

And then there are the funds outside the budget, like the pension fund. In Sweden they are included because payments in nature are very similar to regular government expenditure; they can be influenced by political decisions. In a funded system the Government would have no such right and it would be incorrect to include it.

As regards the budget balance, it is defined in national accounts terms. Having the two global constraints defined in different terms complicates matters technically and pedagogically. An alternative, given the existence of accrual-based accounts in the areas for which the balance is calculated, would be to define it in straight accrual accounting terms. The balance thus calculated could then for comparative purposes – cf. the Maastricht criteria – be translated into NR terms.

Sweden has, for good or bad, made a set of choices for how to define the aggregate ceilings. For any other country, the definitions would have to be based on an assessment what the ceilings should and could achieve and what the technical options for defining the ceilings are.



## The Swedish Budget Process: Expenditure Targets and Top-down Decisions

by

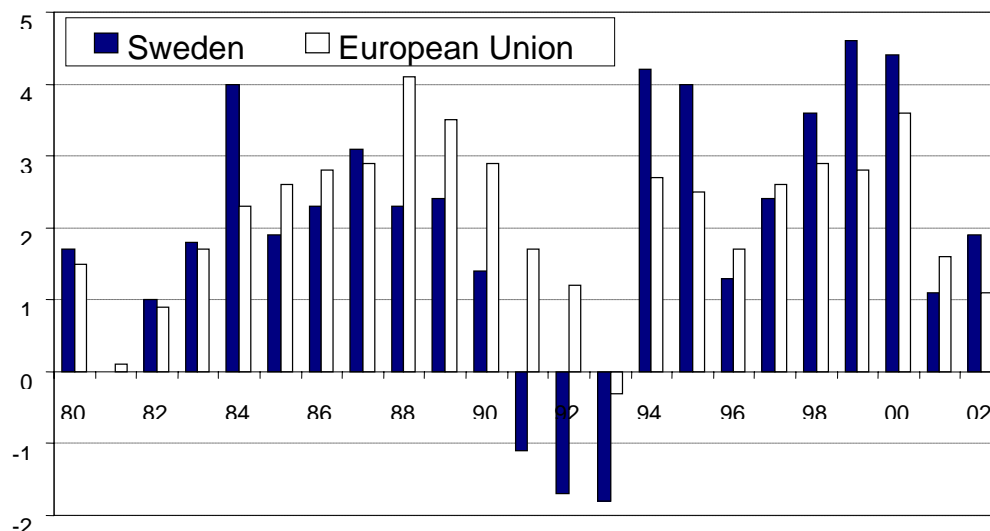
*Niklas Frank, Sweden*

### 1. Background

In Sweden the Parliament is highly involved in the budget process. From a formal point of view the Parliament can change anything it wants in the budget. All the standing committees in Parliament, there are 16 all together, are involved in the process, and the responsibility for expenditure is divided between the various committees. The budget is split in to 27 expenditure areas designed to reflect different areas of political interest, and the responsibility for the expenditure areas are divided between the committees according to their specialities. One committee may be responsible for one or more expenditure area but no expenditure area may be split between committees.

When the Government submits a bill to the Parliament, each Member of Parliament has the unrestricted right during 15 days to submit counter proposals, so-called motions. The motions are then distributed to the same committee that has been assigned the bill. Based on the bill and the motions, the committee then produces a report to the Chamber. This report contains the formal proposal on which the Parliament votes, as well as written argumentation about all the proposals. The committees must respond to every bill and every motion, none of them may be put aside. This applies also in the budget process. The Parliament subsequently has to process the Governments' budget documents as well as all the counter proposals that have been made by individual members.

Figure 6-1. Annual GDP growth 1980-2002

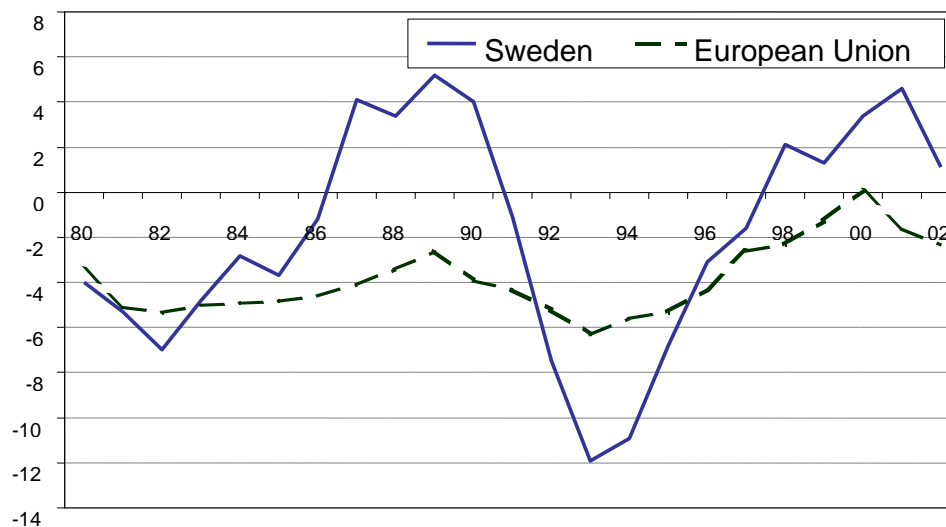


The Swedish budget process was radically reformed in the middle of the 1990s, from a bottom-up to a top-down process. The starting point of the reforms was the deep economic recession that hit the country in the beginning of 1990s. The environment in which the budget reforms took place was an environment of crisis.

In 1993 which was the worst year of the recession unemployment rose to 8 percent, a historically record high level. Growth in GDP was negative by 1.8 percent and the situation for the public finances was very serious.

The Central Government borrowing requirement amounted in 1993 to almost 17 percent of GDP and the overall deficit in the public sector was almost 12 percent of GDP. The deterioration of the public finances was great and very rapid. In the late 1980s Sweden had one of the largest surpluses in the OECD and only a few years later one of the largest deficits. By 1993 the national debt amounted to 76 percent of GDP, and was rising rapidly. Between 1988 and 1993 the public sector expenditure rose from 55 to 68 percent of GDP.

Figure 6-2. Public sector financial balance, percent of GDP, 1980-2002



At the same time there were serious problems in the financial sector as well. The Government had to spend about 4 percent of GDP to save banks from going bankrupt. In November 1992 the fixed exchange rate was abandoned for a freely floating rate, after the Central Bank had unsuccessfully tried to defend the fixed exchange rate by raising the short-term interest rate to 500 percent. The value of the currency quickly dropped by about 25 percent.

To stabilize the public finances and lay foundations for an economic recovery, broad and radical measures were taken – both reductions in public expenditure and increases in taxes. There was also a broad political understanding that besides dealing with the immediate crises in the public finances, there was a need to find ways of preventing a similar situation from reoccurring in the future. In order to improve the long-run stability of the public finances and prevent a repetition of the dramatic deterioration during the early 1990s, the institutional arrangements around the budget were fundamentally changed.

The new budget process, which was in place in 1997, was stronger than the old process in virtually all respects. Changes were made in how the Government prepares the budget and in the way the Parliament considers and approves the budget as well as in the control and steering mechanisms on the implementation of the budget by the various Government agencies. The principles and rules for the budget were given a stronger legal status in the form of a budget law that was approved by the Parliament. According to a comparative study about the strength of the budget processes in a number of European countries, the Swedish process went from being one of the weakest in Europe to being one of the strongest after the budget reform.

The reformed budget process enabled the Parliament to take a more general and co-ordinated approach to the budget, focusing less on details and more on aggregates. The level of Central Government expenditure is determined three years ahead by setting an expenditure ceiling, and decisions on the budget are taken in two stages, the so-called framework model. The decision-making approach is top-down, starting with the whole and ending with the details. A surplus target for the whole public finances is being used.

In this presentation, I will focus on two elements of the new budget process, the two elements I regard as being the most important. First there is the use of two budgetary targets – the Central Government expenditure ceiling and the surplus target for the total public sector, and second there is the two-stage decision process in the Parliament.

## **2. Two budgetary targets, the expenditure ceiling and the surplus target**

A central element of the reformed budget process is the usage of quantitative budgetary targets. The Government has set up two such targets. There is a target stating that the expenditure of the Central Government budget must not exceed the expenditure ceiling that Parliament has decided upon. There is also a target for the financial balance in the total public sector, stating that as an average over a business cycle, there should be a surplus of two percent of GDP.

The two targets are different in their construction and use, and they should be regarded as complementary parts of an integrated budget system.

### **2.1. The structure of the budget**

The expenditure side of the Central Government budget is divided into 27 expenditure areas, which are subdivided into around 500 appropriations all in all. The revenues are divided into about 150 revenue items.

Before the budget reforms there were a number of extra budgetary funds such as the unemployment benefit fund, the health insurance fund and the early retirement fund, to mention some. Expenditure from these funds amounted to a substantial part of the state expenditure but was formally not a part of the budget. Thus there was a significant discrepancy between the budget balance and the borrowing requirement. One of the changes in the budget reform was to abolish all such funds and bring all expenditure in to the budget. In the new system, the central Government budget deficit therefore equals the borrowing requirement.

Another change was to abolish the use of net budgeting. All expenditure and all revenue should be accounted for separately. This is an important principle that increases the transparency and openness of the budget, as well as it makes manipulation of the budget figures difficult.

## 2.2. The expenditure ceiling

### 2.2.1. Construction of the expenditure ceiling

The expenditure ceiling is a unique system that has no link to external demands or international standards. It is a voluntary restriction taken on by the Government. It should be pointed out that the budget law requires neither the Government nor the Parliament to use a ceiling for the expenditure, but it does stipulate rules on how such a ceiling should be handled if the Government should choose to use one.

In 1996 the expenditure ceiling was introduced. The system is based on a three-year budget cycle. In the autumn of year  $t$ , the Government proposes a level of the expenditure ceiling for the year  $t+3$  to the Parliament. At the same time, the Government puts forward a proposal about the distribution of expenditure between the 27 expenditure areas for the year  $t+1$ , and a preliminary distribution for the years  $t+2$  and  $t+3$ . The Government also presents the expenditure ceilings for the years  $t+1$  and  $t+2$ , which have previously been decided by Parliament one and two years earlier. The Government is free to propose new levels for the ceilings even for the years  $t+1$  and  $t+2$ , but in practice the Government has never done so. The only changes in previously decided ceilings have been of a technical nature due to changes that has not altered the budget balance.

The expenditure ceiling covers 26 of the 27 expenditure areas. The only expenditure area that is exempt is the interest on the national debt, which differs from other forms of expenditure in that it is less subject to control in the short run. In addition to the 26 expenditure areas, the ceiling covers the old-age pension scheme, even though this technically is not a part of the Central Government budget. Thus, the only public expenditure not included in the expenditure ceiling is the interest on the national debt and the expenditure of the Local Governments. (Concerning the 290 Local Governments in the country, there is a legal requirement that their budgets must balance each year. This means that all public expenditure is either subject to the expenditure ceiling or the Local Government balance requirement.)

Since it is difficult to assess expenditure changes three years ahead with a high degree of certainty, the expenditure ceiling is set at a level slightly above the estimated expenditure level. The difference between estimated expenditure and the ceiling is the so-called budget margin. This margin provides scope for meeting unforeseen increases in expenditure or for taking further spending decisions without exceeding the ceiling. However, use of the budget margin means that when Central Government expenditure increases, there must be matching increases in revenue for the budget balance to be maintained. The expenditure ceiling is defined the following way:

$$\begin{aligned}
 & \text{Expenditure area 1} \\
 & + \quad \dots\dots\dots \\
 & + \quad \dots\dots\dots \\
 & + \text{ Expenditure area 27} \\
 & = \text{ Sum of expenditure areas} \\
 & - \text{ Interest on National Debt} \\
 & + \text{ Public pension system expenditure} \\
 & = \text{ Expenditure capped by ceiling} \\
 & + \text{ Budget margin (residual)} \\
 & = \text{ Global Expenditure Ceiling}
 \end{aligned}$$

The expenditure ceiling is stated in nominal terms, which means that the level set for each year of the three-year budget cycle is neither adjusted for inflation, nor indexed in any other way. The calculation of the ceiling is based on a macro-economic forecast that is presented in great detail in the budget documents. The inflation target of the central bank is to keep inflation at 2 percent (+/- 1 percentage point), and the macro-economic forecast for the budget is done in accordance with this target, assuming that the central bank meets its target.

The Parliament's decision on the expenditure ceiling is a so-called guideline decision, which means that it is not legally binding, and the Parliament is also able to review an earlier decision on an expenditure area. This could happen if there was a change of Government, in which case the incoming Government has the opportunity of submitting a proposal that differs from expenditure levels determined earlier. The expenditure ceiling should be regarded as a very strong budgetary commitment on the part of the sitting Government to implement a policy where aggregate Central Government expenditure (excluding interest on national debt) is kept within levels previously determined.

### *2.2.2. Expenditure ceilings and entitlements*

The expenditure ceiling is, as mentioned before, set in nominal terms and includes all expenditure except interest on the national debt. Thus there is no kind of indexation in the ceiling and there are many expenditure items included even though they are highly sensitive to cyclical changes in the economy. This obviously means that there are potential tensions built in to the system. What if inflation increases so that the expenditures threaten to exceed the ceiling, even though the financial balance in the public sector is not worsened? What if the legal rights for individuals to receive entitlements exceed the limits set for the expenditure? Which is the stronger, the legal rights of the individual or the budget restrictions?

The Swedish attempt to solve these problems is strict on one hand and pragmatic on the other. When the ceiling is set it is crucial that there are credible forecasts on the economy as a whole, as well as on the individual expenditure items. In fact, one consequence of the new budget system has been to increase focus on the quality and reliability of the economic forecasts.

According to the budget law, if there is reason to believe that the ceiling might be exceeded, the Government is obliged to take measures to avoid this. At the same time, an individual may take a case to court to receive his or her legal entitlement.

In the short run, the right of the individual takes the upper hand. The Government can not deny an individual his legal entitlement by referring to the expenditure ceiling. The budget law does not state any legal consequences for the Government that violates it. In practice, the expenditure ceiling has never been exceeded, even though the margin to doing so has been very small a few times. The Government has taken measures by the end of the year to prevent the ceiling from being exceeded. What the consequences would be of exceeding the ceiling has therefore not yet been put to a real test, but surely there would be a political price for doing so.

If the expenditure forecasts indicate that the ceiling will be exceeded, for whatever reason, the Government has to address the problem. In order to keep the expenditure from exceeding the ceiling the Government must reduce some other expenditure, or in the medium term, consider the sustainability of the entitlement rules. The expenditure ceiling therefore works as a trigger for political considerations at an early stage, before expansion of expenditure has gone too far. The system thus makes it impossible for the Government to ignore or overlook a situation where the expenditure is about to exceed the limits.

### **2.3. The surplus target**

The surplus target is defined to include the three sectors that make up the entire public sector, the Central Government, the Local Governments and the Public Pension system. The target is specified in accordance with the European accounting system (European System of Accounts, ESA95) and numbers are comparable to the other EU-countries. This is also the system used when evaluating the European stability pact to make sure that no country has a public sector deficit that exceeds 3 percent of GDP at any time.

The target stipulates that as an average over the business cycle, the over all public sector should show a surplus of two percent of GDP. For an individual year the surplus might, and should, deviate from the two percent depending on the current macroeconomic situation. Twice every year, the Government reports to the Parliament about the financial balance and presents three-year forecasts for the economy and the public sector financial balance.

The surplus target and the expenditure ceiling should be regarded as complementary targets. When the expenditure ceiling is set, it must be set in such a way that the surplus target is met, provided the estimated revenues. If revenues exceed the forecast those extra funds may not be used to increase expenditure more than is permitted by the expenditure ceiling. If revenues fall below the estimates then revenue either will have to be raised or expenditure cut in order to maintain the surplus target. Together the two targets provide a strong framework for the budget formulation.

## **3. The framework model**

The decision process in the Parliament is called the framework model. It is a process designed for top-down decision-making. First, limits are set on an aggregate level and then the details are decided, under the aggregated restrictions. The process revolves around two annual bills, the Spring Fiscal Policy Bill and the Budget Bill. The Parliamentary decisions on the Budget Bill are taken in two distinct stages during the autumn, leading up to the start of the fiscal year.

### **3.1. The Spring Bill**

The budget process in the Parliament begins when the Government submits its Spring Fiscal Policy Bill. The bill, which must be submitted no later than April 15, contains an assessment of the current economic situation with perspectives for the next three years and proposals for the orientation of the economic policy and the budget policy.

In the Spring Bill there are no formal proposals from the Government involving precise numbers. The bill contains detailed medium-term forecasts for the macro economy, the Central Government expenditure and revenue, and the overall public finances. In the bill the Government presents the expenditure for the coming three years on expenditure area level, divided in to the 27 different areas. At this stage the Government presents a calculation of the year  $t+3$  to the Parliament for the first time. Calculations of revenue are also presented in a relatively high level of detail.

The Spring Bill is thus used to give Parliament a rather detailed picture of the economy as well as the budgetary situation. There must however be neither tax proposals, nor proposals concerning the expenditure at this stage. The detailed



presentation of the budget gives the Parliament information about what the Government intends to propose later in the Budget Bill, due in September.

As with all Government bills, the members of Parliament have 15 days to write their counter proposals, their motions. In the case of the Spring Bill, the opposition parties, currently four, present their alternative views on the economic situation and their alternative suggestions regarding guidelines for the economic policy and the budget policy. In this process the special committees in Parliament may submit their opinions about the Government bill, as well as about the oppositions proposals, to the Committee on Finance.

The Spring Bill, the proposals from the opposition and the opinions from other committees, are all submitted to the Committee on Finance, which writes a report to the Chamber where the political alternatives are presented. In the middle of June a formal decision is taken about the guidelines for the economic policy and the budget policy.

## **3.2. The Budget Bill**

### **3.2.1. Overview**

The Government submits its Budget Bill for the following year by September 20 at the latest, a few days after the opening of the parliamentary session. During election years the submission period may be extended, but no later than November 15. The Budget Bill covers all expenditure and revenue, since no further proposals with budgetary consequences may be submitted before the beginning of the fiscal year. The gross principle is applied in that all revenue and expenditure are accounted for separately.

All intended changes for the coming year in revenues and expenditure must be presented to the Parliament in the Budget Bill. The estimates of expenditure as well as revenue must include all the proposed changes. There must be no last minute changes of taxes or expenditure after the presentation of the Budget Bill.

The expenditure is presented with its 27 expenditure areas and 500 appropriations, and the revenue is presented with its 150 items. The opposition parties present their alternative proposals to those of the Government. Usually the opposition parties provide an overall presentation of their budget alternatives in special motions on economic policy. In this context they present their proposals for the expenditure ceiling and for the allocation of expenditure between the expenditure areas. In their motions on economic policy the parties also present an overview of the changes in taxes and charges they wish to implement, and how proposals for different reforms should be financed.

A more detailed specification of the various parties' budgetary proposals is set out in special tax and appropriations motions, where the parties usually present their proposals in the form of one motion per expenditure area.

### **3.2.2. The Budget decision, stage one**

The decision-making procedure that the Parliament uses when considering the Budget Bill is known as the framework model. This means that the Parliament first takes a decision on the overall size of the budget, i.e. total Central Government expenditure and how this should be allocated between the 27 expenditure areas. By means of this decision, expenditure is fixed and the level determined for each expenditure area, the so-called expenditure area frames. Thereafter these frames function as limits which may not be exceeded in the second stage, when the Parliament finalizes the budget.

In the first decision the Parliament also determines changes in the taxes and charges for the next fiscal year. This enables the level of Central Government revenue for the following year to be estimated. For obvious reasons, it is not possible to determine limits for revenue in the same way as for expenditure. This is why the Parliament does not make a decision on revenue limits. Revenues are determined by how the tax base changes, which itself is related to changes in the economy, and the rules applicable to taxes and charges. These rules apply until they are changed or removed and are not considered by the Parliament each year when determining the budget. The budget proposal can, however, contain proposals for changes in the regulatory framework covering e.g. tax changes. The Parliament approves an estimate of the Central Government revenues during the coming fiscal year, and at the same time decides which changes in taxes and charges are to be implemented. Since the levels of revenue and expenditure are thus determined, the level of borrowing requirements can also be stated.

The Committee on Finance handles proposals on the frames for all the expenditure areas. The other committees may submit their views to the Committee on Finance on the expenditure areas for which they are responsible. The committees are free to propose changes in the level of the different expenditure areas and/or recommend a reallocation of funds between expenditure areas. In the same way, they can make proposals that affect the level of Central Government revenue.

The Committee on Finance then examines these proposals and uses them as a basis for submitting an overall proposal that will be considered by the Chamber around November 20. The debate in the Chamber concludes with the Parliament making one single decision determining several important elements simultaneously. The main elements of the decision are:

- The overall expenditure ceiling for the year  $t+3$ .
- Expenditure ceilings for the years  $t+1$  and  $t+2$ , in case they are being changed.
- The allocation of expenditure between the 27 areas for the year  $t+1$ .
- All proposed changes in taxes and charges for the year  $t+1$ .
- Approval of an estimation of total revenue for the year  $t+1$ .

The fact that all these points are decided by Parliament in one single decision, is not a mere technicality, but is of crucial importance to the top-down character of the budget process. The Committee on Finance decides the distribution of expenditure between the expenditure areas, in a single decision. Thus any Parliamentary changes in the Governments' suggested distribution can only be done by the Committee on Finance in this first stage of the decision process. This single decision system has at least two important implications for the budget process.

Firstly, it sets a restriction on what the special committees can do in the second stage of the process. The special committees are responsible for the distribution of expenditure appropriations within their respective expenditure areas, but they have to keep expenditure inside the expenditure area frame set in the first stage. A special committee can therefore not expand the expenditure in its own area even if there is a majority in that committee to do so. The room for maneuver in the special committees is therefore highly restricted.

Secondly, it forces the opposition parties to present complete budget alternatives instead of only picking the pieces they prefer to discuss. To present a feasible alternative to the Governments budget proposal, the opposition has to present an alternative decision including all its tax changes and its distribution of expenditure between the 27 expenditure areas. All expenditure limits and tax changes are treated as

a single “package,” and alternatives are considered against each other as single “packages.” The Parliament then takes a position on the entire package. This means that even if the opposition parties agree on an issue, they cannot form a majority on this issue alone and use this to reject a part of the Government proposal. To defeat the Government in the parliamentary vote, the opposition must agree on an entire budget package.

This budget decision is probably the single most important decision that the Parliament takes during the year. If the opposition would actually win this vote there would be a Government crisis. Without support for its budget policy the Government might have to resign, or there would most likely be at least a vote of no confidence.

With this package decision, six weeks before the start of the year  $t+1$ , the Parliament sets the expenditure limits and concludes its revenue deliberations and determines the tax regulations that will be in force in the coming year. Still remaining is the more detailed allocation of Central Government expenditure. This is dealt with during the second stage of the budget process.

### **3.2.3. The Budget decision, stage two**

In the second stage of the budget process, the 15 various special committees handle their respective expenditure areas. The special committees put forward proposals on the goals of the activities and the allocation of funds in their expenditure areas. The whole expenditure area is treated in a single report and the Parliament makes a decision on the appropriations and their distribution within the total expenditure area by means of one single decision.

This is parallel to the decision of the distribution between expenditure areas in the first stage, and the implication for the opposition parties is the same. It is not possible to single out individual items within an expenditure area, and increase expenditure for those items. In order to change the distribution within the expenditure area the opposition parties must agree on all appropriations in that area. An increase in one expenditure appropriation must therefore be financed by a decrease of another appropriation in the same area. Any other way of financing the new expenditure is closed. A special committee that is responsible for more than one expenditure area may not reallocate expenditure between those areas. The decision on the frames in stage one applies for each expenditure area regardless of which special committee has the responsibility in the second stage.

The committee may not put forward any proposals that would lead to the previously determined limits from stage one being exceeded. If a committee wishes to take an initiative of its own, or act on a private member’s motion, the financial effects must be taken into account. Such proposals must be financed by an equivalent reduction elsewhere within the same expenditure area. It is not even permissible for dissenting opinions to propose a limit higher than previously decided on by the Parliament in the first stage.

Should a committee consider that an expenditure frame ought to be expanded, for instance, on the grounds that there has been a change in some underlying variable, this can only take place if the Parliament – on a proposal from the Committee on Finance – decides so. In such a situation, the Committee on Finance may consider whether the limit for other expenditure areas should be reduced. The aim of this procedure is that the Committee on Finance and the Parliament should also consider how the proposed increase in expenditure is to be financed.

Each special committee writes a report on their respective expenditure areas and these are finalized in the beginning of December. After the debates in the Chamber, decisions are taken on the various appropriations for the coming year. When this has

been done, the Government issues budget letters to its agencies with instructions for how the appropriations are to be used.

When all the reports have been dealt with, the Parliament compiles the now finalized Central Government budget for the coming year and hands it over to the Government a few days before Christmas.

#### **4. Effects of the reformed budget process**

The changes in the budget process have had a number of consequences and I will mention the most important ones.

##### **4.1. It has moved focus towards the medium-term perspective**

One important element in the budget process is the setting of a nominal expenditure ceiling for the year  $t+3$ . This has made it necessary for the Government to make a detailed macroeconomic forecast as well as detailed expenditure and revenue forecasts for three years to come. This in turn has put pressure on the Government to improve its forecasting methods. The requirement for the Government to act in case the expenditure ceiling is threatened has moved increasing public expenditure higher on the political agenda. With the reformed budget system, budgetary problems need to be identified and dealt with in a relatively early stage.

##### **4.2. It has put a minority Government in a strong position**

Sweden has a proportional electoral system. The representation of the different political parties in Parliament is strictly proportional to that of the popular vote, limited only by a 4 percent minimum requirement of the votes to get seats in Parliament. Without going in to details about different electoral systems, it is a well-established conclusion that proportional systems have a tendency to produce weaker Governments than systems based on majority voting. Sweden has a long history of either Minority Governments depending on the additional support in Parliament of at least one more party, or coalition Governments with up to four co-operating parties. Strengthening the position of a Minority Government was therefore a desired effect of the budget reform.

In order for the opposition to overthrow the Government's budget proposal, it has to agree on a complete alternative. It is not possible for the opposition to agree on certain items and change the Government's bill on those items only. Obviously, agreeing on the entire budget is politically much more difficult than agreeing on individual issues. With the reformed system, a Government that has a relative majority has a strong position in the parliamentary budget process. In this way you might say that the reformation of the budget process has moved power from the Parliament to the Government.

##### **4.3. It has strengthened the Committee on Finance**

The two-stage decision model has given the Committee on Finance the overall responsibility for the budget in the Parliament. The Committee on Finance has been given the power to restrict the other committees' possibilities of spending resources in their own areas. Giving this power to the Committee on Finance has been an important element in creating a top-down structure of the process. The overall expenditure ceiling and the distribution between expenditure areas are decided first, setting the limits for the appropriations in the different expenditure areas. Provided that the expenditure

area frames are not exceeded, the special committees however still have great freedom to redistribute the expenditure within their respective expenditure areas.

#### **4.4. It has increased the transparency of the budget process**

Transparency has improved in several ways. The budget has been made complete and extra-budgetary funds abolished. Revenue and expenditure are accounted for separately and net budgeting is not permitted. The need for the opposition to present complete budget proposals has made the political alternatives more open and comparable. It is no longer possible for an opposition party to present for instance large increases in benefits without declaring how it will be financed.

### **5. Criticism and problems in the budget process**

Even though there has been a high degree of political consensus surrounding the reformation of the budget process, there has been criticism and some changes have been made.

#### **5.1. The budget process takes all year**

One criticism from the Parliament has been that the budget process takes all year. Producing a complete budget alternative is a great deal of work for the opposition parties, particularly for a small party with limited resources. This aspect led to a change in the system in 2002. Before then the formal proposal on the overall expenditure ceiling was a part of the Spring Bill. The Spring Bill then contained guidelines for the economic policy and for the budget policy as well as an expenditure ceiling for the year  $t+3$ . In 2002 this was changed so that the ceiling for  $t+3$  is proposed in the Budget Bill in September. This was a controversial change decided by a united opposition against the will of the Government, who argued that the change would weaken the budget process.

#### **5.2. The budget margin is too small**

When the system was launched, there was a guideline about the size of the budget margin saying that the margin should be approximately 1.5, 2.0 and 2.5 percent of the total expenditure for the years  $t+1$  to  $t+3$ . As uncertainty about the numbers grew over time, so would the budget margin. In practice, however, this margin has not been upheld. Instead there has been a tendency to use the margin for new expenditure, leaving little or no room to accommodate increased expenditure due to changing underlying variables. Several times the Government has had to take short-term measures in the end of the year to avoid the expenditure ceiling being exceeded. This has had a tendency to shift focus back again from the medium term to the short term, at least in the end of the fiscal year.

This problem has been discussed extensively as the Government has been criticized for its handling of the budget margin. The Government has been requested by the Parliament to present new guidelines about the size and use of the budget margin in the Spring Bill in April this year.

#### **5.3. Technical measures to avoid the expenditure ceiling**

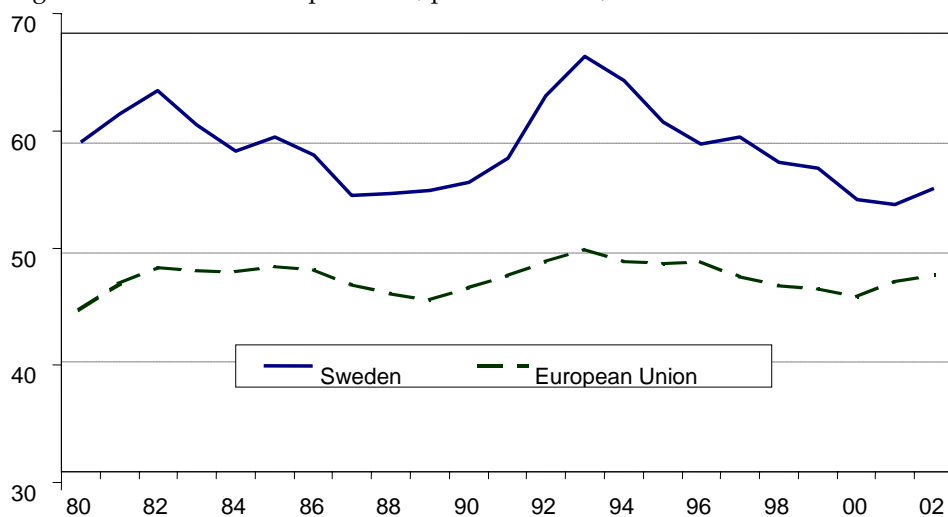
The lack of margin to the ceiling at the end of the year has led to short-term measures to avoid exceeding the ceiling. At times such measures have been dubious

from the perspective of the budget law. The Government has for instance decided to delay expenditure from December to January and there are examples where net budgeting has been applied even though the budget law prohibits it. These short-term measures are obviously closely related to the problem of having a too small budget margin.

## 6. Concluding remarks

Both the Government and the Parliament have made evaluations of the budget process, and both have concluded that the reformation has been very successful. The two evaluations have pointed out the problems mentioned above, but put in perspective of all the changes that were made, these problems must be considered limited. There can be no doubt that the new process is far stricter than the old, since it was strengthened in practically every respect and transformed from one of the weakest to one of the strongest in Europe.

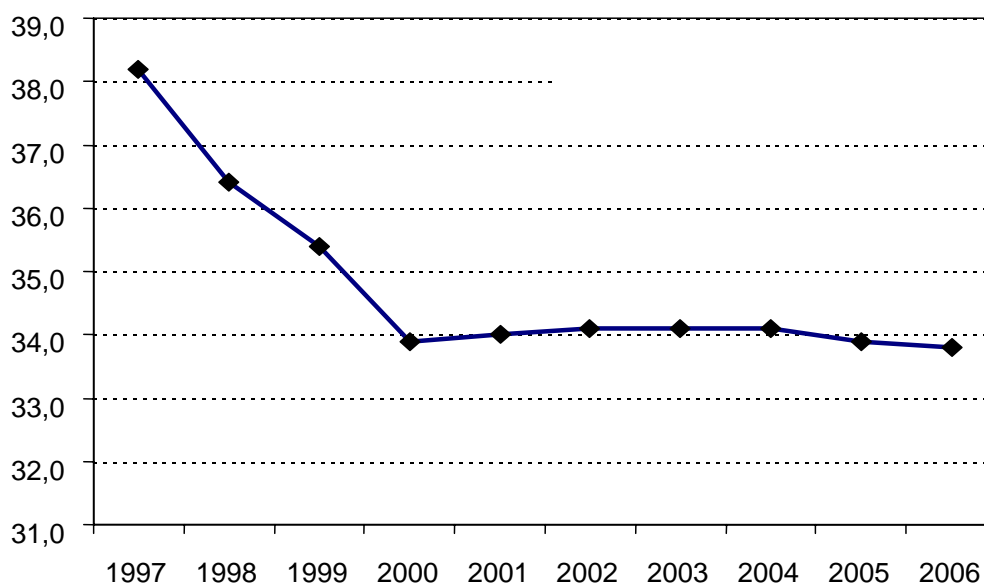
Figure 6-3. Public sector expenditure, percent of GDP, 1980-2002



How important is the budget process to the outcome of the budget policy? Would the budgetary situation look different if the budget reform had never taken place? Concerning this, a few observations can be made. The far-reaching decisions that were taken in the middle of the 1990s to strengthen the public finances were all taken before the reformation of the budget process. In the rather critical situation of 1993 there was a great need to strengthen the budget and no time to wait. When the political will was strong enough, drastic measures could be taken even without a strong budget process.

After the immediate crises, during the years in the late 1990s the economy was performing relatively well. Between 1998 to 2000, the economy grew faster than the European average. Tax revenues were exceeding the forecasts and there was a substantial surplus in the total public sector. At the same time the expenditure ceiling was set so that expenditure were reduced as a share of GDP. Between 1997 and 2000 the expenditure ceiling was reduced from 38 to 34 percent of GDP. Since then the ceiling has been stable.

Figure 6-4. The expenditure ceiling, percent of GDP, 1997-2006



I believe there is a rather strong case for the claim that the reformation of the budget process has contributed to the stable development of the public finances since the middle of the 1990s. A lot of political prestige has been invested in the new system, both by the Government and the opposition, and the potential political risks of ruining or undermining the system are considerable. During this period there has been a Social Democratic minority Government that has negotiated the budget with either one or two other parties, and the respect for the expenditure ceiling has been a cornerstone all through those negotiations. As mentioned above, the budget margins have become very small at times, but measures have been taken to stop the ceiling from being exceeded. It is not a very brave guess that without the ceiling, the negotiations would have generated significantly higher expenditures.

It should be added though, that the real test for the system is yet to come. During the boom years of the late 1990s the surplus target for the public sector could be upheld with relative ease thanks to the high levels of tax revenue. There was even room to fulfil the surplus target and cut taxes at the same time. The last few years, however, have shown a less favorable macroeconomic development. This has led to weaker growth in tax revenues and increases in expenditure mostly related to health insurance and unemployment. For the first time since the new budget system was put in place, there is now simultaneous pressure on both budgetary targets, and the macroeconomic situation is not helping to ease the pressure.

It is crucial to keep in mind, even though it may seem self-evident, that in the long run no budget process is stronger than the political will to maintain it. There is a delicate balance between a system strict enough to have substantial influence on the budget policy, and loose enough to provide the necessary room for political maneuver.





## CHAPTER 7

# Medium-term Financial Planning in the Federal Republic of Germany

by

*Astrid Lübke, Germany*

## 1. Introduction

This paper provides an overview of the federal government's medium-term financial planning in the Federal Republic of Germany.

Section 2 describes the historical development of medium-term financial planning since the 1969 budget reform as well as the need for and the objectives of such financial planning. The basic features of the content and of the planning period are outlined. Section 3 shows in detail which parties offer advice and help shape the medium-term financial planning and sketches the planning procedure. Section 4 takes as a specific example the current budget preparation procedure to demonstrate how financial planning can be realized in the same cycle.

## 2. Principles of medium-term financial planning

### 2.1. Historical development

The 1969 budget reform set up a mandatory, standardized framework for the budget law of the central and regional governments. For one thing, the budget provisions in the Basic Law of the Federal Republic of Germany (Sections 109 to 115) were revised. For another, the Law on Budget Principles was passed. The Law on Budget Principles contains the common principles which the federal government and the Länder must follow in managing their budgets. The Law on Budget Principles provides the substructure upon which is built both the Federal Budget Code of the German federal government, and the Land budget codes of all the federal States (Länder) of the Federal Republic of Germany.

The principal innovations introduced by the budget reform in conjunction with the Law to Promote Economic Stability and Growth (StWG), which had already entered into force in 1967, were the following:

- In their budget management, the Federation and the Länder are enjoined to take account of the requirements of macroeconomic equilibrium (stable prices, a high level of employment, and external balance accompanied by steady and adequate economic growth) (Article 109 (2) GG).
- Revenue from borrowing may not exceed the total expenditure for investment provided for in the budget estimates (Article 115 GG). Exceptions to this rule are permissible only to remedy a serious and sustained disturbance of macroeconomic equilibrium.
- The Federation and the Länder each base their respective budget management on a financial plan covering a five-year period (Section 50 of the Law on Budget Principles - HGrG).

- A financial planning council chaired by the Federal Ministry of Finance (FMF) was set up to submit recommendations for co-ordinating the financial plans of the Federation, the Länder, the communes and associations of communes (Section 51 HGrG).
- In order to ensure that the budgets of the federal government, the Länder, and the local authorities can be judged by uniform criteria, a standardized budget system was developed with the following characteristics:
  - system of classification by object: revenue and expenditure are classified by **categories** (for example tax revenue, staff expenditure, interest payments, and investment expenditure).
  - system of classification by function: expenditure and revenue are classified according to **tasks of public administration** (e.g. defense, environmental protection and conservation, health).

Since this reform, adopting an approach geared to the medium term has become a matter of course in all sectors of budget and fiscal policy. As employed by the FMF, the financial plan has become a useful tool for fending off excessive demands on the budget. The obligation to draw up a financial plan each year reinforces awareness within the federal government of the need for fiscal discipline and responsible budget policy and helps to ensure a balanced fiscal policy. In this way any need for fiscal policy action can be identified at an early stage.

Though financial planning is a valuable instrument, it cannot guarantee the implementation of a sound fiscal policy.

## 2.2. Need for medium-term financial planning

Medium-term financial planning is necessary in order to be able

- to take account of likely developments in public finance in the medium term when making the decisions incorporated in the yearly budget;
- to identify at an early stage the financial impact of new measures, reform projects, statutes and the like;
- to assess in good time the scope available for fiscal policy action in future years; and
- to identify in good time undesirable fiscal policy trends with longer-term impact and to counter them at an early stage.

## 2.3. Object of financial planning and planning period

"Financial planning" is taken to mean the actual process of planning, whilst the "financial plan" is the outcome of this process.

*Financial planning is detailed:* Financial planning comprises the detailed planning by budget title of all individual revenue and expenditure positions included in the budget in the planning period, that is, not just aggregate figures for total revenue and expenditure. Currently these comprise about 1,100 revenue titles and about 5,300 expenditure titles, grouped in chapters and departmental budgets.

*Financial planning is comprehensive:* It includes expenditure which can already definitely be earmarked, and provision for risks which loom in the medium-term planning period. Sound financial planning includes reserves as well.

*Financial planning has a macroeconomic orientation:* It is based on the medium-term projection of aggregate economic development produced by the federal government in April of each year. From this, calculations can be made in particular of labor market expenditure on the spending side and of tax revenue on the receipts side. In addition, for revenue planning the figures produced by the Working Party on Tax Estimates are also consulted. This working party consists of experts from the federal and Land governments as well as independent experts.

*The financial plan is not a fixed five-year plan of the type used in planned economies, rather, it is a rolling plan:* Each time the budget is prepared, the federal government's financial planning is also brought up to date by the Federal Ministry of Finance and rolled forward by one year. In concrete terms this means that at the same time as preparation of the 2005 federal budget is now getting underway, work is also starting on converting the currently valid 2003-2007 financial plan into the 2004-2008 financial plan.

The planning period covers five years:

- the current fiscal year (now: 2004)
- the draft budget for the next fiscal year (now: 2005)
- three more genuine planning years (now: 2006-2008)

A five-year period has shown itself to be most practicable. A longer planning period would involve too many uncertainties.

*For comparison purposes, the published financial plan ought to be drawn up according to the same system as the budget:* In the German financial plan as published, expenditure is presented in about 40 categories put together in accordance with functional considerations. However, all medium-term planning data on roughly 5,300 expenditure and some 1,100 revenue titles in the budget are available within the administration.

*The financial plan is a government plan:* It is negotiated and revised title by title with the ministries. Then it is summarized into main categories and submitted to the legislative bodies together with the government's draft federal budget for the next fiscal year. There is no need for the financial plan to be adopted by the legislature (unlike the budget). It is submitted to parliament for information only.

### **3. Participants and procedures in the medium-term financial planning of the German federal government**

#### **3.1. Participants**

##### **3.1.1. Federal Ministry of Finance**

The federal government's medium-term financial planning is under the overall control of the Budget Directorate-General of the Federal Ministry of Finance. All relevant information is brought together in the Policy Division for the Federal Budget. In order to identify undesirable trends at an early stage and react appropriately, the financial planning is continuously being updated within the government. But only once a year — in the course of the budget preparation for the next calendar year — is a new financial plan drawn up and presented to the legislative bodies.

The relevant divisions in the Budget Directorate-General are responsible for individual departmental sections and chapters of the budget. Early in the year they start re-evaluating the individual budget titles and estimating the risks connected with

them. Later in the budget preparation procedure they will have to negotiate their estimates at working level with the departments for which they are responsible.

### **3.1.2. Financial Planning Council**

The necessary co-ordination of the budgets and financial plans of the different levels of government is undertaken in the Financial Planning Council. This is a co-ordinating body at ministerial level with the FMF in the lead, comprising in particular the finance ministers of the Länder and representatives of the associations of communes. Representatives of the Deutsche Bundesbank may participate in the consultations. The Financial Planning Council meets twice a year (spring / autumn). These meetings strive to reach agreement on future spending policy, which can also find expression in agreements on expenditure ceilings.

### **3.1.3. Working Party on Tax Estimates**

Estimates of future revenue are based on the estimates (spring/autumn) drawn up by the "Working Party on Tax Estimates", meeting each year in May. This body includes representatives of all the financial and economic experts in Germany:

- Federal Ministry of Finance,
- Finance Ministries of the Länder,
- Six leading economic research institutes,
- Federal Statistical Office,
- Deutsche Bundesbank,
- Board of Experts for the Assessment of General Economic Trends, and
- Federal Union of Central Associations of Local Authorities.

## **3.2. Procedure**

At the start of the calendar year, which is also the start of the budget preparation year, the financial plan is updated based on the actual figures of the fiscal year which has just ended. As the new budget is prepared, the individual revenue and expenditure titles must be re-evaluated. At the same time, during this process account is also taken of the risks and of any changes in the law. In this way it is then possible to roll the individual titles forward for another three years and to evaluate them on this basis.

Once a first compilation has been made, the financial plan is first analyzed internally by the Federal Ministry of Finance in order to identify any need for action in areas in which particularly strong increases or undesirably high expenditures are expected. This information may be input into the development of the policy guidelines of the federal government.

At issue in the budget negotiations between the Federal Ministry of Finance and the departments are the budget estimates for the coming fiscal year and also simultaneously the financial plan. Thus the planned figures for next fiscal years are debated within the government between the Federal Ministry of Finance and the other federal ministries. The results of this process of consultation result in a further adjustment of the financial plan.

It is essential for expenditure and revenue to be brought into line with the aggregate productive capacity of the national economy. To this end, planning must be based on a medium-term projection of key macroeconomic data, which can enable a forecast to be made in particular of tax revenue and expenditure for the labor market.

In the German system of financial planning, a forecast of aggregate economic development is made for the first two years of the planning period, taking account of

discernible trends in economic activity. The medium-term projection of the envisaged development of the economy in the last three years of the planning period deliberately makes no allowance for fluctuations in the level of economic activity.

Based on this macroeconomic projection, the Working Party on Tax Estimates produces a forecast of tax revenues in the financial planning period.

### **3.3. Links between the medium-term financial planning of the federal government and of the Länder**

All Länder and communes in the Federal Republic of Germany are obliged to draw up a financial plan.

In a country consisting of a federation of states, the fiscal policies pursued by the different levels of government must be co-ordinated in the interest of achieving the envisaged development of the economy as a whole. To this end, the financial planning data of all levels must be combined in an aggregate public-sector budget. This means that the budgets and financial plans of public authorities must be comparable and must in particular employ a standardized system of budget classification.

As a member of the European monetary union, the Federal Republic of Germany must fulfil certain criteria concerning the general government deficit (no more than 3 percent of gross domestic product) and the total amount of public-sector indebtedness (no more than 60 percent of gross domestic product).

Since in Germany the Länder and the federal government are autonomous and independent of each other in their fiscal administration (Article 109 Basic Law), they need to reach mutual agreement on their spending policies if the "Maastricht criteria" are to be fulfilled. For this reason the Law on Budget Principles had added to it the new Section 51 a, which sets up the so-called "national stability pact."

This development has lent increased importance to the Financial Planning Council, as this has become the body in which the budgetary developments of the federal government and of the Länder are discussed and in which recommendations for the observance of fiscal discipline are drawn up. Spending policies are discussed twice a year in the meetings of the Financial Planning Council, and – if possible – agreement is reached.

The comparability of the data is based on the arrangement of the budget system, a standard which is equally binding for the federal government and the Länder; it formed part of the 1969 budget reform and is laid out in the Law on Budget Principles.

## **4. Medium-term financial planning in the budget preparation procedure**

In view of the close links between the budget and the financial plan it is expedient for the latter to be drawn up at the same time as the yearly budget. The financial plan then serves a year later as starting-point and guideline for preparing the new draft budget and the new financial plan.

### **4.1. Introduction**

The Federal Ministry of Finance (FMF) is responsible for the budget preparation procedure. The procedure begins one year before the passage of the budget law with a circular to all government departments to submit their bids/estimates to the FMF.

In accordance with the arrangement of the budget system, as set forth in the Federal Budget Code (BHO), the budget is subdivided into departmental budgets,

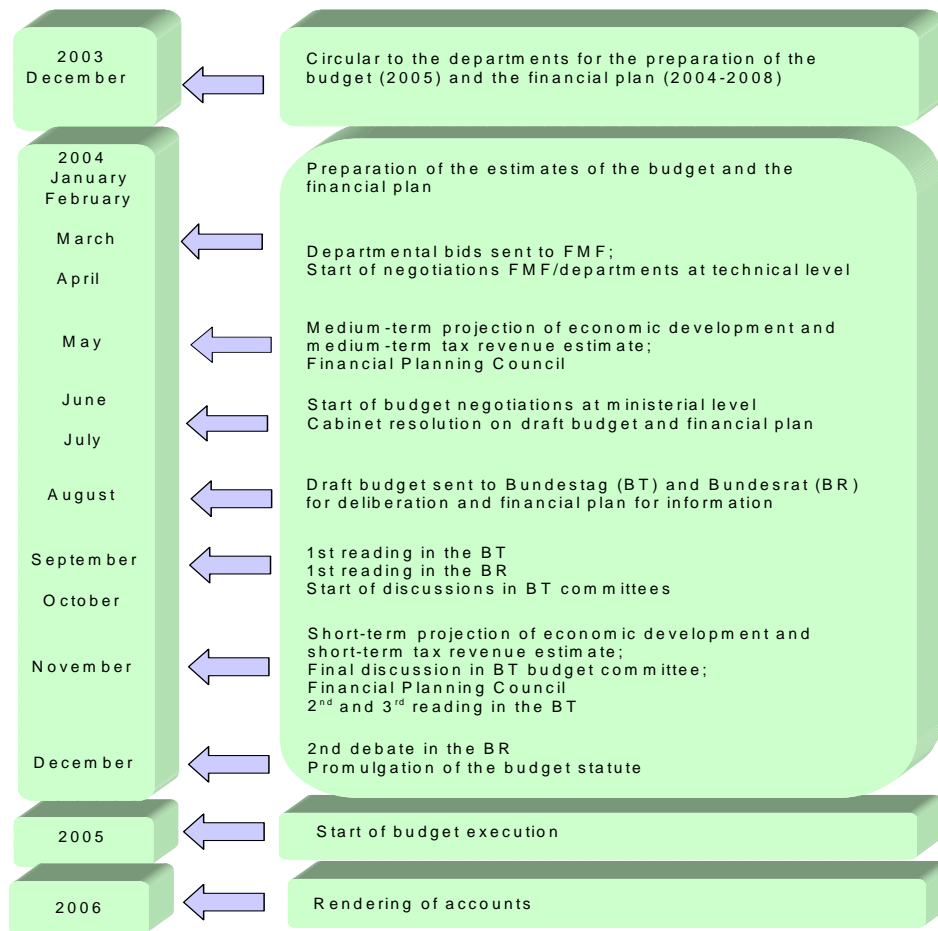
chapters and titles. The departmental budgets contain the funds appropriated for the ministries. They are subdivided into chapters for the ministry, general appropriations, subordinate authorities, etc. Each chapter is subdivided into titles, which are the smallest subdivisions in the budget.

At present the federal budget comprises approximately 1,100 revenue titles and 5,300 expenditure titles, grouped together in chapters and departmental budgets. These titles are subject to ex-ante control in medium-term financial planning and in the budget preparation procedure. After the close of the fiscal year, they are audited by the Federal Court of Audit (FCA) to see if they were managed effectively.

## 4.2. Schedule

The budget preparation procedure may be seen from the following diagram:

Table 7-1. Preparation of the budget 2005



### 4.3. Negotiation of the medium-term financial plan

After the circular on the preparation of the budget has been sent to the departments, the preparations for the medium-term financial planning begin in the FMF. This includes a stocktaking of the finished titles of the fiscal year which has just come to an end and the forecast of future expenditure based on the individual titles. The tax estimate of the previous autumn as well as discussions of the Financial Planning Council form the first foundation for the macroeconomic benchmark data.

The bids/estimates of government departments are submitted to the FMF in the spring and are checked against the principles of need, conformity with regulations, and economy.

These principles also guide the negotiations which follow at working level with the departments on the draft budget and the financial plan. The divisions assigned to examine the titles ("twinned" divisions) are independent of the departments and are subordinated through the Budget Directorate-General to the executive level of the FMF (Finance Minister and State Secretaries).

Any issues that cannot be settled at this level are the subject of further negotiations at directorate or ministerial level. This process is aimed not only at bringing together the positions of the FMF and of the departments. At the same time, the macroeconomic benchmark data must be reconciled with the detailed, title by title planning in the draft budget and with the financial plan. This is an iterative process in which each and every individual title is negotiated between the FMF and the department concerned and rolled forward for the financial planning period, so that within the administration medium-term planning data is available for all the expenditure and revenue titles. The law – the Federal Budget Code – requires that a realistic estimate be made for every budget title, so the key data of the starting position may have to be corrected. In this process, more recent data is provided by the macroeconomic projection in April and the latest tax estimate in May.

After having been adopted by the cabinet (June), the draft budget is submitted to the Bundestag and the Bundesrat for consultation. In addition to the draft budget, the federal government's financial plan (scope and nature of expected revenue and expenditure over a five-year period; Section 9 StWG) is also presented. However, the Bundestag and the Bundesrat merely take notice of the financial plan.

At this point in the budget preparation procedure, the medium-term financial planning has been completed. The parliamentary procedure concerns only the draft budget for the coming fiscal year.

### 4.4. Consideration of the draft budget in the Bundestag

After the first parliamentary reading in the Bundestag, the draft budget is referred to the Budget Committee of the Bundestag, which takes charge of the subsequent deliberations.

The Budget Committee scrutinizes all the estimates and, where necessary, submits proposals for amendment. The decisions of the Budget Committee are prepared by a number of committee members. The rapporteurs/co-rapporteurs of the Budget Committee discuss the draft budget with representatives of the supreme federal authorities concerned and of the FMF and the Federal Court of Audit (FCA). Proposals submitted by the rapporteurs form the basis of deliberations in the Budget Committee and are adopted in most instances. A detailed debate is generally held in the Budget Committee if the rapporteurs and co-rapporteurs are unable to reach agreement on specific points or if an issue is of such fundamental significance as to require to be dealt with by the Budget Committee itself.

The comments of the specialized committees and of the Bundesrat are taken up in the deliberations of the Budget Committee. Issues that cannot be finally disposed of when the departmental budgets are considered by the Budget Committee are shelved until the so-called "settlement" session. This is usually held in November, and marks the conclusion of the Budget Committee's deliberations on the draft budget. The FMF submits documentation for decisions to be taken in the settlement sessions combining all the deferred issues and other matters on which it considers a decision necessary (the so-called settlement items).

This is followed by the second and third readings of the budget law in parliament, during which minor amendments are made, and the final debate in the Bundesrat.

## **5. Conclusion**

Medium-term financial planning in the Federal Republic of Germany has proved to be an effective instrument in the quest for a stable fiscal policy.

It is based essentially on the fact that each of the approximately 6,400 revenue and expenditure titles are re-evaluated at the start of the budget preparation procedure and planned for the next four years, taking into account the expected risks. At the same time the Federal Ministry of Finance evaluates the overall economic situation of the country on the basis of the macroeconomic data. In this way the German federal government gains an exact picture which is determined by the macroeconomic climate and which also takes detailed account of future revenue and expenditure.

On the one hand the analysis of these data makes it possible to identify any fiscal policy action which needs to be taken by the government. On the other hand from the negotiation of the financial plan with the departments in the budget preparation procedure there emerges a target specification on the expenditure ceilings for the coming years. The financial plan forms the basis for the budget preparation and facilitates the budget negotiations in the following years.



## CHAPTER 8

# Medium-term Perspectives in Budgeting: The U.S. Case

by

*Bill Dorotinsky, The World Bank*

## 1. Introduction

In the United States, medium-term aspects of budgeting are an integral part of the annual budget process, and as such are somewhat difficult to disentangle from the annual budget process. This paper will outline the major rules and process in multi-year budgeting, covering both the executive and legislative budget processes.

After presenting the necessary institutional background for understanding the U.S. public sector, the evolution of budgeting, and key actors, the paper turns to multi-year macrofiscal forecasting in the annual budget process. The paper then turns to sectoral allocation of resources, including conflict resolution mechanisms. The paper then briefly addresses the question of policy content and ownership of the executive budget, the role of the legislature, and in-year spending ceilings. The paper concludes with a summary assessment of multi-year budgeting in the U.S. and some lessons learned.

## 2. Background

### 2.1. Governmental structure and public finance roles.

The United States has a presidential system of government. Power is separated between three branches of government (executive, legislative, judicial).

- The legislature (Congress) has the ultimate authority over spending, granted to it under the Constitution.<sup>64</sup> Providing authority to spend is exclusively a legislative power. The executive branch may not spend more than the amount appropriated, and it may use available funds only for the purposes approved by Congress. In theory, the Congress could develop a budget without any presidential input, although this has not been the case in modern history. It is also important to point out early that while the President does propose one comprehensive budget, the Congress enacts the budget through 13 separate appropriations bills or votes, roughly corresponding to function.
- The President and executive branch have important roles in the budget process in that (i) they propose the budget first, thus setting the agenda; (ii) they have the detailed spending information needed to prepare good budgets; and, (iii) the President has Constitutional power to approve or veto legislation (including the 13 appropriations bills).

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<sup>64</sup> "No money shall be drawn from the Treasury, but in Consequence of Appropriations made by Law."

## 2.2. Evolution of Budgeting

The relationship between the executive and legislative branches over budgeting and control of public finances has developed gradually over the 200 years of the country's history, with the balance of influence over spending shifting between the two branches. Until 1921, spending agencies submitted budget requests directly to the Congress. While Congress had preeminent authority in spending decisions, it was very dependent on the budget estimates and requests submitted by spending agencies. As the complexity of the public finances expanded, this uncoordinated approach placed too high a burden on Congress to prepare a coherent fiscal position, and also provided too little formal room for Presidential policy in advancing a coherent executive fiscal position.

The Budget and Accounting Act of 1921 established the executive budget process, requiring the President to prepare and submit a comprehensive federal budget to Congress annually. The Act also created the Bureau of the Budget (renamed the Office of Management and Budget (OMB) in 1974) to support the President in carrying out coordinating the executive branch budget. OMB assists the President in overseeing the preparation of the Federal budget and also supervises budget execution /implementation. OMB evaluates the effectiveness of agency programs, policies, and procedures, assesses competing funding demands among agencies, and sets funding priorities. OMB ensures that agency reports, rules, testimony, and proposed legislation are consistent with the President's budget and with Administration policies. In addition, OMB oversees and coordinates the Administration's procurement, financial management, information, and regulatory policies. And, not a small task, OMB is in charge of general management oversight and reforms in the public sector.

Along with OMB, the Council of Economic Advisors and the Treasury Department assist the President by providing economic projections and revenue estimates.

With the passage of the Budget and Accounting Act, influence over budgeting shifted to the executive branch. This tendency generally continued until the early 1970s, when Congress began to reassert its role. By the mid-1960s, the size and complexity of the Federal budget had grown significantly. Some programs from the Depression (Social Security) and War on Poverty (such as Medicaid and Medicare) were large and growing, and were entitlement programs not governed by the annual budget. To manage these programs required more than an annual focus in the budget.

In 1970, Congress passed the Legislative Reorganization Act, requiring more budgetary information from the President, including that the budget cover the budget year and four additional years.

In 1974, Congress passed the Congressional Budget and Impoundment Control Act. The Act further reinforced the congressional budget role establishing important tools for managing its handling of the budget. The House and Senate Budget Committees were created to coordinate congressional consideration of the budget, and the Congressional Budget Office was established as a source of nonpartisan analysis and information, including providing an alternate economic forecast for the Congress. The law also established a specific timetable for action on the budget and a concurrent budget resolution on budget aggregates (a legislative device that does not require Presidential approval, but guides legislative action on the budget).

CBO's role is to provide the Congress with objective, nonpartisan analyses on economic and budget decisions, and with information and estimates for the budget process. CBO prepares analyses and estimates relating to the budget and the economy, and presents options and alternatives for the Congress, but does not make policy

recommendations. CBO helps the Congress formulate a budget plan, stay within that plan, and assess the impact of federal programs.

Congress also has the Congressional Research Service, which provides research on specific topics for Members of Congress, as well as the General Accounting Office – the Supreme Audit Institution or external audit body – that provides evaluations of programs in addition to audit reports.

To understand the U.S. budget process generally, including multi-year budgeting, it is important to understand both the executive and legislative budget processes.

### **3. Foundations of budget preparation: macrofiscal**

#### **3.1. Executive branch macroforecasting, expenditure forecasting, and fiscal envelope**

Formal econometric models are not used in preparing economic forecasts of key economic variables for use in the President's Budget. Professional economists in OMB, Treasury, and the Council of Economic Advisors (the 'troika') focus on trends in six key variables:

- (1) real GDP growth;
- (2) CPI (higher CPI lowers indexed tax revenues and increases budget spending via automatic cost-of-living allowances, etc.);
- (3) GDP price index (higher GDP growth increases tax revenues);
- (4) unemployment;
- (5) short-term interest rates (90-day Treasury Bill rate); and,
- (6) long-term interest rates (10 year Treasury bonds yield).

Some attention is also paid to projected income distributions, which will effect tax revenue projections (profits versus wages). Policy discussion focuses more on the wedge between the GDP price index and CPI than on each measure itself. The CPI generally out-paces the annual rate of GDP growth. The rule of thumb: the wider the gap between the two measures, the worse for the Federal Budget.

In debating the appropriate level of key economic variables for use in the President's Budget, participants do receive other forecasts as benchmark levels (several academic private sector estimates, as well as estimates by international organizations).

The existence of these alternate estimates is thought by some to place constraints on the extent to which political officials might manipulate economic estimates beyond reason in order to support their political agenda via the budget. Regardless, alternate estimates do provide substantive grist for the debate.

The process of forecasting is really an incremental one. Analysts begin with the most recent official forecast, and then proceed to review the key variables in light of trends in the economy. The current forecast is modified where a consensus is reached among OMB, Treasury, and CEA on necessary changes.

Generally, only first-order effects on the economy are considered. Professional economists in the executive branch are loath to attempt second-order estimation (e.g. the effect on tax revenues of a change in tax laws which change behavior).

Forecasts are updated every six months. Executive branch economists constantly monitor key statistical releases on economic activity, and are always thinking of the implications of the news for the official forecast.

### 3.2. Process: from policy approval to budget production

Once staff of the troika have finished their review and developed opinions on necessary revisions, senior policy officials meet to discuss the forecast. Eventually, the Chairman of the CEA, the Director of OMB, and the Secretary of Treasury must agree on the final numbers before they can be used to develop the Budget.

Policy consensus must be reached for economic forecasts. The key policy officials involved in fiscal policy must reach some consensus on broad policy directions as they consider the economic forecasts. (In the 1980s, this policy review often resulted in more optimistic estimates, which led to the appellation 'rosy scenario' forecasting based on economic theory dubbed 'voodoo economics'.)

Generally, the key policy officials will include the troika, as well as senior administration officials (possibly the President, Vice-President, Chief of Staff, and other White House political staff). These arrangements have varied by Administration. Under President G. H. W. Bush, domestic and economic policy were the domain of two very influential officials, the Chief of Staff John Sununu and the Director of OMB Richard Darman.

Under President Clinton, a formal advisory body called the National Economic Council (NEC) was established in 1993 to provide advice to the President and build consensus among key policy officials. The Council was composed of the President, Vice-President, seven domestic Cabinet Secretaries, the Secretary of State, Director of OMB, Chair of the Council of Economic Advisors, National Security Advisor, Assistant to the President for Domestic Policy, and Secretary of Defense.

The important point to bear in mind is that there were vehicles for achieving policy consensus within Government. As of 1993, these have become more formalized in the NEC. This would be roughly analogous to Cabinet consensus in Parliamentary systems.

### 3.3. From forecast to budget preparation

Once approved, CEA staff use a private sector econometric model (dubbed the 'black box') to produce somewhat greater detail for the forecast, especially consumption, investment, and export components of the national accounts. Also, greater detail in terms of income distribution is sought for use by Treasury in forecasting revenues. While based on an econometric model, the black box really is an accounting device or reverse model, where key variables are entered, and consistent details are generated. The black box assures that basic national accounting identities are observed to produce a generally consistent set of supporting detail for the approved policy variables. This black box output detail is then given to OMB and Treasury for production of further detail.

The U.S. Treasury is responsible for tax-based revenue forecasts, while OMB generally estimates user fees and similar non-tax revenues. Treasury has formula based on historical tax collection records of estimated revenues given the basic national account and income distribution data.

OMB has simple formulae based on recent historical trends and simple regression models which provide greater detail on inflation, a wider array of interest rate estimates, etc. (e.g. Medical inflation is, on average, 2 percent greater than the CPI estimates). These more detailed estimates are then provided to the executive branch agencies for use in estimating future year or budget year costs. Agencies use estimates of inflation and possible pay increases in calculating their budget requests (policy) and current services estimates.

The set of variables which the Federal Executive Branch has determined are necessary for producing the budget are listed in Box 8-1.

**Box 8-1. Economic variables used in developing the President's Budget**

Basic Budget Data

1. Pay and personnel-related costs for civilian employees
2. Pay and personnel-related costs for military personnel
3. Non-pay costs for discretionary programs

Alternate Price Measures

4. GDP Deflator (chain-weighted);
5. CPI-W (quarterly and annual);
6. States-local expenditure Index;
7. Federal non-pay, non-defense expenditure deflator;
8. Federal non-defense non-residential structure construction;
9. Private construction non-residential structures.

Revenue-related estimates

10. GDP (quarterly and annually)
11. GDP Price Index (quarterly and annually)
12. Civilian unemployment (quarterly and annually)
13. Corporate profits
14. Goods imports
15. Personal income, broken into wage and non-wage income (interest income, dividend income, rental income, proprietors' income) (quarterly and annually)
16. Civilian labor force (quarterly and annually)
17. Treasury bill rates (91, 182, and 364-day rates (quarterly and annual)
18. Treasury notes and bonds (2, 3, 5, 7, 10, and 30-year rates) (quarterly and annually)
19. Prime rate (quarterly and annual)
20. LIBOR (quarterly and annual)
21. AAA state and local bond rate (quarterly and annual)
22. Mortgage rate (quarterly and annual)
23. Energy prices (imported and domestic oil, coal, natural gas, and a hybrid gas and oil index) (quarterly and annual)
24. Housing starts, mortgage originations (existing and new homes), average single-family home

### 3.4. Expenditure trends

Many of the routine budget tasks, such as applying a pay inflator to base year pay and projecting into future years, are automated in the OMB budget database system. The appropriate economic estimate is fed into the OMB computer, and the relevant accounts are directly updated.

In early budget discussions at the macro level, OMB uses the most recent approved budget information (congressionally-approved budget), adjusted for information on implementation of the current budget, to make projections of spending trends. Several concepts unique to the U.S. budget system need to be understood; baselines, discretionary spending, and mandatory spending.

Baselines provide the President and Congress with a framework for making and enforcing budgetary decisions, serving as a benchmark. OMB and CBO baselines project federal spending, revenue, and budget surplus or deficit amounts that would occur if existing budget policies were left unchanged. The rules for calculating the baseline are set in law.

Discretionary spending applies to programs whose funding must be provided annually in the budget. Mandatory spending encompasses entitlements to individuals and other programs whose spending is controlled via separate legislation, and not subject to the annual budget.

Mandatory spending and receipts are generally assumed to continue at the level prescribed by existing law. Discretionary spending is assumed to continue at the level of the current year's spending level, adjusted to reflect certain assumptions. The projections for mandatory spending, receipts, and discretionary spending are based upon economic assumptions (e.g., economic growth, inflation, and unemployment) and technical assumptions (e.g., demographic and workload changes).

There is no formal or informal discussion between executive branch staff and staff at the Federal Reserve on economic forecasts. However, Washington, D.C. based economic professionals do have a general idea of what others in their field are thinking.

The Federal Reserve has their own model, and do not share their forecasts. The Federal Reserve MPS model does, however, have some close similarity to the private sector economic model the executive branch uses for obtaining more detailed estimates. However, since the President's Budget is released publicly, including the basic economic assumptions underlying the budget, the Federal Reserve has the basic information on Executive Branch economic thinking to use in their own forecasts and decision-making.

### **3.5. Congressional Budget Office Forecasting**

Once the President's Budget economic forecasts are released with the President's Budget, the Congressional Budget Office makes their own set of estimates. CBO is thought to follow a similar consensus and incremental approach to forecasting. However, CBO does invite private and academic forecasters to present their views of the economy. Also, CBO, being a single agency, has a somewhat easier time in arriving at consensus estimates, versus the executive branch with three separate agencies involved. CBO does subscribe to some private sector forecasting services, though which ones, and how these private forecasts are used in developing the official CBO forecast, is not known.

OMB and CBO do have some different assumptions and conclusions on income distribution and some key variables. Particularly with regards to income distribution, OMB has tended to estimate greater GDP growth and greater corporate profits – which are highly taxed – and hence greater Federal tax revenues, than CBO has projected.

Because of lingering suspicion over OMB economic estimates after President Clinton's inauguration, the President declared that CBO economic assumptions would be used instead of OMB's. While only lasting for a short while, the President's decision did serve to remove different economic estimates as a source of budget debate, and also chastened the troika to produce more pragmatic estimates.

Publication of the economic estimates in the President's Budget also allows close scrutiny of the soundness of the estimates.

### 3.6. Revenue forecasting

As noted above, within the executive branch, the Treasury has general responsibility for tax policy, including estimating the effect on revenues of changes in tax policy.

Most of the laws establishing the federal government's revenue sources are permanent and continue year after year without any additional legislative action. Revenue legislation may be considered in the congressional budget process when President proposes changes in taxes.

### 3.7. Debt

Within the executive branch, the Treasury also has responsibility for debt policy. Because of the size of the economy, debt policy has generally not been a major focal point in budget debates, except for the 1990s under President Reagan, and again now with the rapid increase in deficits. Most of the focus has been on taxes (revenues) and spending, with deficits and debt a residual. (Note that for smaller or less open economies with more limited access to capital markets, debt policy is a far greater issue.)

Perhaps the more immediate administrative issue for the Treasury in debt policy is Congressional limits on debt. The gross federal debt consists of the debt held by the public plus the debt held by government accounts. Almost all of the gross federal debt is subject to a public debt limit. The Treasury can borrow funds only up to statutory debt limit. Most gross federal debt is held by the public, though a significant amount (roughly 30 percent) is held by government accounts (primarily trust funds such as Social Security, whose surpluses must be invested in special federal government securities by law).

Congress occasionally will enact increases to the debt limit. Within the congressional budget process, the annual congressional budget resolution specifies the appropriate level of the public debt for each fiscal year covered by the resolution. In order to actually change the public debt limit, however, legislation must be passed by both Houses of Congress and signed by the President. The House of Representatives Ways and Means Committee and the Senate Finance Committee are the responsible committees of Congress for debt limit issues.

In addition to the annual budget process, debt limits are another means for Congress to control the executive branch, and force the executive to discuss debt issues directly.

A Mid-session Review is also required by the law to be sent to Congress by July 15 of each year. The Mid-session updates the economic estimates and President's Budget proposal.

## 4. Strategic Allocation

### 4.1. Sectoral ceilings

In the U.S., sectors are termed functional classification. The President's budget classifies federal budgetary activities into functional and subfunctional categories that represent the major purposes of the federal government. Each budgetary activity of the federal government, including budget authority, outlays, tax expenditures, and credit authority, is classified into a subfunction based on the primary purpose it serves

without regard to the agency or other unit responsible for it. There are currently 21 functional and 77 subfunctional categories. Figure 8-1 presents the current functional and subfunctional classification.

The functional categories provide a broad statement of budget priorities and facilitate the analysis of trends in related. They are not used for setting ceilings.

Figure 8-1. Functional Classification

<b>050 NATIONAL DEFENSE</b>		<b>570 MEDICARE</b>	
051	Department of Defense-Military	571	Medicare
053	Atomic energy defense activities		
054	Defense-related activities	<b>600 INCOME SECURITY</b>	
<b>150 INTERNATIONAL AFFAIRS</b>		601	General retirement and disability insurance (excluding social security)
151	International development and humanitarian assistance	602	Federal employee retirement and disability
152	International security assistance	603	Unemployment compensation
153	Conduct of foreign affairs	604	Housing assistance
154	Foreign information and exchange activities	605	Food and nutrition assistance
155	International financial programs	609	Other income security
<b>250 GENERAL SCIENCE, SPACE AND TECHNOLOGY</b>		<b>650 SOCIAL SECURITY</b>	
251	General science and basic research	651	Social security
252	Space flight, research and supporting activities	<b>700 VETERANS BENEFITS AND SERVICES</b>	
<b>270 ENERGY</b>		701	Income security for veterans
271	Energy supply	702	Veterans education, training, and rehabilitation
272	Energy conservation	703	Hospital and medical care for veterans
274	Emergency energy preparedness	704	Veterans housing
276	Energy information, policy and regulation	705	Other veterans benefits and services
<b>300 NATURAL RESOURCES AND ENVIRONMENT</b>		<b>750 ADMINISTRATION OF JUSTICE</b>	
301	Water resources	751	Federal law enforcement activities
302	Conservation and land management	752	Federal litigative and judicial activities
303	Recreational resources	753	Federal correctional activities
304	Pollution control and abatement	754	Criminal justice assistance
306	Other natural resources	<b>800 GENERAL GOVERNMENT</b>	
<b>350 AGRICULTURE</b>		801	Legislative functions
351	Farm income stabilization	802	Executive direction and management
352	Agricultural research and services	803	Central fiscal operations
<b>370 COMMERCE AND HOUSING CREDIT</b>		804	General property and records management
371	Mortgage credit	805	Central personnel management
372	Postal Service	806	General purpose fiscal assistance
373	Deposit insurance	808	Other general government
376	Other advancement of commerce	809	Deductions for offsetting receipts
<b>400 TRANSPORTATION</b>		<b>900 NET INTEREST</b>	
401	Ground transportation	901	Interest on Treasury debt securities (gross)
402	Air transportation	902	Interest received by on-budget trust funds
403	Water transportation	903	Interest received by off-budget trust funds
407	Other transportation	908	Other interest
<b>450 COMMUNITY AND REGIONAL DEVELOPMENT</b>		909	Other investment income
451	Community development	<b>920 ALLOWANCES</b>	
452	Area and regional development	921-929	Allowances [Assigned by OMB]
453	Disaster relief and insurance	<b>950 UNDISTRIBUTED OFFSETTING RECEIPTS</b>	
<b>500 EDUCATION, TRAINING, EMPLOYMENT, AND SOCIAL SERVICES</b>		951	Employer share, employee retirement (on-budget)
501	Elementary, secondary, and vocational education	952	Employer share, employee retirement (off-budget)
502	Higher education	953	Rents and royalties on the Outer Continental Shelf
503	Research and general education aids	954	Sale of major assets
504	Training and employment	959	Other undistributed offsetting receipts
505	Other labor services	<b>999 MULTIFUNCTION ACCOUNT</b> [used for accounts that involve two or more major functions]	
506	Social services		
<b>550 HEALTH</b>			
551	Health care services		
552	Health research and training		
554	Consumer and occupational health and safety		



Indicative ceilings for the annual budget process in the U.S. are set according to the ministry (department) classification set for the budget year, and four subsequent years. Generally, OMB begins with the second year of the prior budgets' multi-year forecast, and makes adjustments for total spending trends and limits, economic or legislative changes, and also to reflect known policy preferences. A 'new policy reserve' has sometimes been set at this stage, representing a pool of unallocated resources that will be used to fund new initiatives (whether arising from the President or from ministries). In some cases these are provided to the President for information, and in other instances not, depending on the degree of interest of the President in budget issues and the degree of delegation to staff and the Director of OMB.<sup>65</sup>

The ministry ceilings are indicative. OMB requests that agencies stay within the ceiling, but there are no formal sanctions for not doing so. Because the ceilings are not Presidentially-approved or sanctioned, they have few 'teeth.' Even if there were, it is highly unlikely a cabinet member would be reprimanded or dismissed for not meeting the ceiling. However, there are more informal pressures for compliance that operate more at a career staff level. In advising the Director of OMB and President, OMB staff do make note of whether the ministry complied, and by how much they were off ceiling. Further, even if the ministry does not specify where they would reduce to meet the ceiling, OMB staff will recommend where reductions should take place. So, it is in the interest of ministries to themselves identify low priorities.

Further, implicitly, there is always some question in ministry budget staff minds as to whether OMB scrutinizes their budget more closely if ceilings are ignored. (For small agencies, over which OMB has more direct influence, there is greater likelihood of compliance with the ceilings.) Regardless, ministry requests are generally within 5-10 percent of ceilings.

## 4.2. Conflict resolution and consensus-building

After receiving ministry requests, OMB prepares policy papers for the President's decision. There is a well established process for decision-making, with only the most significant issues ever making it to the President's desk. Many will be made by the OMB director, and for smaller issues, by political appointees within the OMB.

After decisions are taken, the decisions are 'passed-back' to the ministries, usually around Thanksgiving (November). Ministries are given a tight deadline for reviewing and formally registering any appeal to the passback levels. This process of passback and appeals can be very contentious between OMB and ministries.

The process of resolving appeals involves direct meetings between OMB staff and ministry budget staff and focused debate. Efforts are made to resolve as many issues as possible at a staff level, before raising the issues to a political level. Eventually, some issues may need to be resolved by the Director of OMB and affected cabinet secretary. Generally, few issues require appeal all the way to the President. Some Presidents (Ford, Carter, and Clinton) have taken a direct role in deciding appeals. Others (Nixon, Reagan, George H.W. Bush and George W. Bush.) have delegated appeal decisions to presidential aides or the OMB Director.

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<sup>65</sup> While the formal President's Budget document includes the budget year and four additional year, down to the program level, over the last decade or so the Senate has included language in the budget resolution requiring ten-year estimates. The executive has generally complied with this request, submitting these estimates at a more aggregate level.

Throughout this process, it is the better prepared, better argued, and better documented case that tends to win out. For OMB and agency staff, the premium tends to be on data and analysis. For highly political issues, of course the political officials will take the decision and weigh many factors. Even the best analysis will not win out against politics. But for the majority of issues OMB would deal with during this time, data, documentation, and analysis are the key factors.

Out-year estimates can sometimes also be used in resolving disputes with agencies, at least for discretionary spending. There have been instances where an agency agreed to a lower increase in its proposed budget in exchange for increases in its budget for the budget year +1 or beyond. Of course, the subsequent years ceiling will be revisited in light of changing circumstances during the next budget cycle, and the agreed increase may not in fact happen.

With this in mind, OMB puts a premium on hiring the best staff, and having access to as much data as possible. It is not uncommon for, OMB staff – outnumbered by budget staff in ministries – armed with agencies' own data, to provide critical information or data at a key moment in negotiation that wins out – when the agency may not have itself reviewed its own data.

Once agreements are reached and appeals resolved, the ministries are responsible for preparing the budget documentation and justification. In addition to the formal President's Budget, each agency will prepare a separate budget justification for transmittal to Congress, as well as congressional testimony for their executives. OMB reviews and approves all these documents before they are sent to Congress, to assure they are all in alignment with Presidential/administration decisions and policies.

Agencies do have direct relationships with Congressional committees and staff, and have been known to provide information informally which sometimes undermines the budget. However, OMB staff closely monitor these discussions, and do report back to the Director of OMB on ministry behavior. Egregious breaches might solicit a call from the OMB Director to a Minister, but these are not common.

### **4.3. Final budget allocation**

Final budget allocations (passback and appeals) are set relative to the ceilings. This has been especially true with the enactment of legally binding ceilings on discretionary and mandatory spending through the Budget Enforcement Act (BEA). While the BEA addresses aggregate spending levels, these are translated into ministry ceilings, and the sum of ceilings must of course match the legal limits.

The actual ministry budget allocation, while taken relative to the ceiling, is really determined by the accumulation of individual decisions on programs and policies. The policy papers prepared for decision (referred to above) incorporate extensive analysis by OMB staff of agency budget requests, as well as other research or findings (e.g. audit findings) regarding programs and policies. The analysis results in OMB staff recommendations for specific changes in funding, programs, policies, employment, etc. It also reflects the 'findings' of OMB staff from budget hearings held with each agency (at which each agency can make their case for their request). As each decision is taken, its effect relative to the ceilings is monitored to assure the totals are not exceeded.

While only some appeals will be addressed directly by the President, in the end it is the President's Budget that is transmitted to Congress, under his signature. The President is ultimately responsible for its content. The Cabinet does not formally approve the budget.

#### 4.4. Roles

The U.S. does not have a formal MTEF. The budget process has evolved, particularly after 1974, to incorporate medium-term projections in the process, as well as ministry strategic plans. Generally, the relationship between OMB and ministries has not changed dramatically due to the introduction of medium-term forecasts. Other factors influence relations more. For example, during periods of deficits, Presidents with a policy of spending reduction, and OMB Directors with high influence over domestic policy, OMB tends to be stronger relative to the ministries, and during these times OMB may be less 'collegial' in relations with ministries. At other times, OMB influence may be less, and relations with Ministries become far more collegial.

That said, there was some movement under President Clinton towards a more collegial approach by OMB. Early in the Clinton Administration, a survey was conducted of spending ministries as to what they thought of OMB, and barriers to agency efficiency. Not surprisingly, the results were rather negative, with ministries feeling OMB was too much into rule-mongering and second-guessing, and too high-handed. The results were at first surprising to OMB staff, and certainly not accepted. After a series of brown-bag discussions between staff and the OMB Director, some acceptance of the results seemed to sink in, with staff understanding that to really be effective, the ministries needed to be partners and understand the overall constraints. No subsequent surveys have been taken, so it is not clear if the ministries would report differently now than a decade ago.

### 5. Policy and budgets

Generally, because of the requirement for the President to submit a budget, and that the budget embodies the President and Administration policies, it is 'owned.' Presidents can and do issue veto threats to Congress over exclusion (inclusion) of issues that they support (oppose).

Much of the President's involvement in the budget takes place through the OMB. When macroforecasts are developed and the budget outlook prepared, OMB advises the President and presents policy recommendations. The President makes policy decisions, which are passed to agencies through OMB. These initial policy decisions may set out broad budgetary goals, or may include specific policy proposals and spending ceilings to guide agencies in preparing their budget requests. Policy guidance on budget development often varies from year to year, depending on current economic and political conditions.

As noted above, ministries develop their budget requests. Direct Presidential involvement in many details is limited by the nature of the process. Presidential involvement tends more to policies and some specific proposals.

With respect to multi-year budget estimates, it is important to note that the President's Budget includes two sets of estimates for Congress: current services baseline and President's policy (showing the multi-year impact of the President's policy choices). These aid in transparency, and allow quick identification of those areas where major budget policy changes are proposed.

## 6. Legislature

As noted in the introduction, the Congress has the authority to change the executive budget proposal completely, including total revenue, total expenditure, deficit, debt, and allocations to ministries. This authority is in practice counterbalanced by the executive authority to veto the budget bills.

Over time the congressional budget process has been improved to give Congress greater ability to manage its own affairs. General examples of these from the early 1970s were mentioned in the introduction. This section will go into the congressional budget process in more detail.

The Congressional Budget and Impoundment Control Act of 1974 established the basic structure for the congressional budget process, creating the House and Senate Budget Committees and CBO. The Congress' budget process starts in February with the submission of the President's budget, after which the House and Senate Budget Committees begin developing their budget resolutions.

The annual budget resolution establishes total spending and revenue for five or more years, allocates spending by functional classification, and includes CBO baseline estimates of revenues. The spending amounts are then allocated to the House and Senate Appropriations Committees for discretionary spending, to the authorizing committees for mandatory spending, and to the House Ways and Means Committee for revenue targets. The Appropriations Committee of each house subdivides the discretionary allocation among its 13 subcommittees (broadly, the major functions). The committee allocations are one means of enforcing the aggregate spending levels in the budget resolution by holding committees accountable for meeting their targets.

After extensive hearings, each of the subcommittees reports one of the 13 regular appropriations bills to its respective full appropriations committee, which in turn reports the bills to their Chamber. A cost estimate of each bill is prepared and compared to the amount allocated or subdivided to the relevant subcommittee. The Congressional Budget Act prohibits bills from exceeding the budget resolution committee allocations. However, to be enforced, a Member of either Chamber must raise a point of order when the bill is being considered on the floor of the respective Chamber.

For mandatory spending, revenues, and debt limits, the process of reconciliation (also established under the Congressional Budget and Impoundment Control Act) is used to enforce the budget resolution allocations. Congress includes reconciliation instructions in the budget resolution directing the authorizing committees to recommend changes in law to achieve the direct spending, revenue, and debt limit targets in the budget resolution. The Budgets Committees of each Chamber then compile the various proposed legislative language from the authorizing committees into a reconciliation bill. Unlike the process for discretionary spending, there are no points of order for a reconciliation bill that does not meet the budget resolution mandatory spending targets. Amendments on the floor of each Chamber may seek to bring the reconciliation bill closer to the budget resolution targets, but that is entirely at the discretion of a Member, and subject of course to a successful vote for the amendment. For revenues, a point of order may be raised for amendments that would reduce revenues below the budget resolution.

The Congressional Budget and Impoundment Control Act does prohibit either Chamber from considering amendments to a reconciliation bill that would increase the deficit. The law also provides a congressional budget process timetable; the budget

resolution should be adopted by April 15, and the reconciliation bill by June 15. (These are frequently not met.)

The Budget Enforcement Act of 1990 also required that any measure reducing revenues below the budget resolution or increasing mandatory spending be offset with equivalent revenue increases or mandatory spending reductions (commonly referred to as the pay-as-you-go rule). This is also enforced by a sequestration process, whereby any violation will trigger an offsetting sequestration of nonexempt mandatory spending programs.

## 7. In-year Effect

Generally, OMB has been responsible for costing new legislation. As a practical matter, not all legislation is costed. Only executive branch proposals, and legislation in Congress likely to be passed by Committee and proceed to the floor.

During the budget process, 'scorekeeping' (measuring the budgetary effects of pending and enacted legislation against the baseline) is used to compare proposed budget policy changes to existing law and to enforce spending and revenue levels agreed upon in the budget resolution and other budget legislation, such as the discretionary spending caps and pay-as-you-go rules.

During the fiscal year, scorekeeping is also used for new legislation. As OMB must clear all legislation before transmittal to Congress, no uncosted or unfunded legislation is transmitted from the executive. All proposals must fit within the ceilings.

## 8. Discussion and overall assessment

This presentation of medium-term budgeting in the U.S. has focused on the process, technical details, rules and roles. It has tried to provide both the hard facts, and some of information on how it works in practice. But to the reader it may appear a dizzying blizzard of rules and procedures. This summary tries to draw out the key features of the process, and also the key strengths and weaknesses of the process.

One aspect of note is in fact the interplay between executive and legislature. The competition between the two branches has led to innovations in budgeting and a fairly high degree of accountability in public finances. That is not to say all spending is efficient. But there are pressures to become more efficient.

For the medium term aspects of budgeting, the important points are:

- (1) In considering policy and programs, thinking beyond one year to the outyear effects of proposals and existing spending is common throughout the system. Over a quarter century of requirements for multi-year estimates, and progressively greater attention to these estimates, have made multi-year thinking a normal part of public finance.
- (2) The baseline estimates serve as a useful reference point for considering changes in policy and programs over several years, and better inform decision-makers. This has likely led to different choices in programs, and in reallocation from lower to higher priority programs, early in the budget process – but it is not possible to systematically measure this effect.
- (3) Beyond the 'information' effect noted above, including use of indicative ceilings in the budget process, the multi-year estimates had limited bite. Not until the large deficits of the 1980s and general political and public consensus that

deficits were 'bad' did multi-year estimates and ceilings gain real teeth. And further, not until the Gramm-Rudman-Hollings and Budget Enforcement Act legislated ceilings and pay-go requirements did the real effect of ceilings and estimates come to be felt.

- (4) Some means of bringing consensus on multi-year policy is critical. It is this consensus that shapes behavior and changes direction the most. For the U.S., consensus within the executive branch is achieved through the NEC. Within the legislative branch, it is achieved via the negotiations that take place in the Budget Committees in crafting the budget resolution (frequently including negotiation with the executive branch). And finally, the Budget Enforcement Act represented the executive-legislative consensus necessary in the U.S. political system to really begin to reign in deficit spending.
- (5) Despite the presence of multi-year estimates for a quarter century, this has not prevented growth in spending. It has influenced choices, and might even have contributed to a shift towards more mandatory spending programs not directly under annual budget control. For the U.S., information on future impact has not been enough to effectively limit spending growth. This might be part of the curse of riches, where deficits and postponement of decisive choices on fiscal matters can be financed given the easy access to international capital markets enjoyed by the U.S. The impact of multi-year information might be greater for countries with less easy access to capital markets. For the U.S., hard, legally binding fiscal targets were required to make a difference.
- (6) The Gramm-Rudman hard targets proved too demanding, and the targets could not be reached through the political process. The BEA proved more successful, by limiting discretionary spending and requiring off-sets for deficit-increasing changes to entitlement programs. These procedural rules changed the incentives in the budget system to limit spending growth, and this proved more successful than hard deficit reduction targets.
- (7) With the short-lived budget surpluses in the late 1990s and early 2000s, the consensus on budget discipline broke down, and the BEA lost emphasis. The multi-year estimates are firmly entrenched and still prepared, and at least provide the political officials with clear information on the direction they are heading. The availability of this information does likely serve as some break on excess, but again the 'teeth' are lacking. However, as the outyear picture worsens with continuous provision of multi-year estimates, the pressure to contain spending will likely reassert itself – a self-correcting mechanism, albeit with lags in effect. Even in the absence of hard legal constraints, multi-year information is of value.

While the deficits are large, and there is increasing suggestions of the imprudence of current policy, some of the expansionary fiscal policy is intended to boost economic growth. The policy is intended as counter-cyclical – just as large surpluses were incurred during years of strong growth and used to pay down the debt, so now deficits are incurred. One can debate whether it is really needed, or needed in the size and form in which it is incurred (tax cuts). It does not mean the underlying budget system is entirely broken. Where a policy decision is taken to operate an expansionary fiscal policy, it does not mean the underlying process is dysfunctional. It would be if the expansionary policy were taken absent information on likely outcome, but that is not the case.

## **Part II**

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# **Performance Management**





## CHAPTER 9

# An Overall Framework for Considering Performance Management

by

*Joel Turkewitz, The World Bank*

## 1. Overview

Moving This paper provides a brief overview of major issues in the design of performance-enhancing reforms in the public sector. As this paper is written as an input into a dialogue between the Government of Korea and the World Bank on improving public expenditure management, specific particular attention has been given to experience and learning in achieving greater performance orientation through alterations in the allocation and spending of public financial resources. The first section of the paper reviews some current thinking about the fundamentals of improving performance in the public sector. The second section presents a discussion of different approaches to generating enhanced performance orientation in the budget process, and the final section examines the evidence to date on the impact of performance-oriented reforms and the implications of that evidence on the design of performance management programs.

## 2. Performance in the public sector

Performance is not a new idea in the public sector. The earliest state bureaucracy, established in ancient China, was founded upon the importance placed on a highly trained cadre of people working in the interests of the state. As the public sector has evolved over time, it has consistently retained a commitment to performing work in the public interest in an effective and efficient manner – a concept enshrined in the notion of a “public service ethic.”

While the general concept of performance has a long history, the idea of performance in the public sector has been reinvigorated over the course of the past two decades. As governments expanded in the post-World War II era, pointed questions started to be asked by the voting public as to what was being accomplished. The greater the external pressure on politicians to demonstrate that money was being well spent, the greater the internal need on public servants to identify and quantify public sector products and positive societal outcomes. “Performance” in the public sector became increasingly associated with measuring, monitoring, and evaluating the outputs of projects and the outcomes of policy initiatives.<sup>66</sup> The last 20 years has witnessed the introduction of reforms throughout the developed and developing worlds designed to orient public sectors towards the more effective and efficient delivery of services.

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<sup>66</sup> For a discussion of the idea of performance in the public sector, see Schick (2003).

The drive to improve public sector performance has given a new look to the public sector as it entered the 21<sup>st</sup> Century. Processes and organizations have been remade through innovations like program budgeting, medium-term expenditure frameworks, accrual accounting, and performance auditing. Privatization and decentralization have reshaped the state, while contracting-out and performance contracting has modified public sector employment. Enhanced monitoring and evaluation, program reviews, and increased civil society participation in setting policy and reviewing results have changed how managers and politicians are held accountable for results.

Decades of reform efforts have achieved mixed results. Initial expectations in countries like the United States and Sweden that improved performance could be rapidly achieved through changes in the budget process have failed to materialize, while experiences in such places as New Zealand, South Africa and many smaller public sector organizations has been much more positive. The inability to state definitively whether performance management works is not a data problem but instead reflects the fact that reforms vary greatly in their objectives, the traditions and histories of the countries undertaking reform, and the variations in the reforms that have been tried. Some countries that have undertaken performance-oriented reforms have succeeded in improving their overall public finance performance, reallocating resources across sectors, and improving efficiency within programs. In other countries, reforms appear to have done little more than reshuffle arrangements within the public sector with no discernable impact on public finance or service delivery.

Reforms that have succeeded in creating well-performing public sector have benefited from inputs that can neither be planned nor designed – such as good timing, effective leadership, and governmental stability. Successful reforms have drawn upon a generally accepted group of ideas regarding the organization and operation of high-performance public sector environments. As stated by Allen Schick (1999), those ideas include:

- “Performance improves when managers are told what is expected of them, and results are measured against these expectations.
- Performance improves when managers are given flexibility in using resources to carry out assigned responsibilities.
- Performance improves when operational authority is devolved from central agencies and departmental headquarters to operating levels and units.
- Performance improves when government decisions and controls focus on outputs and outcomes rather than on inputs and procedures.
- Performance improves when managers are held accountable for their use of resources and the results that they produce.”

It is interesting to note that ideas about performance improvement look not to specific processes or rules but rather at the role of managers and the alignment of managerial incentives. Performance-enhancing efforts that have focused on adopting new techniques, even those as far ranging as the implementation of a medium-term expenditure framework, have succeeded in impacting on performance only to the extent that they have generated a change in the informal rules and culture that defines how managers operate.

Convergence on the factors that generate performance improvements, does not equate to convergence in reform design. Efforts to increase performance in the public sector are as varied as the countries that have designed them. At the same time, the individual reform programs that have been developed have at their core a limited number of drivers of change. Some reforms seek to engender improvement through increased competition, some by greater managerial authority. Others look to enhanced program oversight and review, or deregulation and simplification to generate change. A particular reform might draw upon multiple drivers of change, although not all combinations are equally compatible.<sup>67</sup> For example, New Zealand has worked hard to enhance competition in the public sector, but has combined this with increased attention to program review. Canada, on the other hand, has repeatedly worked to introduce program review, while the U.S. has tried a combination of enhanced managerial autonomy and program review.

There is no evidence to suggest that any single driver of change dominates other models. Successful reforms are crafted around the strengths of existing organizations and institutions and are specific to their environment. The importance of categorizing reforms based upon their central change strategy is that each strategy raises a specific set of challenges. Reforms designed around enhancing competition need to find ways to minimize transaction costs and ensure that clients have sufficient information to make informed choices. Alternatively, freeing up managerial authority is likely to succeed only if accountability systems are strong and managers have the ability to manage for results.

Up until now, I have not included in my discussion of performance-oriented reform a discussion of the role of monitoring and measurement. Performance and measurement are undoubtedly linked in the minds of many people as is evident by oft-repeated phrases, such as "If you do not measure results, you do not know if you are succeeding" or the stronger "That which gets measured gets done." Much writing on the subject often assumes that monitoring performance leads directly to improving performance. Work in the area has focused disproportionately on the monitoring side with little attention given to the pathway by which performance monitoring gets translated into performance improvement.

There is little empirical reason to be sanguine about the impact that performance information per se has on organizations and individuals since both frequently have a variety of ways to deflect or reinterpret performance data in ways that allow them to retain comfortable patterns. Indeed, it may very well be that performance information is valuable only after an organization has been transformed into one that is oriented to continuous improvement in its effectiveness and efficiency. Britain's Next Steps Initiative, widely regarded as a successful performance innovation, is an example of this pathway - the impact of robust performance information was predicated on redesigned service organizations solely focused on the efficient delivery of services.<sup>68</sup> While monitoring and results information have a vital function within performance reforms, they are not the foundation for change.

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<sup>67</sup> See Schick (1999) for a discussion of strategies for reform, and the associated case studies for analysis of specific reform efforts. Efforts to increase managerial autonomy may have a hard time co-existing with efforts to enhance program oversight, especially when those efforts are introduced simultaneously.

<sup>68</sup> See Schick (2003) for a discussion of the fallacy of performance as measurement.

### 3. Improving performance through the budget process

Much of the work designed to enhance performance in the public sector has focused on altering budgetary processes in order to more closely link spending and performance. Attention to the budget process is completely sensible given the role of the budget as the primary instrument for setting government policy. The link between budgetary reform and performance-oriented change is so strong that sometimes the entire performance movement is grouped together under the banner of performance budgeting. This is a mistake since there are many efforts to enhance public sector outcomes that do center on the budget.

While it is useful to distinguish between broader performance management and performance budgeting, it is also useful to define what is meant by performance budgeting. For the purposes of this paper, we will utilize Professor Marc Robinson's definition: "performance budgeting refers to procedures or mechanisms intended to strengthen links between the funds provided to public sector entities and their outcomes and/or outputs through the use of formal performance information."<sup>69</sup> This definition does not limit performance budgeting to government-wide budgeting or exclusively relate the concept to central allocation processes.<sup>70</sup>

Like performance management, efforts at performance budgeting have existed for some time. Attempts in the early 1960s in the United States and later in Sweden were undertaken with the expectation that it would be possible to create a system that relatively mechanically linked allocations and performance. It is perhaps not surprising that these efforts to reform the budget process into a technocratic exercise divorced from politics did not succeed. The U.S. Planning-Programming-Budgeting System (PPBS) attempted in the 1960s and the famous performance budgeting effort of its time has been described by one noted observer as producing "a vast amount of inchoate information characterized by premature quantification of irrelevant items."<sup>71</sup>

Although early efforts were not promising, performance budgeting has grown to be a standard feature of the budgeting process in most developed countries. An OECD 2001 survey found that 70 percent of member countries included performance information in their budgets. Perhaps a better measure of the penetration of performance ideas into the budget process is that 40 percent of survey respondents answered that their measures distinguished between outputs and outcomes.<sup>72</sup>

As we will see in the case studies that accompany this piece, performance budgeting comes in many different forms. All of the reforms share a movement away from traditional concentration on inputs and an attempt to counter-balance the forces of incrementalism in budget setting.<sup>73</sup> The following table from Professor Philip Joyce expresses some of the major differences between performance and traditional budgeting.<sup>74</sup>

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<sup>69</sup> See Robinson (2004).

<sup>70</sup> An alternative term "performance-informed budgeting" has been suggested recently in the United States. See Philip Joyce (2003).

<sup>71</sup> See Wildavsky (1969).

<sup>72</sup> Kristensen (2002). For a useful discussion of performance budgeting, see Diamond (2003).

<sup>73</sup> Incrementalism refers to the tendency for budgets to be determined by slight modifications in allocations based upon a determination of what is needed this year to do what was done last year.

<sup>74</sup> Joyce (2003), p.15.

Table 9-1. Difference between performance and traditional budgeting

Traditional Budgeting	Performance Budgeting
Inputs as ends in themselves	Relationship between inputs and outputs
Changes in inputs as the margin	Change in inputs and results for the entire program (for example, how much more money for how much more results)
Divorced from planning and management in agencies	Budgeting integrated with planning and management
Budgeted resources	Costs

The different approaches to performance budgeting can be largely divided into efforts that focus on tighter *ex ante* linkages between results and budgets (through targeting) and those that concentrate drawing tighter *ex post* linkages between performance and allocations through the use of budgetary incentives.<sup>75</sup>

The strongest example of *ex ante* targeting is provided by the U.K. Public Service Agreements (PSAs). The PSAs, signed by each agency, set out key objectives and targets. "Headline" targets focus on broad outcomes such as improving literacy in children. These targets are translated into operational targets at the agency of program level which concentrate on outputs, activities, and processes. The PSA approach was adopted at the start of beginning of the Labour Government in order to ensure that planned increases in funding for education and health were tied to concrete improvement commitments.

Output-purchase budgeting represents an alternative approach whereby government purchases a specified output based upon detailed unit cost calculations. This radical version of budgeting for results has been pursued most vigorously in New Zealand starting in the late 1990s. The creation of a budget model based upon a purchaser-provider relationship is the extreme form of budget reform that focuses on outputs. In such a system, each agency is viewed as a business and failures within the production function can cause governmental organizations to register losses.<sup>76</sup>

The two approaches discussed above work by linking budgeting with *ex ante* expectations of performance. Efforts of this sort have frequently experienced incentive problems since the consequences of not meeting targets has remained relatively uncertain. Poor performance can be a justification for increasing budgets (since an objective may be critical and poor performance may indicate insufficient funding) just as good performance can justify holding a budget allocation steady or even reducing it (program goals have been achieved or the program has demonstrated its ability to produce results with existing funding). For this reason, some commentators have questioned the extent to which budgeting based upon expectations of future performance provide adequate incentives for managers to truly improve agency and program performance.

<sup>75</sup> The following discussion draws heavily on Robinson (2004a) and Robinson (2004b).

<sup>76</sup> For a discussion and analysis of the reforms, see Schick (1996) and Robinson (2002).

Performance approaches that link *ex post* evaluations with future allocations seek to increase the pressure on managers to perform. The Bush administration's President's Management Agenda (PMA) and the complementary Program Assessment Rating Tool (PART) in the United States are leading examples of a strategy dedicated to incorporating past results into future allocations. The PMA requires the OMB to assess the management of agencies, with a focus on the degree to which the agency's senior management utilizes performance information in their strategic and day-to-day decision-making. The PART program requires the Office of Management and Budget (OMB) to determine whether a program is well functioning, with over 50 percent of the PART score determined by an analysis of results and accountability. Both PMA and PART are integrated into the budget process by the OMB, as well as through the unusual step of making PART scores public and using a traffic light scale (green for go, yellow for caution, and red for halt) for its PMA evaluation in order to ensure maximum accessibility of agency rating to politicians and their constituencies.<sup>77</sup>

The current U.S. approach is fundamentally similar to a series of reforms undertaken by the Government of Canada. An extensive program review was initiated in 1994 on the heels of efforts to rationalize programs that was begun in the 1980s. While the initial efforts focused on building up evaluative capacity in the Comptroller General's Office, the later, more successful efforts have required explicit reallocation of resources within fixed budgets and have been combined with other reforms designed to enhance managerial attention to service delivery and citizen needs. Detailed program evaluations have also been a feature of the Australian governments approach to improving performance, especially in the period from 1987 to 1997, but have been abandoned in the period since 1997.<sup>78</sup> The challenge faced by all efforts to conduct systematic program evaluations is the sheer time and cost required to perform rigorous evaluations. In many cases, program evaluations appear to have been forced to compromise on quality, and have led to enormous conflicts within public administration with relatively minor gains.

As with performance reforms in general, there does not appear to be a compelling case for promoting one performance budgeting reform over the other. The case studies that accompany this report will provide greater detail as to the mechanics of each of these strategies – information that will be essential for Korean policy-makers in their determination of a suitable approach for the country. Instead of looking at their differences, I want to turn now to a brief consideration of two features that are common to all performance budgeting efforts – the restructuring of budgets around programs and the selection of performance indicators. It is the author's belief that the former, the creation of programs, has generally received insufficient attention while the latter has received too much focus.

If one were to read through recent discussions of performance budgeting, it would be easy to get the impression that the core of the effort was defining the right set of indicators and ensuring their rigorous monitoring. It might come as a surprise that such efforts would likely be useless if the operative budget retained its traditional line-item structure. In a traditional line-item model, it is hard if not impossible to determine the policy objectives that are driving spending or to identify the amount of money

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<sup>77</sup> The Bush Administration has combined these enhanced agency and program reviews with a significant increase in the use of monetary performance bonuses to reward managers for high performance. The effectiveness of such performance rewards in generating effective and efficient public sectors has been challenged.

<sup>78</sup> For a discussion of the role of evaluation in the Australian reforms, see Mackay (2004).

spent on achieving a particular goal. Enhanced expenditure classification systems can sometimes allow for expenses to be more closely allocated to individual projects but inherently fail to capture all relevant costs. Restructuring the budget into a program structure creates the foundation for any serious performance budgeting effort.

We choose the term restructuring the budget rather than reconfiguring it because it requires ministries and agencies to rethink their activities as well as recalculate their spending. The initial stage in the process is for a government body to define its programs – a group of activities and projects, usually under a single manager, which contributes to a specific program objective. This is anything but a trivial exercise, as the initial PART review revealed. In the 2003 exercise, the OMB determined that fully 50 percent of programs could not be evaluated because they failed to have defined objectives or measurable results – an astounding conclusion given that the Government Performance Results Act (GPRA) had been enacted in 1993 precisely to get agencies to define programs and objectives.

Program budgeting is now a common feature within the OECD. A set of generally accepted principles exist that may help guide the transition from line-items to programs that provide a constructive basis for performance budgeting. As stated by Jack Diamond (2003, p.17), these principles include:

- “Programs are mono-functional so that each program is linked to only one function.
- Programs are hierarchically constructed, so that each program has a number of subprograms and each subprogram can be decomposed into a number of activities and projects. Each subprogram is related to only one program, likewise each activity and project is related to only one subprogram.
- Each program has an appropriate size for efficient management.
- Programs and subprograms should be defined in a way to support political decision-making and prioritization, by making clear the relationship between the resources used and the envisaged outputs and envisaged policy results (outcomes).
- Programs must consider all related activities (including regulatory ones) and projects, which together assist in achieving their objectives. This means that capital and recurrent spending should be considered together in judging program performance relative to its objectives.
- Accountability of subprograms should have clear managerial responsibility, usually and preferably, within a single organizational unit.
- Responsibility for implementing each particular program should almost always align by administrative unit to one chapter in the budget. Where it is not possible to maintain this, it is important to assign lead roles to a particular chapter.”

Defining a program is an exercise in translating policy into action. It involves policy-makers working alongside managers in order to ensure an alignment between agency functions, managerial responsibilities, and oversight arrangements. Moreover, it also requires that financial management arrangements be configured in order to ensure the accurate assignment of costs, both direct and indirect, as well as the creation

of system to supply relevant and timely data on finances and outputs. The integration of financial management with budgeting is an enormous task, frequently requiring new cost coding as well as new accounting practices, such as accrual accounting.

Establishing a program structure to budgets is, therefore, improperly understood as a procedural step on the way to introducing performance measures. When it is properly done, establishing a program structure requires changes within agencies, as well as the creation of a completely new relationship between budgeting and financial management. The importance of the changes that can be introduced in the programming exercise have already been mentioned in the discussion of overall performance reform – the process of organizational and institutional restructuring precedes the capacity to utilize data to improve performance.

Against this backdrop, the selection of performance indicators can appear to be a relatively minor component of reform. This is incorrect since it is clear that selecting inappropriate indicators or establishing unreasonable targets for performance can destroy the momentum of reform. Indeed, establishing useful indicators and utilizing data in the budgetary<sup>79</sup> process is critical to achieving the objectives defined in the programming process.

Struggles to define useful indicators have been reported almost universally among the countries in the vanguard of reform. This reflects the complexity of the task as well as the unfamiliarity of most public sector managers in thinking in monitoring terms. Undoubtedly, problems will be encountered by nations or agencies embarking on their own performance budgeting effort, especially in the tricky area of identifying realistic outcomes and ascribing causality in areas effected by multiple programs. At the macro-level, monitoring of performance is likely to be a frighteningly inexact undertaking.

Countries are fortunate in that they now have the ability to examine a growing glossary of indicators defined in the course of previous reforms as they develop measures that are suitable for them. Experience also suggests that the development of indicators is a continuous process, as measures evolve over time due to dialogues between managers and policy-makers and the modification of programs.

#### **4. Results of performance reforms and implications for the design of performance-enhancing reforms**

The author has repeatedly stated in the sections one and two that evidence on the impact of performance reforms in general, or specific strategies, is hard to come by and generally inconclusive. This result obtains from a variety of factors already discussed. For the most part, performance management remains, in Allen Schick's elegant turn of phrase, an idea whose time has come but whose implementation has not.

The above statement should not be understood to mean that performance reforms have generated no improvement in performance since this clearly is not the case. The implementation of performance-orienting reforms in countries like New Zealand, the U.K., and others is associated with improvements in overall public finance performance, as well as more efficient service delivery. The case studies that

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<sup>79</sup> As Diamond (2003) writes, "experience suggests that the benefits of a budget program format will soon be lost unless departments (and most central agencies) continue the momentum and purpose of reform by moving to develop standards of service delivery and search for ways by which these standards can be continuously improved and services delivered more effectively."



accompany this piece, along with other studies referenced in this paper, suggest some of the successes along with the challenges of demonstrating impact.

One of the problems in coming to empirically based conclusions on effective program design is a result of the restricted nature of existing analysis. As one commentator has recently noted, "Regrettably, the empirical literature on *government-wide* performance budgeting is disappointingly limited in scope and methodology, and does not provide for strong conclusions about the efficacy of these systems."<sup>80</sup> The absence of a robust empirical literature may be due in part to the complexities of reform but also may be related to somewhat mistaken preconceptions as to where performance management and performance budgeting would have greatest impact.<sup>81</sup>

Early efforts at performance management and performance budgeting were invigorated by an interest in centralized management of economies and social programs. The early attempts at government-wide performance programming, borrowed from the U.S. Defense Department, envisioned the ability to distribute budgetary resources across the government in order to maximize societal welfare. Since that time, the performance movement has evolved greatly but has retained a overwhelming interest in improving the allocative efficiency across sectors through centralized processes involving a limited number of organizations. In the U.S., this has meant that attention has focused on the creation and approval of federal budgets, with a specific concentration on those processes involving the OMB.

The initial and continuing focus on centralized allocative processes has perhaps decreased appreciation of the other processes that determine how public money is allocated and spent. For example, agencies provisionally allocate money through their budget submissions, and managers further reallocate money once budgets have been determined in the operation of their programs. Money also gets reallocated within the execution process through delays in payment or via payment to third parties.<sup>82</sup>

It may well be that performance budgeting and performance management is most likely to have impact at levels that have been obscured by our preconceptions. There is significant evidence to suggest that managers in a large variety of programs within the United States have made use of performance information to direct resources to greater effectiveness and inefficiency. This has included defining inter-agency allocation processes that are influenced by performance as well as mid-year reallocations based on interim program results.<sup>83</sup>

Ultimately, improvements in public sector performance come about through some combination of better calibrated allocative processes distributing resources to better designed programs that are managed in an environment that demands performance. In this brief review, we have suggested some of the choices to be made in program design, and some of the factors associated with changing managerial cultures and improving decision-making. I conclude this brief piece with a quote from Allen Schick, "At the

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<sup>80</sup> Robinson (2004a), p.42.

<sup>81</sup> Robinson suggests that the paucity of data is due to a lack of interest on the part of economists and financial management analysts in the issue, as well as the preponderance on performance budgeting reform that has taken place in the United States.

<sup>82</sup> See Joyce (2003) for an excellent discussion of the variety of allocation processes within the federal budget process, as well as an examination of how performance information can be utilized across the entire budgeting process.

<sup>83</sup> See Joyce (2003). For a discussion of how outcome information is being used at the federal level in the U.S., see Hatry, et al (2003).

end of the day, improving performance is essentially a matter of getting organizations and the people who work in them to behave differently...To make a difference, an organization must be obsessed with purpose, so that the critical actions it takes in allocating staff and resources, designing and delivering services, assessing results and feeding back the findings to new decisions are all done through the lens of performance...Governments that don't manage for results don't budget for results, even if they install the outward trappings of performance budgeting...Rather than being the locomotive that drives government to change, performance budgeting is the caboose that confirms the transformations that have been made."<sup>84</sup>

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<sup>84</sup> Schick (2003), p. 8, 19, 22.

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## Introducing Performance Management

by

*Youngsun Koh, Korea Development Institute*

### 1. Performance management framework

#### 1.1. Structure of performance management framework

Performance management typically consists of the following four steps:

- (1) Setting performance targets
  - Delineating the mission and strategic objectives of the organization
  - Defining quantitative and/or non-quantitative performance indicators
  - Choosing targets for indicators
- (2) Designing the program
  - Designating who is in charge of the program
  - Designing the service delivery system
  - Planning human and financial resources
  - Drawing up evaluation plans
- (3) Implementing the program
  - Delivering service with inputs of human and financial resources
  - Measuring performance indicators
- (4) Assessing the performance
  - Performance monitoring
  - Program evaluation

As the last step indicates, there are various tools to assess performance. The first is performance monitoring. In performance monitoring, performance indicators are defined and then measured on a regular basis. The measured performance is in turn compared to the targets that were chosen at the start of the period. In Korea, examples can be found in the Performance Budget Pilot Project that was carried out in 1999-2002 and the Performance Management System that was introduced in 2003.

Performance monitoring can produce information on outputs and outcomes in a frequent and timely manner at relatively low costs. Based on this information, the organization in charge of the program can modify its business plans and service delivery system. On the other hand, monitoring by itself can rarely explain the causality between inputs and outputs/outcomes. It only describes the measured performance of a program, and says nothing about the extent to which the program contributed to the observed performance. In addition, performance monitoring does not question the relevance and appropriateness of the chosen performance indicators,

and takes as given the objectives and design of the program. Moreover, it is often difficult to measure with only a limited number of indicators the performance of a program that has diverse stakeholders and multiple objectives. In some cases, it is even impossible to define performance indicators. Despite these limitations, however, performance monitoring plays an important role in the overall performance management process by providing the basic information on program performance.

A second tool for performance assessment is program evaluation. According to the OECD (1999), performance evaluation can be defined as “a systematic and analytical assessment addressing important aspects of a program and its value and seeking reliability and usability of results.” Program evaluation addresses the question of why and how the program produced certain outputs and outcomes. It purports to analyze scientifically the impact of a program on the expected and unexpected results, describe objectively the factors that contributed to the success or failure of the program, and provide information that can be used to redesign the program and for other purposes. Program evaluation can also question the relevance and appropriateness of the chosen performance indicators and reassess the objectives and design of the program. On the other hand, program evaluation usually requires large amounts of money and time, and cannot be performed on all programs.

Of course, there are other tools for performance assessment than these two. Audits have traditionally been the most important instrument to ascertain the regularity and integrity of public sector operations. More recently, performance audits have been employed by the supreme audit institutions of many countries to analyze the efficiency of government programs. In addition, many countries have also been utilizing performance appraisal of individual government employees to attribute the outputs and outcomes of an organization to those of individuals, and to reflect the information on their promotion and salary determination.

Table 10-1. Key Differences between evaluation and monitoring

Monitoring	Evaluation
<ul style="list-style-type: none"> <li>● periodic;</li> <li>● assumes appropriateness of program, activities, and indicators;</li> <li>● tracks progress against small number of indicators;</li> <li>● usually quantitative;</li> <li>● use data routinely gathered or readily available;</li> <li>● cannot indicate causality;</li> <li>● difficult to use for impact assessment;</li> <li>● usually internal.</li> </ul>	<ul style="list-style-type: none"> <li>● Usually episodic;</li> <li>● Can address a wide-range of potential questions about a policy, program, or project;</li> <li>● Can identify what has happened as a result of an intervention and provide guidance for future directions;</li> <li>● Can address “how” and “why” questions;</li> <li>● wide-range of quantitative and qualitative research methods possible;</li> <li>● can use data from different sources;</li> <li>● can identify unintended as well as planned impacts and effects;</li> <li>● can involve internal, external, or self evaluation.</li> </ul>

Source: Perrin (2000).

Among these tools, performance monitoring and program evaluation are deemed the most important, and accordingly they take a central stage in performance

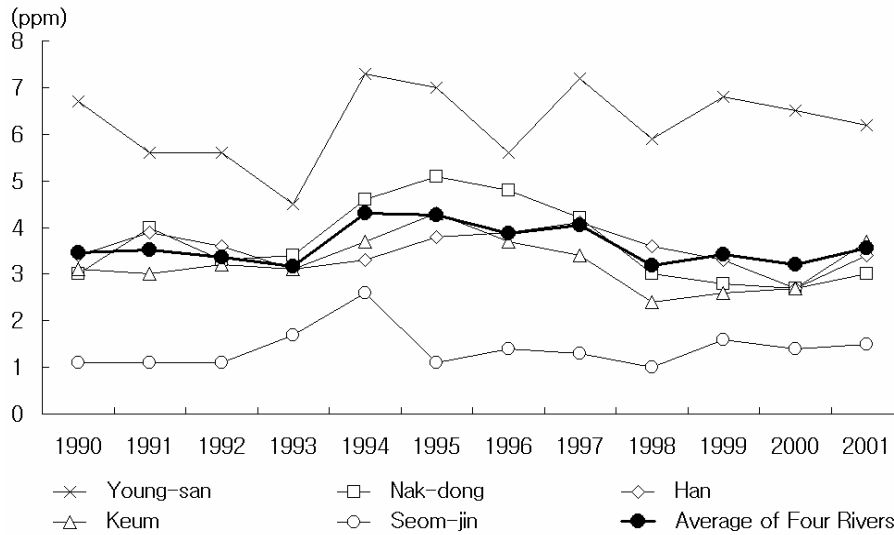
management. Some, such as Rist (2003), even equate performance management with performance monitoring and evaluation (PM&E). Table 10-1 contrasts the main characteristics of monitoring and evaluation.

## 1.2. Performance assessment: an example

An example is provided below of the performance monitoring and evaluation.

The Korean Government has made a lot of efforts to reduce pollution in rivers. Figure 10-1 shows the BOD (Bio-chemical Oxygen Demand) level of four major rivers in Korea. The graph indicates a weak declining trend in the BOD level since the mid-1990s, but the trend is not clear.

Figure 10-1. BOD levels of four major rivers



Source: Kang and others (2003).

Kang and others (2003) tried to estimate the impact of pollution abatement investment in the following way. First, they calculated EBOD, which is defined as the difference between the actual BOD and the assumed level of BOD when no investment has been made since 1990:

$$EBOD_t = 3.46 (w_1 D_t + w_2 W_t + w_3 L_t) - BOD_t,$$

where

3.46 = BOD in 1990 (ppm),  
 $D_t$  = pollution by households (1990 = 1),  
 $W_t$  = pollution by firms (1990 = 1),  
 $L_t$  = pollution by livestock farming (1990 = 1),  
 $w_1, w_2, w_3$  = weight of each pollution source, and  
 $BOD_t$  = actual level of pollution (ppm).

Because they did not have data on  $w^1$ ,  $w^2$ , and  $w^3$ , Kang and others (2003) assumed various levels for these weights. In the next step, they estimated the following equation with the standard regression method:

$$EBOD_t = \alpha + \beta R_{t-1} + \gamma P_t + u_t,$$

where

$R_{t-1}$  = accumulated investment after depreciation up until year t-1 (100 million won), and

$P_t$  = annual precipitation (100mm).

The estimated value of  $\beta$  ranges between 2 and 2.5, and indicates that the pollution abatement investment has not been very cost-effective. According to Table 10-2, each investment of 100 million won (around 83 thousand USD) reduces pollution by 0.00002 ppm. In this case, it costs 500 billion won (around 420 million USD) to reduce pollution by 0.1 ppm.

Table 10-2. Estimation results

Weights			$\alpha$	$\beta$ (x 0.00001)	$\gamma$ (x 0.01)	$R^2$	DW
$w_1$	$w_2$	$w_3$					
0.4	0.1	0.5	-1.02	2.14 (3.47)	6.16 (1.67)	0.64	1.80
0.4	0.2	0.4	-1.05	2.28 (2.75)	7.50 (1.37)	0.53	1.56
0.3	0.2	0.5	-0.84	2.19 (2.67)	6.71 (1.24)	0.51	1.59
0.3	0.4	0.3	-0.90	2.47 (1.93)	8.20 (0.97)	0.36	1.33
0.2	0.3	0.4	-0.87	2.33 (2.22)	7.46 (1.08)	0.43	1.43
0.2	0.4	0.4	-0.07	2.38 (1.86)	7.41 (0.88)	0.34	1.35
0.1	0.4	0.5	-0.49	2.28 (1.78)	6.61 (0.78)	0.31	1.36
0.1	0.5	0.4	-0.52	2.43 (1.60)	7.36 (0.74)	0.27	1.29

Note: In parentheses are t-statistics.

Source: Kang and others (2003).

In this example, the annual measurement of BOD in Figure 10-1 corresponds to performance monitoring, while the estimation of the impact of pollution abatement investment in Table 10-2 corresponds to program evaluation.

It should be noted that the above program evaluation has a couple of deficiencies. First, Kang and others (2003) took account of only point-sources of pollution, and did not include pollution from non-point sources such as farm land and roads in their estimation. Presently, there are no data on the latter kind of pollution. Second, they estimated the impact of pollution abatement investment on the average level of BOD across the four major rivers, rather than on those of individual rivers. This is again due to the lack of data.



Such a lack of adequate data can be observed in other areas as well, and poses a serious threat to the successful introduction of a performance management framework in Korea.

### 1.3. Uses of Performance Information

Performance information produced in the performance assessment process can be utilized in many ways. The OECD (1999) defines three objectives of evaluation, which can be readily extended to the case of performance management in general:

- improving decision-making;
- assisting in resource allocation; and
- enhancing accountability.

According to Schick (2003), “the big problem is not in measurement, but in application. Much attention has been paid to the former, but not enough to the latter. With some notable exceptions, governments that invest in measuring performance rarely use the results in managing programs. They do not base civil service salaries on performance, nor do they hold managers accountable for performance or allocate resources on this basis. Efforts to budget on the basis of performance almost always fail, as do reforms that aim to link pay and performance.”

This observation indicates that producing performance information is a separate issue from utilizing it. Below we will discuss various problems surrounding the uses of performance information.

#### 1.3.1. Improving decision-making

Most importantly, performance information should be used by those who are directly responsible for the success of the program. For example, the program manager can identify more efficient and effective ways to implement the program, change the design, and utilize the lessons learned in planning future programs. At a higher level of decision-making, the ministry in charge can modify current policies or propose new ones based on performance information. In short, performance information provides an opportunity to learn and improve.

A performance management framework cannot be established on a firm ground unless it is used as a tool for learning. As Perrin (2002) notes, there appears to be general agreement that performance management can only be effective if people working within the system actually *believe* in the value of a results-orientation. With a true results-focus, a results-focus permeates everything that one does, for example, with managers and staff constantly asking themselves what the benefits of their activities are supposed to be, how they know, and what they can do to be more effective. Otherwise, what takes place would likely be mainly a paper exercise, with people going through the motions rather than really acting in a results-oriented manner.

A great danger emerges when managers and staff do not believe in the value of a results-orientation, which is distorted performance data. Performance data often rely on official statistics produced, for example, by national statistical offices. But more often they are produced by managers and staff themselves. When they suspect that performance information will work against their own interests, they have an incentive to distort the data in their favor. At the least, when they perceive performance management as an unnecessary and onerous exercise, they will take little care in recording and reporting the data, and the data quality will suffer.

In this regard, improving decision-making is the most important use of performance information. The information produced for this purpose also forms the basis for information produced for the purposes of assisting in resource allocation and enhancing accountability. Managers and staff should check whether the expected outputs and outcomes have been obtained at each stage of the program implementation. They should also scan all major aspects of the program. They therefore need to produce as detailed and diverse information as possible on program performance. In contrast, higher-level decision-makers or the budget authorities need far less information on individual programs unless they want to overwhelm themselves with an excessive amount of data. The information supplied to them is therefore necessarily a subset of that produced by the program.

### **1.3.2. Assisting in resource allocation**

#### *1.3.2.1. Two ways to link performance to budgeting*

Performance information can be used in the budgeting process. In particular, when the government is faced with severe budget constraint, performance information can provide valuable guidance in setting up priorities across different expenditure areas and reallocating resources from less efficient and effective programs toward more efficient and effective ones.

Resource allocation proceeds in multiple steps (Politt, 2001). In the first step, the budget is allocated among various sectors such as defense, education, and infrastructure investment. In the next step, sectoral budgets are further divided among major programs. For example, within education, the budget is allocated among elementary, secondary, and higher education. In the third step, program budgets are allocated to individual projects (free lunch for elementary school students, for example) and/or institutions (universities, for example). In the final step, the budget is allocated to specific activities (teachers' salaries, research support, library maintenance, etc.).

The budget authorities usually have the final say in the first and the second steps. Line ministries often take responsibility for the next two steps, as they correspond roughly to the decision-making process within ministries. Below we will confine our attention to the first and the second steps, namely the macro-budgeting carried out by the budget authorities.

There are two ways to link performance to budgeting. One is pursuing a direct linkage between performance and budgeting, and the other an indirect one. In a direct linkage, a functional relationship between performance and budget is assumed. For example, the Government Performance and Results Act (GPRA) of 1993 in the U.S. originally defined performance budget as that which presents varying levels of performance resulting from different budget amounts.

In an indirect linkage, no such one-to-one relationship is assumed between performance and budgeting. Performance information serves only as one of many references. The budget authorities take other social, economical, and political factors into account when deciding on budget allocation. Subsequently, poorly performing programs are not necessarily cut back or discontinued, and are sometimes assigned more resources.

#### *1.3.2.2. Direct linkage between performance and budgeting*

Most commentators agree that a direct linkage entails many problems (Politt, 2001, Perrin, 2002, and GAO, 2002).

First, one should be able to measure performance precisely in order to directly link it to budgeting. But many government programs do not lend themselves to precise

measurement. Basic research programs, for example, aim to accumulate and diffuse scientific knowledge, which in itself is not quantifiable. Even when quantification is possible, it may be difficult to establish the causality between the intervention and final outcomes. The educational achievement of middle school students, for example, can depend on the current education as much as on the previous ones they received in kindergartens and elementary schools.

Second, program costs should also be measured precisely. To this end, overhead costs from support services should all be allocated to programs. In addition, economic, rather than historic, costs should be the basis for cost comparison, and this requires the introduction of accrual accounting in budgeting. For example, annual depreciation of buildings and facilities should be added to program costs. While many countries currently employ accrual accounting for their financial statements, only a handful of them, including the U.K, New Zealand, and Australia, have introduced accrual accounting in budgeting. This indicates the degree of difficulty involved in the task.

Third, even if it is possible to measure both performance and costs precisely, it will be difficult to link them directly when their relationship is not stable. And even if their relationship is stable, past stability does not guarantee the same stability in the future. For example, a large expansion of a certain program can result in substantial changes in average and marginal costs. When this is expected, the government cannot rely on past data to budget for expansion.

The experiment by the U.S government shows that these concerns are real. The GPRA required the Office of Management and Budget (OMB) to report on the feasibility and advisability of including a performance budget as part of the President's budget (GAO, 2002). In 2001, OMB reported the results of five performance budgeting pilots that explored agencies' capabilities of more formally assessing the effects of different funding levels on performance goals. Overall, OMB concluded that the pilots raised key challenges regarding performance budgeting at the federal level including, for example, the following:

- In many instances, measuring the effects of marginal, annual budget changes on performance is not precise or meaningful.
- While continuing to change from a near total reliance on output measures to outcome measures, it will be much more difficult to associate specific levels with those outcomes, particularly over short periods of time.
- Establishing clear linkages between funding and outcome will vary by the nature of the program and the number of external factors.
- Delays in the availability of performance data, sometimes caused by agencies' reliance on non-federal program partners for data collection, will continue to present synchronization problems during budget formulation.

Based on these findings, OMB is currently aiming at an indirect linkage between performance and budgeting, as indicated by the following passage from the budget circular for FY 2005: "A performance budget consists of a performance-oriented framework, in which strategic goals are paired with related long-term performance goals (outcomes) and annual performance goals (mainly outputs). ... At a minimum, resources are aligned at the program level within this framework, and agencies are encouraged to align resources at the performance goal level (OMB, 2003)."

### 1.3.2.3. *Indirect linkage between performance and budgeting*

Even pursuing an indirect linkage between performance and budgeting is not easy. Many of the problems discussed above still apply. When we cannot quantify and measure the performance or cannot identify external factors that affect the outcomes, even an indirect linkage is difficult to achieve. In addition, resistance from stakeholders can make the task even more difficult.

First, in order to reach the complex and sensitive distributional deals which budget-making entails, and in order to create or maintain sufficiently broad coalitions of support (or at least, acceptance) for continuing this program or cutting that one, politicians (both in the executive and the legislature) need to appeal to vague and general values (Politt, 2001). The last thing they are interested in, during this delicate and frequently adversarial process, is careful comparative evaluations of rival programs or the specification of precise operational priorities and targets. Such exercises would show only too clearly who gains and who loses and what is the relative cost-effectiveness of different programs, and would thus make coalition-management all the more difficult. The progress of performance management, by contrast, requires the participants to discuss and agree on realistic, measurable, dated goals, targets, and standards, with a highly specific identification of client groups and their preferences.

Moreover, politicians are under constant pressure to propose solutions to present political, social, and economic problems, and once their proposals have been accepted and implemented, they need to prepare themselves for the attacks from opponents. When somebody comes along with performance data and says that the proposed program has been ineffective in producing the promised result, only embarrassment will follow.

For these reasons, politicians usually do not welcome performance management.

Second, line ministries may not want performance management for similar reasons. For many civil servants, the most serious threat is the condemnation of poor performance by the public and politicians, which should be avoided at all costs.

Third, the budget authorities may not want to link performance to budgeting even in an indirect way. In any country, the primary responsibility of budget authorities lies in collecting budget requests from line ministries, setting priorities, allocating the budget, and containing the total within a certain limit. In carrying out this function, budget authorities may fear that performance management would reduce their room for discretion. For example, they would sometimes feel obliged, against their will, to increase the funding level for those programs that showed good performance.

There is also what might be termed a cultural divergence between financial and performance management (Politt, 2001). Financial management by the budget authorities emphasizes the central control of spending ministries' demands for resources. In contrast, performance management encourages continual and spontaneous learning and improvement in a spirit of devolution and empowerment. This tension between control and spontaneity can hinder a whole-hearted acceptance of performance management by the budget authorities.

### 1.3.2.4. *A prudent and gradual approach*

The above discussion suggests that a one-to-one direct link between performance indicators and budget discussions generally is not possible or appropriate (Perrin, 2002). Nevertheless, integration does not have to be viewed as being all or nothing. It would not be responsible for a government to forsake completely any hope of linking resources and performance in some way at least. Information about results clearly should represent *one* source of information for use in planning and decision-making,

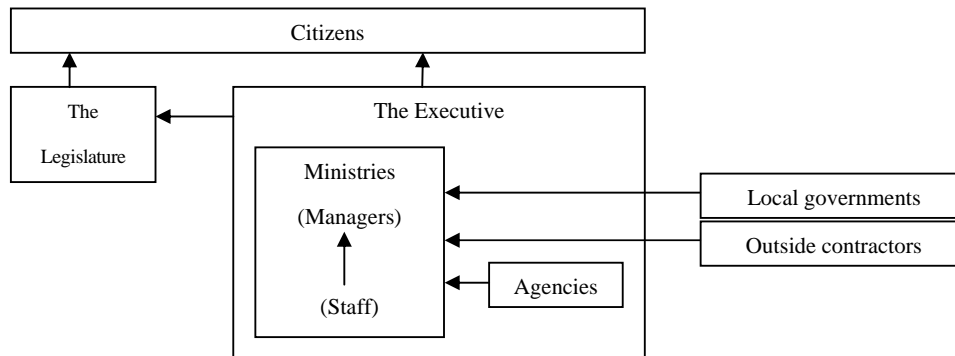
including decisions about future allocations. One should also remember that perfect information is not essential. Decisions are always made on the basis of imperfect information. Making available at least some information on performance may be able to add some greater degree of confidence to the decision-making process. At the least, it can be used to raise questions that should be considered or explored through other means.

At the same time, efforts should be made to minimize the resistance by various stakeholders to performance management. A better understanding of their incentives and interests would help in this regard. Further, a realistic expectation on what performance management can bring about will also help. Success is guaranteed only by a prudent and gradual approach; a firm belief in the value of performance-orientation, but with a clear recognition of the gap between hope and reality.

### 1.3.3. Enhancing accountability

Performance information can also be used for enhancing accountability. Figure 10-2 illustrates the accountability relationship between citizens, the legislature, the executive, and others. The legislature and executive are held directly responsible to citizens, and their accountability is ascertained through the general election (and the presidential election in a presidential system). The executive is held responsible to the legislature through parliamentary hearings, budget approvals, and so on. Within the executive, staff are held responsible to managers, and agencies are held responsible to parent ministries. When the central government provides funds for or imposes regulations on local governments, an accountability relationship can be established between them. Lastly, when ministries contract out part of their operations to outside contractors, the latter are held responsible to the former for the delivery of goods and services.

Figure 10-2. Accountability relationship



Note: The arrows denote accountability relationships.

In this universe of relationships, performance information can be used to assure accountability. In a line ministry, for example, managers can review performance of their staff when considering a promotion or a salary increase for the latter. Citizens can refer to the performance budgets and other documents when assessing the effectiveness of government programs. In addition, a formal contract on performance

can be agreed on between those involved in the accountability relationship. For example, line ministries may stop paying for the service when an outside contractor does not fulfil the terms of performance contract. But even when such formal contracts do not exist, each of the above accountability relationship assumes an informal and implicit contract between the concerned parties.

One should remember, however, that in making efforts to meet the numerical targets specified in performance contracts, government employees may forget their broad and non-quantifiable responsibility to work for the public good as civil servants. Performance contracts can also foster “silo-views” in the public service and hamper cooperation between individuals and organizations. When this happens, the overall performance of the government can be poorer than before the introduction of contracts. Performance contracts should therefore be devised in such a way as to minimize these kinds of risk. Setting a cross-departmental target for interdependent programs is an example.

Trust is another issue to consider in utilizing performance information for enhancing accountability. Schick (2003) emphasizes that performance contracts within government are better characterized as “relational contracts.” They are not real contracts in the sense that they rarely have the same effect as those between private parties. For one thing, within the government, politicians and managers rarely have an arm’s-length relationship; for another, politicians often have little or no effective recourse and have to turn the other cheek when managers fail to perform. They cannot close down the Department of Education and in some cases are pressured to reward the poor performance by increasing the resources provided. In contrast to formal contracts, relational contracts derive their force from the incentives of the parties to the contract to behave in a cooperative, trustworthy manner because they are interdependent. Ministers need managers to produce public services and managers need ministers to get them resources and political support. When the relationship works well, the parties may periodically review progress under the contract and discuss problems with a strong result-orientation.

In contrast, when the public sector lacks trust between its members, relational contracts cannot hold. The contracts cannot be expected to enhance performance by spurring the parties to focus on results. Even worse, they can generate rancor among the employees and lower the morale if the employees find the contracts as unfair and unjust. It is therefore important to build trust in the public sector in general and in the performance management system in particular before utilizing performance information for accountability purpose.

## **2. Current performance Management Practices in Korea**

### **2.1. Overview**

Currently, several systems of performance management are simultaneously at work within the Korean government. They are; (i) the Performance Management System, (ii) the Government Operations Assessment System, (iii) Management by Objectives, and (iv) performance audits by the Board of Audit and Inspection. Table 10-3 explains the main features of these systems. Below we will take a closer look at the first and second systems.

Table 10-3. Systems of performance management

System (Agency in charge)	Main features
Performance Management System (Ministry of Planning and Budget)	<ul style="list-style-type: none"> <li>- Objectives: To shift the focus of expenditure management from inputs to outputs/outcomes by setting up performance goals, measuring the indicators, and feeding back the information to resource allocation.</li> <li>- Based on the pilot project on performance budgeting carried out in 1999-2002.</li> </ul>
Government Operations Assessment System (Office for Government Policy Coordination)	<ul style="list-style-type: none"> <li>- Objectives: To enhance the efficiency, credibility, and accountability of government operations by assessing the performance and organizational capacity of ministries and citizens' satisfaction with them, and by utilizing the results in improving the current operations and planning the future ones.</li> <li>- Composed of the assessments of (i) the central government ministries, (ii) local governments, (iii) specific programs, etc.</li> <li>- The Basic Law on Government Operations Assessment was introduced in 2001 to provide a legal basis for the system.</li> </ul>
Management by Objectives (Ministry of Government and Home Affairs)	<ul style="list-style-type: none"> <li>- Objectives: To foster competition within public service by providing performance-based rewards to individual civil servants based on a strict performance assessment of policies and programs.</li> <li>- Applies to civil servants of degrees 1-4. Sets up individual performance targets, assesses their achievement, and reflects the results on their annual salaries (for degrees 1- 3) and bonuses (for degree 4).</li> </ul>
Performance Audits (Board of Audit and Inspection)	<ul style="list-style-type: none"> <li>- Objectives: To analyze and evaluate the efficiency and equitableness of major government activities and programs from a holistic and comprehensive perspective and to propose effective alternatives, rather than focusing on the disclosure of irregularities.</li> <li>- Performance audits carried out in 1999 corresponded to 3.7 percent of all on-site audits.</li> <li>- Performance audits still mostly address the issue of regularity, and do not meet the standards for program evaluation.</li> </ul>

## 2.2. Performance Management System

### 2.2.1. Overall design and implementation schedule

The *Performance Management System* (PMS), which started in the spring of 2003, is led by the Ministry of Planning and Budget (MPB). PMS corresponds to performance monitoring and does not include program evaluation as its component. PMS requires line ministries to set up performance goals and indicators, prepare annual performance plans and performance reports, and submit them to the MPB at the start of the annual budget cycle. The MPB is in charge of making the system in place by examining the

status of PMS in line ministries, coordinating the implementation, and feeding back the results to resource allocation.

PMS covers only part of ministries' activities, as those activities not involving large sums of expenditure (such as pure policy-making) are excluded from performance monitoring. Also, activities for which the benefits of performance monitoring are expected to be small (such as wages and salaries, "basic program" expenditures,<sup>85</sup> and general administrative expenses) are excluded as well.

For now, PMS applies to 22 "leading" ministries but will be eventually extended to all ministries in the central government. The leading ministries were asked to list the programs ("PMS programs") that will be subject to PMS, pick 30 percent of them for 2004, set up strategic and performance goals for these programs, and develop indicators. In 2004, they begin to measure these indicators, and set up goals for the rest of their PMS programs. Non-leading ministries will start developing their indicators in 2004.

Table 10-4. Timetable for the Performance Management System

Year	Leading ministries	Non-leading ministries
2003	<ul style="list-style-type: none"> <li>● Develop performance goals and indicators.</li> </ul>	
2004	<ul style="list-style-type: none"> <li>● Prepare performance plans for FY 2005 (At least 30 percent of PMS programs should be covered).</li> <li>● Develop performance goals and indicators for remaining PMS programs.</li> </ul>	<ul style="list-style-type: none"> <li>● Develop performance goals and indicators.</li> </ul>
2005	<ul style="list-style-type: none"> <li>● Prepare performance plans for FY 2006 (All PMS programs should be covered).</li> </ul>	<ul style="list-style-type: none"> <li>● Prepare performance plans for FY 2006 (A least 30 percent of PMS programs should be covered).</li> <li>● Develop performance goals and indicators for remaining PMS programs</li> </ul>
2006	<ul style="list-style-type: none"> <li>● Prepare performance plans for FY 2007.</li> <li>● Prepare performance reports for FY 2005.</li> </ul>	<ul style="list-style-type: none"> <li>● Prepare performance plans for FY 2007 (All PMS programs should be covered).</li> </ul>
2007	<ul style="list-style-type: none"> <li>● Prepare performance plans for FY 2008.</li> <li>● Prepare performance reports for FY 2006.</li> </ul>	<ul style="list-style-type: none"> <li>● Prepare performance plans for FY 2008.</li> <li>● Prepare performance reports for FY 2006.</li> </ul>
2008	<ul style="list-style-type: none"> <li>● For the first time, all ministries will prepare performance reports for FY 2007 that cover all PMS programs.</li> </ul>	

Source: MPB, *Guidance on the PMS*, 2003.

<sup>85</sup> In Korea, programs with small and recurrent costs are designated as "basic programs" after negotiation between line ministries and the MPB. Others are designated as "major programs."



### 2.2.2. Coverage of PMS

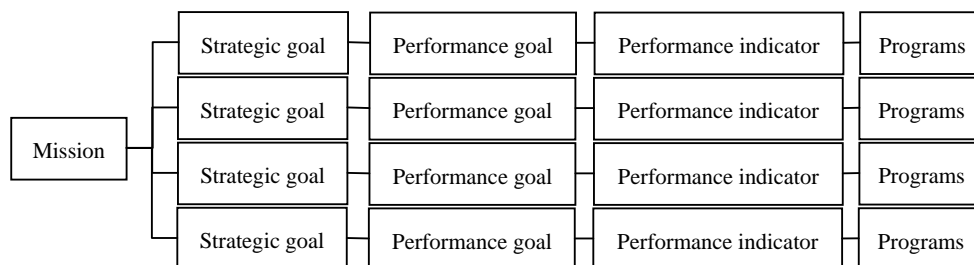
Programs in the general and special accounts that consist entirely of local shared taxes, formula-based grants, financing items, internal transactions between accounts, and contingencies are excluded. Basic programs are excluded except when it is deemed necessary to subject them to PMS. Those programs for which the benefits of performance monitoring are expected to be small are also excluded.

Similar standards are applied to the programs in public funds. In 2003, public funds totaled 59 in number. Among them, 20 are excluded from PMS. Examples of those excluded are the Foreign Exchange Stabilization Fund, various financial funds (which reside outside the scrutiny of MPB and parliament), and those soon to expire..

### 2.2.3. Performance plans and reports

A performance plan sets out in a systematic way the mission, strategic and performance goals, performance indicators, and the budgetary resources of the ministry. It should also contain explanations on how the indicators will be measured and how it can be verified. Optionally, it can describe external factors that affect the performance.

Figure 10-3. Performance structure



Source: MPB (2003).

A performance report describes in a systematic way the degree to which goals have been met. It should list performance goals and indicators as originally set out in the performance plan; describe the performance in terms of goals and indicators; explain the reasons for any poor performances; summarize the assessment; and describe future plans. Optionally, it can include audit results by the Board of Audit and Inspection and summary findings of program evaluations.

### 2.2.4. Utilizing the performance information

According to the MPB, the performance reports should tell us not only whether goals have been met or not but also why. When the poor performance is not due to uncontrollable factors (such as the unexpected change in economic circumstances or in laws and regulations), the program will receive an extensive review by the budget authorities. When it is difficult to identify the reasons for poor performance, a program evaluation will be planned.

PMS will provide one source of information for budget allocation across sectors and programs. Line ministries should present performance information when requesting resources, and the MPB will utilize it when preparing the National Fiscal Management Plan and drafting the budget.

### 2.2.5. PMS in a performance management framework

To the extent that PMS is composed of strategic goals, performance goals, and performance indicators, it is very similar to the performance management framework employed in the U.S, the U.K, Australia, and others. But a significant difference exists in its coverage. PMS is confined to a subset of activities carried out by ministries. In the case of the Ministry of Education, for example, PMS programs take up only 30 percent of total expenditure in 2004. In contrast, the countries mentioned above monitor the performance of all major programs.

Table 10-5. Budget of the Ministry of Education

	(Unit: Billion won)	
	2003	2004
Total expenditure	4,112.3	4,535.2
Major programs (A+B)	3,905.7	4,323.4
PMS programs (a+b)	1,319.3	1,339.9
The general and special accounts	2,490.3	2,639.0
Major programs (A)	2,348.0	2,485.9
PMS programs (a)	1,319.3	1,339.9
Public funds	1,622.0	1,896.2
Major programs (B)	1,557.7	1,837.5
PMS programs (b)		

Source: MPB.

The pilots on performance budgeting that were carried out in 1999-2002 covered all expenditures of line ministries. When significant difficulty was encountered in developing performance indicators, the MPB decided to change the design of the system and cover only those programs for which clear performance targets can be established. But the current design can result in the exclusion of important activities and programs from performance management. In particular, programs whose expenditure consists mainly of wages and salaries or recurrent running costs will be excluded regardless of their importance, as well as the grant programs for local governments. If these programs take a large part in carrying out the mission of the ministry, performance management will lose its substantial meaning.

Of course, there exist cases where performance indicators are difficult to build. But indicators are only a part of the whole exercise. A more important aspect of performance management lies in clarifying the mission of the ministry and classifying its activities in terms of strategic and performance goals. In this process, managers and staff are reminded of the ultimate objectives that they want to achieve, and a cultural change toward a results-orientation emerges within the organization.

## 2.3. Government Operations Assessment System

### 2.3.1. Overall design

The *Government Operations Assessment System* (GOAS) aims to enhance the efficiency, credibility, and accountability of government operations by assessing the performance and organizational capacity of ministries and the citizens' satisfaction with them, and by utilizing the results to improve current operations and to plan future ones (OGPC, 2000). GOAS is composed of five types of assessments; (i) assessments of the central government ministries (*aka* organizational assessments), (ii) assessments of local governments, (iii) self-assessments of the central government ministries and local governments, (iv) assessments of specific programs, and (v) assessments of agencies by their parent ministries.

Table 10-6. Components of Government Operations Assessment System

Types of assessments	Main features
Assessment of the central government ministries ( <i>aka</i> organizational assessment)	<ul style="list-style-type: none"> <li>Assesses ministries in terms of (i) the implementation and performance of their major programs, (ii) their organizational capacities, and (iii) citizens' satisfaction with them.</li> <li>Covers 43 ministries, agencies, and commissions.</li> </ul>
Assessment of local governments	<ul style="list-style-type: none"> <li>The central government ministries assess the operations delegated to and performed by local governments and their grant-based programs and implementation of the national agenda.</li> <li>Covers 16 provinces and metro-cities. Municipalities can also be subjected to the assessment.</li> </ul>
Self-assessments by the central government ministries and local governments	<ul style="list-style-type: none"> <li>The central government ministries and local governments assess their own operations.</li> </ul>
Assessments of specific programs	<ul style="list-style-type: none"> <li>Evaluates those programs that have drawn large public attention or that have surfaced as national and social issues.</li> <li>In some cases, assesses the implementation of major policies and examines urgent problems.</li> </ul>
Assessments of agencies by their parent ministries.	<ul style="list-style-type: none"> <li>Each ministry assesses their agencies in terms of the implementation and performance of their major programs, their organizational capacities, and citizens' satisfaction with them.</li> </ul>

Source: OGPC (2003).

GOAS is led by the Office for Government Policy Coordination (OGPC) within the Office of the Prime Minister. The OGPC performs organizational assessments and oversees other assessments with the help of the Committee for Policy Assessment (CPA). The latter is an advisory committee serving the prime minister<sup>86</sup> and has private sector experts as its members.

Below we will explain the organizational assessment, self-assessment, and assessment of specific programs in greater detail.

### 2.3.2. Organizational assessment

Organizational assessment examines ministries in terms of (i) the implementation and performance of their major operations, (ii) their organizational capacities, and (iii) citizens' satisfaction with them. Assessment of the implementation and performance of major operations is further divided into (i) assessment of major policies and (ii) indicator-based assessment of operations.

Table 10-7. Organizational assessment

Types of assessments	Main features	Frequency
Assessment of implementation and performance of major operations	● Assessment of major policies	● Biannual
	● Indicator-based assessment of operations	● Annual
Assessment of organizational capacities	● Assesses the management capacities of knowledge-base, organization and personnel, and policies.	● Annual
Assessment of citizens' satisfaction	● Assesses citizens' satisfaction with major policies, customer services, and administration.	● Annual

Source: OGPC (2003).

The most important one of these is the assessment of major policies. It is carried out over the core programs of the ministries and/or those programs that embody the major policy agenda of the government. When selecting the programs to be subjected to the assessment, the OGPC selects them at the level of bureaus. Once selected, they become part of the self-assessment programs. That is, ministries should first provide their own assessment of the programs selected by the OGPC. The OGPC then reviews these self-assessments and provide their own views with the help of the CPA. The results are reported to the prime minister in a ministerial meeting twice a year.

The criteria for assessment as suggested by the OGPC are presented in Table 10-8.

<sup>86</sup> The prime minister in Korea is appointed by the president just like the ministers and does not have a political affiliation with a particular party.

### 2.3.3. Self-assessment

Self-assessment is carried out over the central government ministries and local governments. Self-assessment of the central government ministries is implemented in much the same way as the organizational assessment, except that ministries themselves select the programs to be subjected to the assessment. Each ministry also has a Committee for Self-assessment in place, which provides assistance in making self-assessment. The criteria for self-assessment are the same as those for the organizational assessment (Table 10-8).

Table 10-8. Criteria for assessment

Aspects	Criteria	Questions
Policy formulation	Appropriateness of the policy objectives	<ul style="list-style-type: none"> <li>● Does the objective conform to the policy agenda of the government and respond to the changes in policy environment?</li> <li>● Is the objective clearly presented?</li> </ul>
	Adequacy of the implementation plans	<ul style="list-style-type: none"> <li>● Have operational targets and tools to achieve the objective been set out?</li> <li>● Have due steps (such as a survey of the public opinion) been taken in the planning process?</li> <li>● Has cooperation been sought with other ministries that have related roles in achieving the objective?</li> </ul>
Policy implementation	Efficiency in implementation	<ul style="list-style-type: none"> <li>● Is the operation being carried out on schedule?</li> <li>● Are the resources being spent efficiently?</li> </ul>
	Appropriateness of the implementation process	<ul style="list-style-type: none"> <li>● Are the changes in policy environment adequately accounted for during the implementation process?</li> <li>● Are adequate efforts being made for public relations?</li> <li>● Is a cooperation network in place with other ministries that have related roles?</li> </ul>
Performance	Achievement of the objectives	<ul style="list-style-type: none"> <li>● Have the objectives been achieved?</li> </ul>
	Effectiveness of the policy	<ul style="list-style-type: none"> <li>● Does the policy have real impacts on the public?</li> </ul>

Source: OGPC (2003).

### 2.3.4. Assessment of specific programs

In the assessment of specific programs, those programs that have drawn large public attention or that have surfaced as national and social issues are evaluated. The evaluations are carried out by the OGPC. The CPA first selects the programs to be evaluated and for each evaluation, designates one of its members as a supervisor. The supervisors then organize evaluation teams that include outside experts and the OGPC officials. Ministries in charge of the programs also participate in the evaluations. Evaluation results are reviewed by the CPA and reported to the prime minister.

Line ministries can also initiate evaluations. In this case, they need to submit their evaluation plans by mid-March to the OGPC and report the evaluation results to the prime minister.

### ***2.3.5. GOAS in a performance management framework***

GOAS has many features that can be found in a performance management framework. The OGPC (2003) requires ministries to state their policy objectives and the expected results of their programs in terms of quantifiable targets similar to those employed in performance monitoring. In addition, the assessment of specific programs corresponds to program evaluation.

But the similarity ends there. There are significant differences between GOAS and a genuine performance management framework. First, GOAS does not require ministries to set up missions and strategic and performance goals and classify their programs in a systematic way. The focus of the assessment is placed on a limited number of programs that are deemed important. No clear explanation is given on the relation between the selected programs and the overall mission and strategies of the ministry. Second, despite the OGPC's call for quantifiability, performance targets are often stated in abstract terms and lack concreteness and output- and outcome-orientations. That is, one can see what ministries are doing but not the ultimate benefits they bestow on the public. Third, enough use has not been made of the assessment of specific programs. Since 1998, only about 5 programs have been evaluated each year. The quality of evaluations is deemed low in most cases.

## **3. Developing a performance management framework**

### **3.1. Need for expanding the coverage of PMS**

Our goal should be developing PMS into a full-fledged performance management framework. That is, the coverage of PMS should be expanded to all major activities of the ministries. In addition, GOAS should be eventually incorporated into the new framework, making it possible to manage ministerial performance in a comprehensive and coherent way. In my view, there are several obstacles to these efforts.

First, there is a general misunderstanding within the MPB about the purpose of performance management. Many officials in the MPB view it only as a tool for resource allocation and disregard its role in improved decision-making by line ministries. For these officials, setting targets, measuring performance, and then reflecting the results on budget formulation is all that counts. As a result, the MPB decided to confine performance management to those programs whose performance can be easily defined and measured in numerical terms. Even then, suspicions on the practicability of performance management and worries about the constraint it can impose on the budget authorities' discretion are holding back the support for PMS within the MPB.

Second, most line ministries in Korea do not have a sound system of planning and reporting established within them. All ministries report their annual plans to the president at the start of the year, but they are usually 20-30 pages long and contain main policy directions only. Some ministries sporadically publish 5-year or longer-term plans, but these plans mostly lack a close examination of resource availability in the future. They stop at expressing the hopes and expectations of the ministries.

As discussed previously, performance management can have the greatest impact when it is accepted and utilized in the decision-making process of line ministries and when it is part of their planning and reporting process. That is, a system of planning

and reporting is a precondition for good performance management. When it is not well established in line ministries, and when they do not feel the need for such a system, it is difficult to instill a performance-orientation in them.

Moreover, when the primary use of performance management as envisaged by the budget authorities lies in linking performance and budgeting, line ministries will take it as another source of external interference in ministerial affairs and resist its introduction.

Third, the diverse system of performance management as explained in the previous section poses another obstacle to transitioning toward a new framework. PMS, GOAS, MBO, and performance audits are likely to overlap each other and be a source of turf-wars between the sponsoring agencies. To avoid this possibility, the MPB openly announced that it will differentiate PMS from other forms of performance management by focusing on the programs with large expenditures and measurable performances.

But the current fragmented efforts by various central agencies are only second-best to a consolidated drive toward a comprehensive and coherent framework for performance management. Such fragmentation can increase confusion in line ministries, overburden them with paperwork, and generate skepticism. It should therefore be minimized in coming years.

## **3.2. Major issues in developing a performance management framework**

### ***3.2.1. Avoiding a direct linkage between performance and budgeting***

As repeatedly stressed above, we should avoid directly linking performance to budgeting. Performance data obtained in performance monitoring and evaluation can and should be utilized as one source of information for budget decisions. But it is neither desirable nor possible to set up a one-to-one relationship between performance and resource allocation for most programs. The MPB should be aware of this fact. Otherwise, performance management will be forever stuck in the current approach that focuses on those programs whose performance can be easily defined and measured in numerical terms.

In this regard, it is worth noting that the performance budget as currently prepared in the U.S federal government does not aim for a direct linkage between performance and budgeting. Similarly, no direct linkage is being pursued in the U.K and Australia, which represent another group of countries that have systematically introduced a performance management framework in their government.

### ***3.2.2. Establishing a sound system of planning and reporting in line ministries***

As discussed above, a system of planning and reporting is a precondition for good performance management. A first step to help build the system is requiring line ministries to prepare annual business plans and performance reports. The business plan would describe in detail the mission, the strategic and performance goals, the activities to attain the goals, and the associated resources. The performance report would review the performance results and discuss the future course of actions.

Table 10-9. Documents required in GPRA

Documents	Requirements
Strategic plan	<ul style="list-style-type: none"> <li>● Should cover not less than 5 years, and should be updated at least 3 years.</li> <li>● Must contain:               <ul style="list-style-type: none"> <li>- A comprehensive mission statement for major functions and operations of the agency;</li> <li>- General and outcome-related goals;</li> <li>- A description of how the agency will achieve the goals and the operational process and resources required;</li> <li>- A description of how the goals relate to annual performance plan goals;</li> <li>- An identification of key factors external to, and beyond the control of, the agency that could significantly affect the achievement of goals; and</li> <li>- A description of program evaluations, with a schedule for future program evaluations.</li> </ul> </li> </ul>
Performance plan	<ul style="list-style-type: none"> <li>● Should cover each program activity in the agency's budget.</li> <li>● Must:               <ul style="list-style-type: none"> <li>- Establish goals that define the level of performance to be achieved by a program activity;</li> <li>- Express goals in an objective, quantifiable, and measurable form unless an alternative form is approved by OMB;</li> <li>- Describe the operational processes and resources required to achieve goals;</li> <li>- Establish performance indicators to be used in measuring or assessing the relevant outputs, service levels, and outcomes of each program activity;</li> <li>- Provide a basis for comparing actual results with the established goals; and</li> <li>- Describe the means to be used to verify and validate measured values.</li> </ul> </li> </ul>
Performance reports	<ul style="list-style-type: none"> <li>● Should include actual program performance results for the 3 preceding fiscal years.</li> <li>● Must;               <ul style="list-style-type: none"> <li>- Review how successfully performance goals were achieved;</li> <li>- Evaluate the performance for the current year relative to the performance goals achieved during the fiscal year(s) covered by the reports;</li> <li>- Where goals are not met, explain and describe (a) why the goals were not met, (b) plans and schedules for achieving the goals, and (c) if the goals are impractical or infeasible, why that is the case and what action is recommended;</li> <li>- Describe the use and assess the effectiveness in achieving performance goals of any waiver under 31 U.S.C section 9703; and</li> <li>- Include the summary findings of program evaluation completed during the fiscal year.</li> </ul> </li> </ul>

Source: GAO (1998).

In the U.S, federal agencies should prepare strategic plans, performance plans, and performance reports under GPRA (Table 10-9). In Korea, line ministries are expected to prepare performance plans and reports under PMS. More detailed requirements like those in GPRA would help enriching the plans and reports. The MPB can also compare



them across different ministries and propose best practices. It can also rate their quality and publish the result on a web-site. Of course, line ministries should be given the freedom to determine the document formats and encouraged to experiment with different modes of presentation as long as they satisfy basic requirements.

A second step to build a system of planning and budget is introducing a medium-term expenditure framework. The reason for the weak planning capacity in many line ministries can be traced back to the uncertainty surrounding the amount of available resources in coming years. It is very difficult and often meaningless to plan for the future when uncertainty is large. I believe this explains why most ministries currently live from hand to mouth, without a serious effort to prepare a realistic long-term plan and design their annual operations within this plan. A medium-term expenditure framework will certainly be of much help in this regard.

Third, when reviewing the budget requests from line ministries, the MPB should pay attention not only to the outputs and outcomes of individual programs but also to their design and implementation process. This point is illustrated in the Program Assessment Rating Tool (PART) as employed in the U.S federal government. The PART purports to provide a consistent approach to rating programs. It consists of approximately 30 questions, which are divided into four sections (OMB, 2003). The first three sections address program purpose, strategic planning, and management, respectively. The fourth hones in on results and asks whether performance can be demonstrated. Thus a substantial part of the PART questions deal with the issues of program design and implementation under the premise that a good performance cannot follow from a poor design and/or implementation.

### ***3.2.3. Consolidating the diverse systems of performance management***

As noted above, PMS and GOAS should eventually be merged into a new framework for performance management. MBO should also be subsumed under the new framework. For this purpose, once a system of planning and reporting is established, all documents required under different systems should be consolidated into the performance plans and reports, greatly reducing the workload for line ministries.

But the question still remains who will take charge in leading this effort; *i.e.*, who will review the plans and reports of individual ministries, discipline the laggards, and coordinate the whole process. At face value, the OGPC has these responsibilities within the government. But with only limited manpower and without strong leverage against line ministries, the OGPC is not in a position to pursue this effort without help from the MPB. On the other hand, the MPB's role is confined to budgetary matters within the government, and many believe that pursuing a government-wide administrative reform is beyond its ambit.

Therefore a close cooperation between the OGPC and the MPB looks essential, with the OGPC taking the lead and the MPB providing logistics. In particular, officials in the MPB should remember that a performance management framework was initiated and led by the ministry of finance in most countries. In these countries ministry of finance, with the best talent within the bureaucracy, had the capacity to perceive the necessity for change and to carry out the government-wide reforms.

### ***3.2.4. Emphasis on program evaluation***

There appears to be increasing awareness among many countries that performance monitoring and evaluation can provide different types of complementary information (Perrin, 2002). An effective performance management system, in particular one that can provide a focus on outcomes, requires both monitoring and evaluation.

Data obtained through monitoring is rarely sufficient to get at outcomes, and used alone, is not capable of identifying attribution or causality (*e.g.* to what extent can one say that a program activity is directly responsible or not for the given results?). Monitoring information often can best be used to direct management attention and to raise questions that should be explored in greater depth through evaluation.

Evaluation has the potential to identify what actually has happened as a result of a program or initiative, whether planned or not, including unintended outcomes and effects that often may be more significant than the stated objectives. In particular, evaluation has the potential to identify why and how outcomes have come about. This is essential information in order to be able to attribute effects to program activities. It is also critical information in order to make decisions about future policies and programs, to assist in program improvement, and to be able to generalize what has happened from a single setting to elsewhere.

In a country like Korea which has little experience in evaluation, a formal strategy to introduce the evaluation practice seems desirable. The Australian Ministry of Finance, for example, imposed the following four requirements on line ministries (Mackay, 2003):

- Every program should be evaluated every 3-5 years.
- Each portfolio (*i.e.*, comprising a line ministry plus other agencies) should prepare an annual portfolio evaluation plan, with a 3-5 year forward coverage, and submit it to the Department of Finance – these plans comprise major program evaluations with substantial resource or policy implications.
- Ministers' new policy proposals should include a statement of proposed arrangements for future evaluations; and
- Completed evaluation reports should normally be published, unless there exist important policy sensitivity, national security, or commercial-in-confidence considerations, and the budget documents which ministries table in parliament each year should also report major devaluation findings.

This strategy had significant influence in spreading the evaluation practice among line ministries in subsequent years. The MPB should consider adopting a similar strategy. In addition, attention should be paid to the accumulation of data, which is essential for good evaluation. As illustrated at the beginning of this paper, almost all sectors are in dire need of basic data. In particular, an income panel data set, none of which exists at the present, would provide a valuable basis to assess the various welfare programs that have been expanding rapidly in recent years.

### **3.2.5. Restructuring budget accounts**

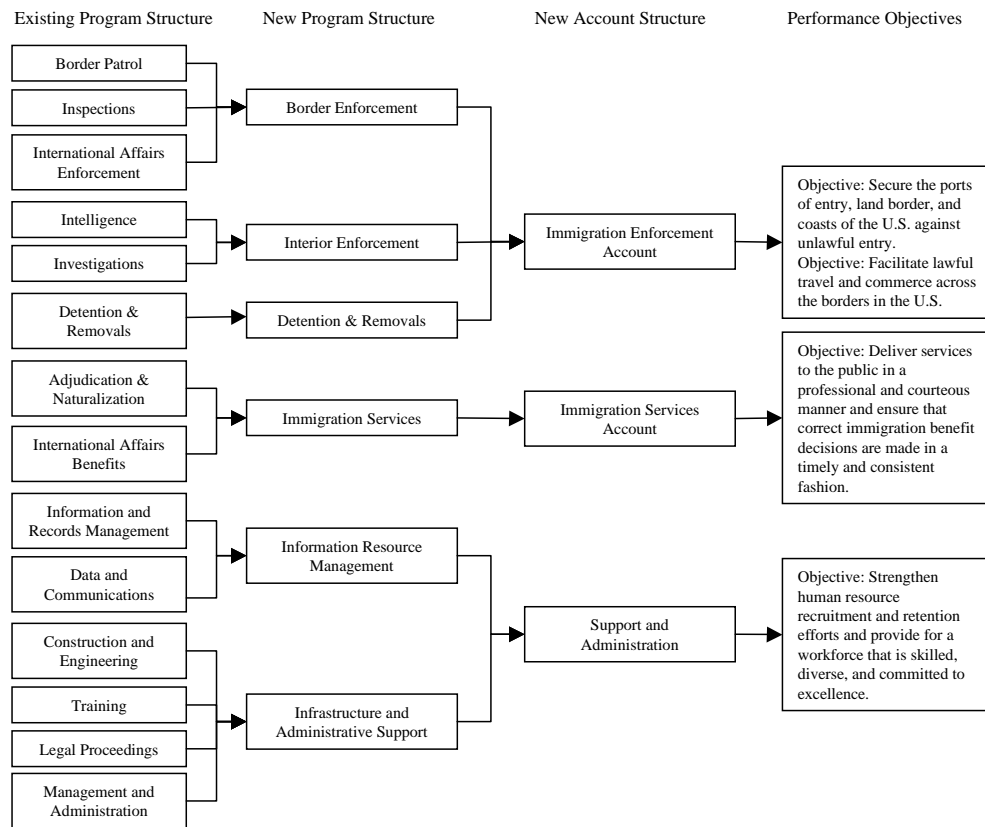
Under PMS, line ministries are asked to reclassify their programs following the structure of strategic and performance goals. This requires in many cases aggregation, disaggregation, or consolidation of existing accounts. The restructuring should continue in the future as PMS expands its coverage over all activities of line ministries. The primary responsibility for restructuring as well as for developing strategic and performance goals would lie with line ministries themselves. Of course, they should consult the MPB and parliamentary committees and get their approval when necessary.

A closely related issue is the allocation of overhead costs across programs. Ideally, program costs should reflect not only the direct costs of running the program but also the indirect costs associated with central services such as payroll management and ministry-wide IT investment. This will facilitate the comparison of costs between programs. But this task can encounter serious practical difficulty and impose undue

burden on line ministries. It should therefore proceed to the extent that it is feasible and meaningful.

Figure 10-4 illustrates how the Immigration and Naturalization Service (INS) of the U.S government realigned its programs and accounts to link them to performance goals. In the new account structure, the support and administration account is temporary, capturing the overhead and support costs that could not be easily spread in 2003 (the first years of restructuring). INS spread these costs in the 2004 budget.

Figure 10-4. Restructuring of accounts in INS



Source: OMB (2002).

### 3.2.6. Introducing accrual accounting in budgeting

At a later stage, we should also consider introducing accrual accounting in budgeting. The restructured budget accounts mentioned above will enable us to better assess and compare the performance and costs of individual programs. However, as long as the programs are costed on a historic, rather than economic, basis, the

information on costs has limited value. The accrual accounting would reveal the true economic costs of the programs.

Here again a pragmatic approach is needed, focusing our efforts on those areas that make significant differences in costing. For example, the U.S government has introduced accrual accounting in federal credit programs – direct loans and loan guarantees – in 1990. Currently, efforts are being made to extend it to three additional areas; government employees’ pension programs, the removal of hazardous materials, and capital assets. According to OMB (2002),

- Pensions and retiree health benefits are earned as Federal employees work; they are paid much later, after the employees retire. The legislation transmitted [to the congress] would require program and other employer accounts to pay the employer share of the accruing costs of these benefits to retiree benefit accounts. These accounts would pay the benefits when they come due.
- Similarly, programs that generate hazardous substances would be required to pay the accruing cost to clean up contaminated assets at the end their useful life. These payments would go to funds responsible for the cleanup.
- In contrast, capital assets are bought before they are used. In this case, an agency Capital Acquisition Fund (CAF) would be created. Following good budget practice, the CAF would request budget authority (BA) up front to acquire assets that are included in the budget, and outlays would be recorded when payment is made. However, this BA would be in the form of borrowing from Treasury authority. The CAF would then borrow for the period of the asset’s useful life; collect annual capital user charges in proportion to asset use, and make the mortgage payments to Treasury.

Other countries have already introduced accounting in budgeting in full scale; examples include the Resource Accounting and Budgeting in the U.K and the Outputs and Outcomes Framework in Australia.

### ***3.2.7. Greater use of performance agreements***

When a performance-orientation has been reasonably established in the government, a greater use of performance agreements can be encouraged. A minister and staff members would agree on a set of performance targets, review the progress, and discuss problems. Similar practices can be introduced between managers at all levels and their staff and between ministries and their agencies.

Under the current system in Korea, performance cannot significantly influence the annual salaries of individual employees. Salaries are determined in most part by the years of service and rank of the individual. But performance agreements do not require performance-based monetary rewards to be effective. As discussed earlier, they provide for “relational contracts” and help enhance performance by spurring the parties to the contract to focus on results.

But it should be remembered that the introduction of performance agreements should be preceded by establishing a reasonably working performance management framework. Otherwise, they can generate rancor and lower the morale among the employees. It is important to build trust in the public sector in general and in the performance management system in particular before utilizing performance information for accountability purposes.

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## Performance Management in the Health Sector

by

*Heesuk Yun, Korea Development Institute*

### 1. Need for performance evaluation in the health field

Most public interventions in the healthcare field intend to increase access to medical care or provide better treatment for patients, and usually result in increased expenditures. In Korea, the Ministry of Health and Welfare's budget accounted for 7.38 percent of the gross national product in 2003 up from 3.82 percent in 1995. Also, total expenditure for public health shows a steeper increase over the same period. The budget size for public health and medical care, and medical security increased from 1.3 trillion won to 5.2 trillion won, an increase of nearly 300 percent (Ministry of Health and Welfare, 2003).

In the case of the United States, unprecedented growth in social and health programs for the disadvantaged began during the Lyndon Johnson presidency in 1964, when Medicare, Medicaid, and other health care programs were launched, and the Congress mandated and funded performance evaluations. Considering this, it is natural that there is increasing awareness for cost containment and cost-effectiveness in the health field in Korea nowadays.

Further, Korea is becoming a more advanced country in terms of public healthcare. Last year the secretary of Ministry of Health and Welfare declared the 'War against Cancer,' which suggests that the targets of public health actions have now expanded beyond infectious diseases to include chronic diseases. This is a common trend indicating a certain degree of development in public health. As shown in the experiences of more advanced countries, the area of public health actions will keep expanding into violence, emerging pathogens, and the social contexts that influence health disparities. With the continuing rise in healthcare costs expected to coincide with this trend, attempts to investigate new proposals for various public interventions will be needed while examining ongoing interventions carefully for more effective management of public health care.

In practice, in advanced countries, large expenditures generally increase the importance of accountability of public and private resources invested in health programs and medical services, and the parliament is concerned about holding programs accountable for the funds. Also, citizens, employers, the government, and other purchasers of health services are concerned with clinical and fiscal accountability, or evidence that healthcare actions deliver effective and quality services in an efficient manner. Pressure of cost containment is being strengthened in Korea as well. The Ministry of Health and Welfare, faced with rising costs, is already considering abandoning the traditional Fee For Service (FFS) payment system and expanding Diagnosis Related Groups (DRG) to a wider set of treatments.

Increasing emphasis on prevention is another factor stimulating interest in performance evaluation in the health field. Many people and health professionals

believe that prevention may be a better alternative to a cure. As a society enters into a more developed stage, more preventive programs and technologies emerge to improve the nation's health. Immunizations to prevent disease, mammography screening to detect breast cancer, and campaigns promoting smoking cessation are such. However, since the potential efficacy of preventive care is hard to prove with certainty, the need for rigorous evaluation will increase in the near future in Korea.

Against this background, this paper attempts to summarize the essential elements and special characteristics of performance evaluation in the health field in relation to a general evaluation framework. Also, emphasizing the need to build an infrastructure for evaluating health interventions, the paper introduces the U.S. experience of devising indicators for measuring health performance. In doing so, standards for effective evaluation of health interventions will be briefly reviewed, and implications for establishing a performance evaluation in the health field in Korea will be extracted.

## **2. Types of performance evaluation in the health field**

Any organized public health action can be subject to a performance evaluation. Public health actions include direct service interventions, community mobilization efforts, research initiatives, surveillance systems, policy development activities, outbreak investigations, laboratory diagnostics, communication campaigns, infrastructure-building projects, training and educational services, and administrative systems. For convenience, these can be divided into three categories; the evaluation of health programs, the evaluation of the health care system, the evaluation of health services (Grembowski, 2001).

### **2.1. Evaluation of health programs**

This type of evaluation targets programs created to reduce or eliminate a health problem or achieve a specific objective. Comprehensive inventory of the categories of health programs that can be implemented to achieve specific health objectives is the subject of evaluation. Examples include exercise programs created to increase physical activity and prenatal care programs to prevent medical complications associated with low birth weight.

### **2.2. Evaluation of the health care system**

This evaluates the performance of the health care system. A health care system has a structure defined by laws and regulations, and has as its components personnel, facilities, organization, and financing. The characteristics of the population that the system serves and the physical, social, and economic environment where they live are also included in the structure components. The structure of the system influences the process or delivery of health services, which in turn produces outcomes. The system performance evaluation typically examines the influence of the structure and structure components on the outcomes. For example, if whether the patients' payment method to primary care physicians has any influence on patients' utilization of health services.



### 2.3. Evaluation of health services

This examines the efficiency and effectiveness of specific health services provided to patients in the system. Evaluation is focused on the measurement of benefits, health outcomes, or a specific health service associated with particular medical technology compared to the costs of producing them. Technologies that produce large benefits at low costs have greater worth than technologies that offer few benefits at high costs.

### 3. Objectives of public health intervention

Most interventions in the health field have multiple objectives, and the objectives consist of a mix of different dimensions such as time, place, method and generality. This multiplicity of objectives is often a source of unproductive disagreement among evaluators. Confusion about objectives could be eliminated by recognizing that these objectives can be classified in a number of ways, and the most common way is ordering objectives by generality (Suchman, 1967).

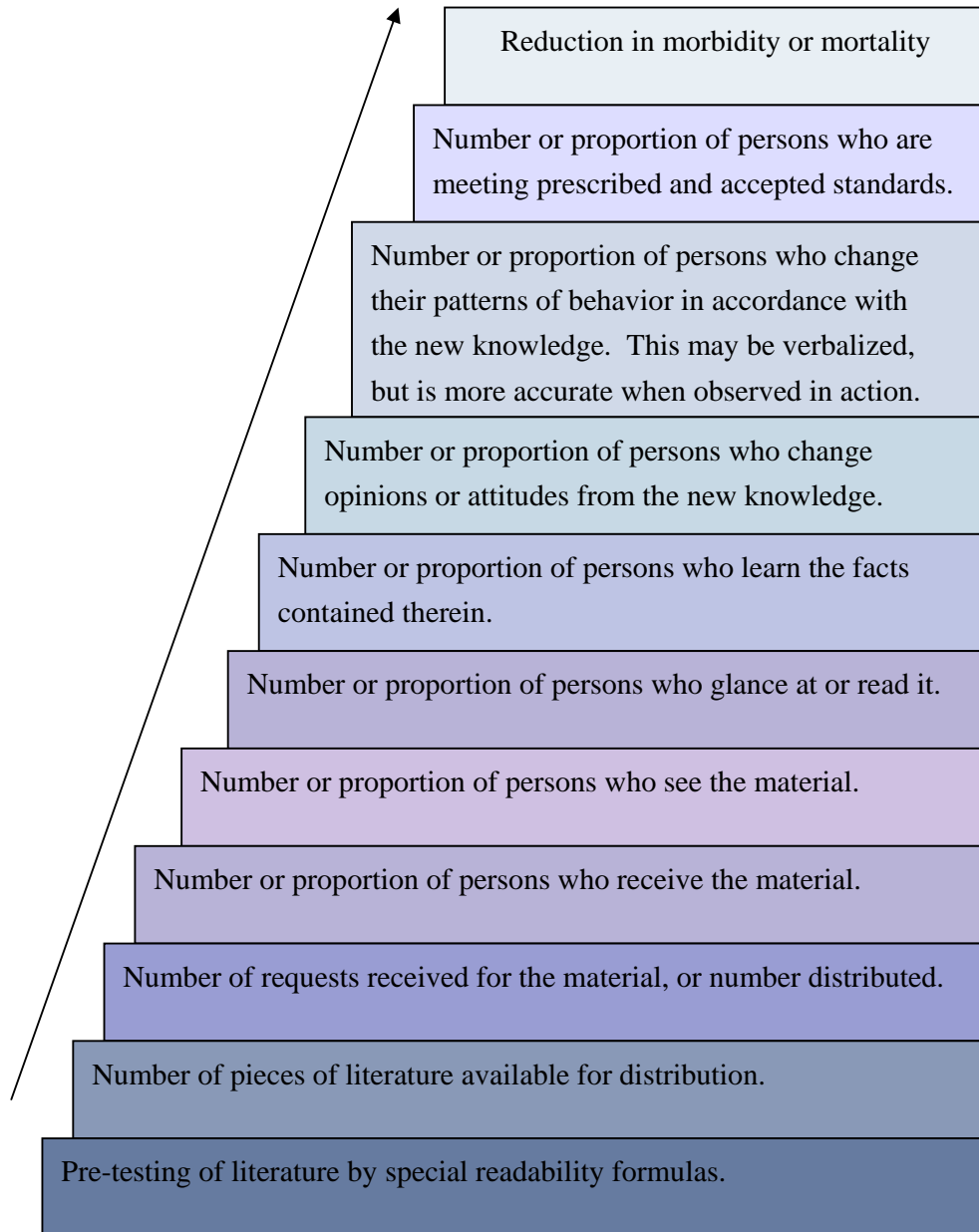
In this case, objectives may range from the most general such as reducing mortality to the very specific such as reading a health pamphlet. Furthermore, objectives and sub-objectives can be hypothesized corresponding to the various steps or actions that make up a program. While these are a continuous series of events, dividing them into a hierarchy of sub-goals is essential for evaluation purposes, each of which may be the result of successfully achieving the preceding goal, and a precondition to the next higher goal. Figure 11-1 illustrates a cumulative chain of objectives progressing from the most immediate practical objectives toward the ultimate ideal goal in a step-wise chart with different levels of evaluation for health educational literature.

After determining the degree to which an objective has been achieved, this finding becomes a step toward achieving the next higher objective.

This logic is based on the assumption that mortality will eventually be affected if a chain of prior accomplishments is fulfilled. In terms of the ultimate objective, this kind of evaluation assumes that the literature will reach a large proportion of the population for whom it was intended and be read, which in turn will have some effect in motivating the reader to go through the recommended procedures, and hence, reduce mortality as a result of it.

An assumption must be made whenever one moves from a higher-order objective to a lower one. Thus, every lower-level objective must assume all of the assumptions made for all of the objectives above it. Any program based on a false set of assumptions cannot be justified, even if sound evaluations are completed for each of the other objectives individually. In order to perform a successful evaluation, one needs to prove the intervening assumptions through research.

Figure 11-1. Chain of objectives in the health field



Source: Suchman (1967).

## 4. Special characteristics of performance evaluation in the health field

Performance evaluation in every field follows general steps. First, questions calling for the evaluations, which are often too general and vague, need to be transformed into questions which are precise enough to be measured and evaluated. This is followed by evaluation designing, analysis with credible evidence and presenting conclusions, and lastly, sharing lessons and ensuring use.

Keeping in mind this commonality, however, particularity of evaluation in the health field should also be emphasized, which brings special features in each step of the evaluation process.

### 4.1. Scientific rigor required

Since the beginning of modern medicine, rigorous scientific inquiry has been the most important factor that characterizes the adoption of new procedures and practices in the health field. This in turn characterizes performance evaluation in the area of health in a way that all causal links, explicit or implicit, in the intervention logic should be certified with scientific rigor.

Intervention logic is a hypothesis on the sequence of events for bringing about change by synthesizing the main program elements into a picture of how the program is supposed to work. As a conceptual link from a program's inputs, or resources devoted to it, to its output, and to the achievement of results and outcome, intervention logic summarizes the program's overall mechanism of change by linking processes to eventual effects (CDC, 1999). Elements in a logic generally include inputs (e.g., trained staff), activities (e.g., identification of cases), outputs (e.g., persons completing treatment), and results ranging from immediate (e.g., curing affected persons) to intermediate (e.g., reduction in tuberculosis rate) to long-term effects (e.g., improvement of population health status).

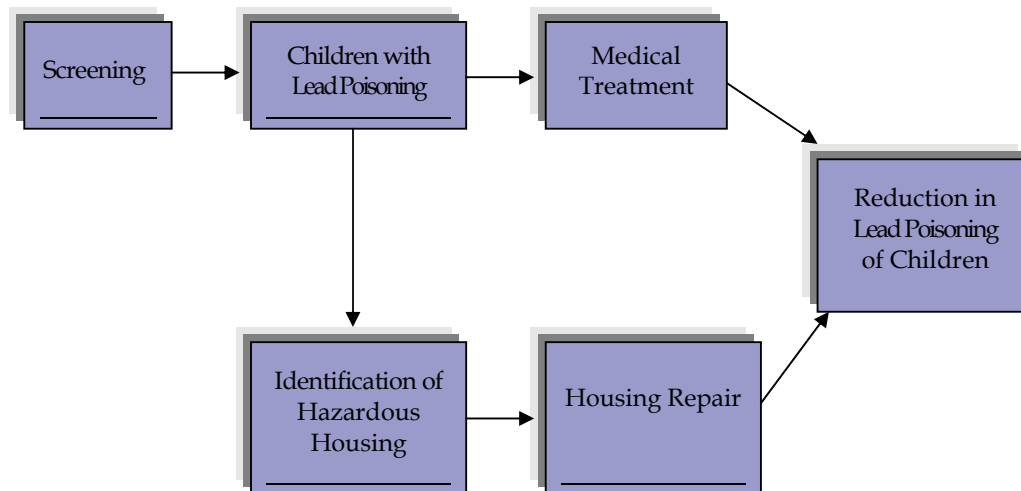
A main purpose of evaluation is to assess effects, and intervention logic, an explanation of what the public action is supposed to achieve and how it is supposed to achieve it, is the basis of the assessment. Since there are usually causal assumptions hidden beneath the surface relating to how the program is supposed to generate its supposed effects, and the state of the external environment such as other policy interventions and other external factors, the logic needs to be investigated carefully. In other words, the main job of the evaluator is to examine the relationship between activities of interest and observed consequences. This can be accomplished by identifying and critically assessing these hidden assumptions concerning conditions for the intervention to be effective. In the health field, intervention logic often involves scientific theory in laboratory diagnosis of disease or pharmaceutical knowledge, which makes it more complicated to identify the hidden assumptions and to investigate their uncertainties. Inevitably, scientific specialty is heavily involved.

A noticeable example is the growing interest in preventive care. While advocates of preventive care assert that diagnosing and treating illness at an early stage can save a significant amount of money and successfully restore the patient to good health, the efficacy of preventive care is difficult to prove. It requires conceptualization of those specific conditions and socioeconomic characteristics of patients for whom preventive care might have some impact. For example, little is known about the circumstances under which various screening programs, such as Pap smears to detect cervical cancer, are effective.

Figure 11-2 shows an example of a community-based program to reduce lead poisoning among children living in low-income, dilapidated housing areas in New York City in 1970. The lead poisoning problem mostly affected young children who ate paint chips based with lead that peeled from house walls. In order to reduce children's exposure to lead-based paint, the city started a program to screen 120,000 children for lead poisoning. If the lead level in a child's blood was high, the child's apartment was inspected, and if evidence of lead exposure was detected, wallboards were erected to prevent further exposure. The intervention logic illustrated in Figure 11-2 assumes the housing repairs would have direct influence in reducing lead poisoning among children.

The result was that the incidence of lead poisoning decreased by 80% in 3 years. However, it was not the installation of wallboards that caused the decrease of incidences. Instead, due to the wide-scale screening and publicity about the program, parents monitored their children's behavior more diligently, preventing them from eating paint chips. This example shows that a causal assumption in the intervention logic, which is that children's exposure to lead paint would be reduced by house repairs, had missed important links. In this case, the program worked as intended but not because of the reasons specified in its intervention logic. It might have had a better result if the resources allocated for housing repairs had been invested differently such as in expanding the number of houses being screened and campaign on children being exposed to lead poisoning.

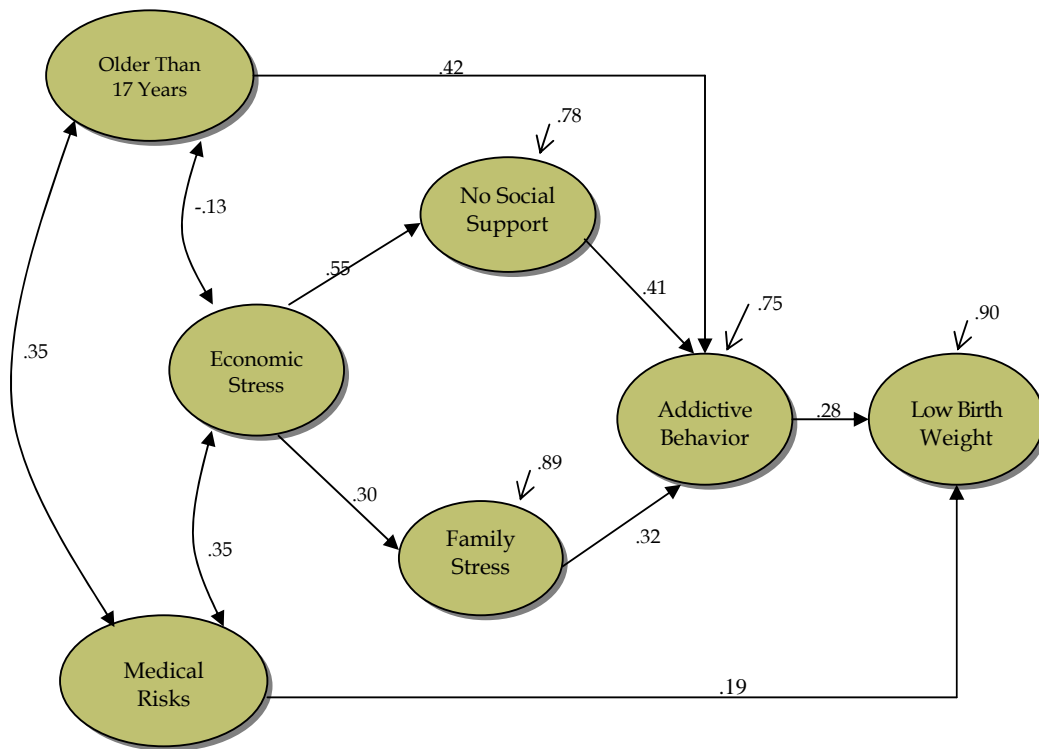
Figure 11-2. Lead poisoning program



Source: Grembowski (2001).

Figure 11-3 shows an example of a smoking cessation program to reduce low birth weight among low-income, pregnant women. Sheehan (1998) examined the association between stress, addictive behaviors, and low birth weight among 5,295 low-income, inner-city women in Hartford, Connecticut. The arrows in Figure 11-3 indicate direct and indirect relationships between various factors and low birth weight. Addictive behaviors such as smoking and alcohol consumption have direct effect on low birth weight in the causal relationships. If a pregnant woman smokes or drinks alcohol more, the child's birth weight would be lowered. The standardized regression coefficients indicate the size of the change in low birth weight produced by a standardized change in various factors. Economic stress has direct effects on family stress and social support, and family stress and social support, in turn, have direct effects on addictive behavior. Hence, the three stress variables have indirect effects on low birth weight through their direct effects on smoking and drinking behavior.

Figure 11-3. Smoking and low birth weight



Source: Sheehan, "Stress on Low Birth Weight," reproduced from Grembowski (2001).

This causal relationship has some implications about the program's expected outcome. First, the program alone is likely to reduce but will not eliminate the low birth weight problem. In the cause and effect structure, 90 percent of the variation in low birth weight is not explained by the variables in the structure. Also, the figure indicates that both medical risks and addictive behavior have direct effects on low birth weight. Thus, because the unexplained variance is large and other risk factors exist beyond the program's control, the program will at most reduce the low birth weight problem.

The size of reduction can also be projected. It is suggested that the program's indirect effect on low birth weight will be smaller than 0.28. If the program reduces smoking by 0.25, then the program's indirect effect on low birth weight would be  $0.25 \times 0.28 = 0.07$ .

Second, the causal relationship in the figure also suggests that the program's performance would be increased if the program was modified. As shown, because stress has a direct effect on addiction and indirect effects on low birth weight, the program would perform better if it also includes a part for stress reduction.

This is an example showing that scientific and statistical reasoning offers an understanding of how the program is supposed to work, and how efficient the program will be in achieving its objectives. Evaluation research in the health field is normally based on theory from laboratory experiments, economic as reasoning and statistical projection, and it should be constantly adjusted with scientific rigor whenever new information about the evaluation logic is added to the information set or the contextual situation is changed.

#### **4.2. Contextual complexity**

In most cases, health programs lie in complicated contexts including historical and geographical settings, political, social, and economic conditions, and influences of related or competing organizations. The most important are the socio-economic conditions. The evaluator should consider the needs of the target population and the particular problems which the program is designed to address. It is difficult to identify what effects are genuinely caused by a program and to separate these effects from other influences on the socio-economic problems. Hence, the evaluator needs to understand these intertwined factors in order to design a context-sensitive evaluation, to interpret findings accurately, and to assess the generalizability of the findings.

It should also be noted that because health programs are often created to reduce health disparities across socio-economic groups, evaluators also must consider political aspects among various income groups and politicians, and interest groups surrounding a health care program (Shortell, 1978). Since politics is about how we attach values to policy issues, politics and values are inseparable from the evaluation of health programs in nature. Consequently, evaluations are always conducted in a political context where a variety of interest groups compete in their own interests.

## **5. Methods of performance evaluation for health care intervention**

### **5.1. Estimating counterfactual situation**

When we say that certain effects were produced or caused by an intervention, this means that if the intervention had not taken place or had taken place in a different degree, those effects would not have occurred, or would not have occurred in the same degree. Simply put, evaluations are carried out to determine what would have happened without the intervention. This is called the counterfactual situation (European Commission, 1997), and ideally, deriving the counterfactual situation with certainty is desired.

Evaluation would be easy when comparing two groups that are identical in every respect except that one group is exposed to the intervention while the other group is not. In the real world, however, this is not the case since we can never find two groups that are identical in every respect except for being exposed to a program. The non-equivalence of the two groups means that the counterfactual situation has to be estimated rather than derived, and this emphasizes the importance of evaluation design's scientific accuracy and data credibility.

The methods for evaluation design are drawn from social, behavioral, statistical and health sciences. Design types include experimental, quasi-experimental, and observational designs, and according to the specific evaluation case, the best fitting design should be selected to provide the appropriate information to address the case specific questions (Fink, 1993). Experimental designs use random assignment to compare the effect of an intervention with otherwise equivalent groups. Quasi-experimental methods compare nonequivalent groups (e.g., health program participants with those on a waiting list) or use multiple waves of data to set up a comparison. Observational methods use comparisons within a group to explain unique features of its members (CDC, 1999). The choice of design has implications for what will count as evidence, how that evidence will be gathered, and what kind of claims can be made. In particular, health problems are usually entangled with other living conditions or other health problems where the origin of the cause is hard to trace. Hence, special attention must be given when selecting a design. At the same time, data availability has enormous importance in performing evaluation in all types of design.

### **5.2. Customizing tools for evaluation**

Though it is true that more rigorous methodological tools and designs focusing on the impact or outcome of evaluations are essential parts to ensuring the quality of healthcare evaluation research, what is more pressing is the need to understand specific program components and the process by which they are implemented since every health program has its special features due to scientific hypotheses or the contextual particularity in which it lies. The interdependency of the health program with other political and environmental factors stated above should also be considered carefully.

For this reason, the observed golden rule is that there is no single evaluation methodology which is universally applicable for the entire health field. Instead, the choice of method should be determined by the particular evaluation problems at hand. Actually, arbitrary choice of method at the beginning without careful examination of the case often results in a poor evaluation. The evaluation methodology should be carefully chosen after examining the targeted health evaluation case, and more importantly, should be customized and modified to reflect the particularity of the case.

Also, if a program's activities are aligned with those of other programs operating in the same setting, or with change of social, economic conditions, certain effects cannot be attributed solely to one program or another. In this case, the goal of the evaluation is to gather credible evidence that describes each program's contribution in the combined change effort.

## **6. Prerequisites for starting-up performance evaluation in the health field: evaluation infrastructure**

### **6.1. Construction of representative frameworks for evaluating public healthcare intervention**

Although it was previously emphasized that each evaluation uses a different and customized methodology for the targeted program, it should also be highlighted that there exists a strong need for a recommended general framework for health field evaluation that is both a synthesis of existing evaluation practices and a standard for further improvement.

The existence of a standardized framework supports a practical approach to evaluation that is based on steps and standards applicable in public health settings. Because the framework is purposefully general, it provides a guide for designing and conducting specific evaluation projects across many different areas of public health intervention. In addition, the framework can be used as a template to create or enhance program-specific evaluation guidelines that further operationalize the steps and standards in ways that are appropriate for each program (CDC, 1999).

By integrating the principles of the general framework into all program operations, it is possible to stimulate innovation toward the improvement of outcomes and better detection of program effects. Consequently, detecting these effects in a more efficient and timely manner will enhance the evaluator's ability to translate findings into practice. Furthermore, guided by the steps and standards in the framework, a basic approach to program planning will also evolve, and integrated information systems will support a more systematic measurement. Also, lessons learned from evaluations can be used more effectively to guide changes in public health strategies.

It should be noted that the standard framework should be considered as a practical, non-prescriptive tool for individual evaluation work; in that it only acts as a guide for public health professionals in their use of program evaluation. However, designed to summarize and organize essential elements of program evaluation, the framework comprises steps in program evaluation practices and standards for effective program evaluation. Adhering to the steps and standards of this framework will allow a better understanding of each program's context and will improve the way program evaluations are conceived and conducted.

It is also worth noting that the general framework can encourage evaluation research to be integrated with routine program operations. Because performance evaluation is in nature a case-specific analysis, it is not easy to practice it consistently across program areas, or sufficiently integrate it into the day-to-day management of most public health interventions. Hence, there needs to be a standard framework that offers operating principles for guiding public health activities.

These principles of evaluation work as guidelines to improve how public health activities are planned and managed. It would be possible to ensure that new and existing programs follow these principles by requiring each program to conduct routine, practical evaluations that provide information for management and improve



program effectiveness. In that way, public health professionals will recognize that the basic steps of the evaluation's framework are parts of their routine work. In day-to-day public health practice, program goals are defined; core questions are stated; data are collected, analyzed, and interpreted; judgments are formed; and lessons are shared.

## 6.2. Constructing indicators for major healthcare evaluation types

Evaluation is about revealing the value of a program. This involves making value judgements on the degree to which a program's performance has been good or bad, so predetermined and transparent indicators are needed to ensure that value judgements do not become arbitrary. For this purpose, a prerequisite for evaluation research is to set up a system of criteria by which to measure the observed effects of a program and the benchmarks on the proper function or success of a program. However, setting the system of indicators may be difficult for a number of reasons. For one, objectives can sometimes be expressed in very vague terms, and a single program may have multiple objectives, either in terms of results of outcomes, some of which may carry relatively more weight, or even be incompatible with others. Also, objectives may also evolve over time, as the program's environment evolves. Furthermore, indicators should ideally allow evaluators to compare the performance with other policy instruments in the same field of action because even if a program falls short of achieving its objectives, its performance may not necessarily be unsatisfactory.

In the health field, where intervention logic is grounded on scientific knowledge and all the political, social, and economic interests, indicators should function as the guiding rules that pertain to the evaluation's focus and questions. The role of indicators should translate general concepts regarding the health program, its context, and its expected effects into specific measures that can be interpreted, while providing a basis for collecting evidence that is valid and reliable for the evaluation's intended uses. For this reason, setting up a system of indicators in the area of health is more complicated than in other fields, because indicators need to present even the puzzling aspects of the laboratory hypothesis in a meaningful form for monitoring.

Indicators include measures of the program's capacity to deliver services, the participation rate, levels of client satisfaction, the efficiency of resource use, and the amount of intervention exposure. Also included are outcome measures such as changes in participant behavior, community norms, policies or practices, health status, quality of life, and the settings or environment around the program. Furthermore, multiple indicators are needed for tracking the implementation and effects of a program.

Developing multiple indicators should be based on intervention logic, and in this sense, intervention logic can be used as a template to define indicators leading from program activities to expected effects. For each step of the model, qualitative and quantitative indicators could be developed to suit the concept in question, linking assumption, the information available, and the planned usage of data. Relating indicators to intervention logic also allows detection of small changes in performance faster than when relying on a single outcome as the only performance measure. In addition, lines of responsibility and accountability are clarified in this approach as the measures are aligned with each step of the program strategy. Consequently, combining intervention logic and indicators results in a set of measures that detect the consequences of intermediate effects on health outcomes of the program.

Even during evaluation, indicators might be modified or new indicators can be adopted. According to changes in the environment or context, indicators need to adjust. It should also be noted that measuring performance by tracking indicators is

only part of an evaluation and must not be the only basis for judging whether an intervention is a success or failure. Serious problems can result from using performance indicators as a substitute for the entire evaluation process and reaching final conclusions. For example, an indicator such as a rising rate of disease might be assumed to reflect a failing program when, in reality, the indicator is influenced by changing conditions that are beyond the program's control.

### **6.3. Preparing data sources**

When an indicator is proposed for use in performance monitoring, appropriate data must be available to support its use. Ideally, data would be collected from the specific population of interest, within the relevant time frame, using valid, reliable, and responsive measures. However, collecting data is expensive work, and realistically, efforts to expand data collection can reduce the resources available for programs. As a result, performance evaluations often have to rely on data collected for other purposes, so evaluators must understand limitations on the applicability of the data. Whether or not specific populations of interest are included in samples from which data are drawn and whether data are collected sufficiently often, or are made available soon enough, need to be considered in the monitoring process.

Another problem arises when only data sources that provide information on a particular group are available, and comparisons need to be made among groups. In this case, understanding the limits of available data has critical importance in drawing appropriate inferences (Drummond et al., 1997).

## **7. Examining indicators for healthcare evaluation: experience of U.S.**

At the request of the U.S. Department of Health and Human Services (DHHS), the Panel on Performance Measures and Data for Public Health Performance Partnership Grants was established. The panel was given the task of examining the state of performance measurement for public health and to recommend performance measures in ten areas including: chronic disease; sexually transmitted disease (STD), human immunodeficiency virus (HIV) infection, and tuberculosis; mental health; immunization; substance abuse; and three areas of prevention of special interest to DHHS—sexual assault, disabilities, and emergency medical services. The panel focused on measures the government would be able to use over the next 3-5 years to negotiate agreements and monitor performance in these areas.

More than 3200 measures were proposed to the panel through various outreach efforts. The panel used four guidelines for assessing them, and measures that scored the highest were recommended for use in performance monitoring. The objective of recommending performance measures is to provide technically sound methods for assessing progress in meeting public health objectives and to provide the government practical and useful tools to advance their public health objectives (National Research Council, 1997).

### **7.1. The panel's framework for assessing suggested indicators**

Although health outcome measures are widely used and have intuitive appeal, they are insufficient by themselves for monitoring the efforts of a given program to reduce complex public health problems. Many measures of health outcomes are affected by various factors that are not under the health intervention's control,

subsequently, compromising the validity of measures of program effect. Hence, changes in outcomes cannot be attributed only to specific program effectiveness. Another constraint is that many important public health objectives, such as lowering the incidence of cancer and HIV infection, cannot be achieved over short periods of time to derive an outcome measure.

For example, if the policy intervention's goal is to reduce the mortality rate from breast cancer, it can reduce the risk of such adverse health outcomes by increasing the number of mammograms it provides to women aged 50 and over. However, the effectiveness of the intervention cannot be shown in a short period of time. Furthermore, there are a series of process activities (health education programs, surgical and nonsurgical treatment, and postoperative follow-up care) and capacity indicators (number of trained staff and facilities offering mammography screening) that are believed to be related to the level of mortality from breast cancer.

In this case, the evaluator needs to consider whether desired health outcomes are achieved, whether specific agency commitments are carried out, and whether the agency has the capacity to conduct all the necessary processes. Outcomes are fundamental, and any process or capacity measure used to assess performance should be widely accepted as being closely related to them.

For this reason, the panel recommends using "intermediate" outcome measures, such as risk status, for which there is general consensus that the result being measured is related to the health status outcome, and that performance monitoring must make use of process and capacity measures to complement available measures of outcomes. Each process and capacity measure should be accompanied by reference to published clinical guidelines or other professional standards that describe the relationship between the process measure or capacity measure and the desired health outcome.

Health outcome: change in the health of a defined population related to an intervention.

Risk status (intermediate outcome): change in the risk demonstrated or assumed to be associated with health status.

Process: what is done for defined individuals or groups as part of the delivery of services, such as performing a test or procedure or offering an educational service.

Capacity: the ability to provide specific services, such as clinical screening and disease surveillance, made possible by the maintenance of the basic infrastructure of the public health system, as well as specific program resources.

To sum up, the effectiveness of an intervention in using resources can most appropriately be evaluated by assessing the degree to which desired changes in health outcomes are achieved, together with a judgement of the degree to which those changes can be attributed to the intervention. When a firm causal link between the resources and processes used and the health outcome sought has not been established, as is often the case, or when the intervention resources are a small part of all the resources that contribute to the outcome, the panel believes that performance assessment must necessarily depend on a combination of health outcome, process and program capacity measures.

And performance measures should be understood and adopted as the product of an evolutionary process, to be revised as additional empirical evidence is obtained and better methods of data collection are implemented.

## 7.2. Guidelines for the assessment of proposed indicators

- (1) Indicators should be aimed at a specific objective and be result oriented. They must clearly specify a desired public health result, including identifying the population affected and the time frame involved. Process and capacity measures should clearly specify the health outcome, or long-term objective, to which they are thought to be related.
- (2) Indicators should be meaningful and understandable. They must be seen as important to both the general public and policy makers at all levels of government and should be stated in non-technical terms.
- (3) Data should be adequate to support the indicator. Adequate data on the populations of interest must be available for the use of indicators and have the following characteristics:
  - Data to track any objective must meet reasonable statistical standards for accuracy and completeness;
  - Data to track any objective must be available in a timely fashion, at appropriate periodicity, and at reasonable cost; and
  - Data applied to a specific indicator must be collected using similar methods and with a common definition throughout the population of interest. Comparisons of an indicator across regions are valid only if the definition and collection methodology are consistent across regions.
- (4) Indicators should be valid, reliable, and responsive. Indicators should as much as possible, capture the essence of what they purport to measure, be reproducible (reliable), and be able to detect movement toward a desired objective (responsive).

## 7.3. Example: Chronic disease

Prevention of chronic disease is the primary goal of many health programs, but chronic disease incidence and mortality data are not useful because the expected time period between most prevention activities and the effect of those activities on disease incidence or mortality tends to exceed several years, which also exceeds the time that health departments are generally willing to wait to assess the intervention's effectiveness. Therefore, potential chronic disease measures are focused on risk reduction and screening, and process measures.

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**Potential Risk Status Measures**


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Risk status measures represent intermediate health outcomes.

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**Tobacco**

Individual adult	Percentage of (a) persons aged 18-24 and (b) persons aged 25 and older currently smoking tobacco
Individual youth	Percentage of persons aged 14-17 (grades 9-12) currently smoking tobacco
Individual pregnant woman	Percentage of women who gave birth in the past year and reported smoking tobacco during pregnancy
Individual working adult	Percentage of employed adults whose workplace has an official policy that bans smoking

**Nutrition**

Content	Percentage of persons aged 18 and older who eat five or more servings of fruits and vegetables per day
Content	Percentage of persons aged 14-17 (grades 9-12) who eat five or more servings of fruits and vegetables per day
Total calories	Percentage of persons aged 18 and older who are 20 percent or more above optimal body mass index

**Exercise**

Individual adult	Percentage of persons aged 18 and older who do not engage in physical activity or exercise
Individual youth	Percentage of persons aged 14-17 (grades 9-12) who do not engage in physical activity or exercise

**Screenings and Tests**

Hypertension	Percentage of persons aged 18 and older who had their blood pressure checked within past 2 years
Cholesterol	Percentage of women aged 45 and older and men aged 35 and older who had their cholesterol checked within past 5 years
Breast Cancer	Percentage of women aged 50 and older who received a mammogram within past 2 years
Colon Cancer	Percentage of adults aged 50 and older who had a fecal occult blood test within past 12 months or flexible sigmoidoscopy within past 5 years
Cervical Cancer	Percentage of women aged 18 and older who received a Pap smear within past 3 years

**Diabetes**

HbA1C	Percentage of persons with diabetes who had HbA1C checked within past 12 months
Foot exam	Percentage of persons with diabetes who had a health professional examine their feet at least once within past 12 months
Eye exam	Percentage of persons with diabetes who received a dilated eye exam within past 12 months

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<b>Examples of Process Measures</b>	
<b><u>Nutrition Program Strategy</u></b> Process Measure	Enable children to learn healthy dietary habits Percentage of schools with menus that meet dietary guidelines for fat content and five or more servings of fruits and vegetable daily
<b><u>Physical Activity Program Strategy</u></b> Process Measure	Increase opportunities for sedentary working adult to exercise  Percentage of worksites with worksite wellness programs that include physical exercise
<b><u>Smoking Program Strategy</u></b>  Process Measure	Limit illegal youth purchase of smoking tobacco; Increase the price of tobacco products; Restrict smoking tobacco advertising; Restrict indoor tobacco smoking; Educate children about hazards of smoking tobacco; Increase access or availability of smoking cessation programs; Market effective antismoking message to the general public  Percentage of vendors who illegally sell smoking tobacco to minors; Amount of excise tax per pack of cigarettes; Percentage of communities with ordinance or regulations restricting smoking tobacco advertising; Percentage of worksites that are smoke free; Proportion of schools with age-appropriate smoking prevention activities and comprehensive curricula; Proportion of current tobacco smokers visiting a health care provider during the past 12 months who received advice to quit; Percentage of adults who can recall seeing an antismoking message during the 12 months following a media campaign; etc
<b><u>Screening Program Strategy</u></b>  Process Measure	Educating patients regarding need for and appropriate timing of screening tests  Percentage of persons with diabetes receiving diabetes health education
<b><u>Screening Program Strategy</u></b> Process Measure	Improving access to screening services  Percentage of managed care organizations in which patients can schedule mammograms at convenient times for them
<b><u>Screening Program Strategy</u></b> Process Measure	Implementing tracking and recall systems  Proportion of providers with chart-based or other real-time system for identifying women in need of mammography

<b>Examples of Capacity Measures</b>	
<b><u>Resources</u></b>	<p>Number of full-time health department employees for chronic disease prevention</p> <p>Number of public service messages prepared by state agency shown annually for chronic disease prevention</p>
<b><u>Proficiencies</u></b>	<p>Number of key surveillance systems and data sets (i.e., death certificates, cancer registry data, birth certificates, Behavioral Risk Factor Surveillance System (BRFSS), Youth Risk Behavior Surveillance System (YRBSS), hospital discharge data, Medicare and Medicare encounter information and other relevant local data sets) that are established and maintained</p> <p>Percentage of local health departments receiving technical assistance and training</p> <p>Percentage of labs that meet quality standards</p>
<b><u>Planning</u></b>	<p>Percentage of population served by systematic community planning process, with leadership provided by the official health agency and participation of all relevant groups (e.g., consumers, providers, advocates)</p> <p>Percentage of population covered by written comprehensive chronic disease prevention plan(s) containing priorities and objectives based on needs, resources, and local demands</p>
<b><u>Community Involvement</u></b>	<p>Percentage of health care providers working under agreements established with public health departments to provide population-based prevention programming to reduce major risk factors for premature morbidity and mortality</p> <p>Proportion of health department programs that operate within the framework of a community coalition or have a community advisory group</p>

#### 7.4. Example: STDS, HIV, and tuberculosis

HIV infection, tuberculosis, and many of the STDs resemble noninfectious chronic disease. The interval between the acquisition of infection and the development of serious consequences may be years long. Monitoring the long-term consequences of these infections does not provide a useful short-term indication of the performance of prevention efforts, so measuring in this public health area is more complex than in others. Three general strategies for preventing these diseases are: reducing the risk of exposure, reducing the probability that an exposed person becomes infected, and reducing the duration of the infectious state among persons who became infected.

<b>Potential Health Status Outcome Measures</b>	
<b><u>Incidence rates of selected STDs</u></b>	Rate of reported gonococcal urethritis in men Rate of reported chlamydial urethritis in men Rate of reported cases of primary and secondary syphilis Rate of reported cases of congenital syphilis
<b><u>Incidence rates of HIV infection</u></b>	Rate of reported newly diagnosed cases of HIV infection Rate of perinatally acquired HIV infection of infants
<b><u>Prevalence rates of selected STDs</u></b>	Prevalence rate of gonococcal infection in women in defined populations Prevalence rate of chlamydial infection in defined populations Prevalence rate of syphilis in defined risk groups, e.g., pregnant women Prevalence rate of rectal gonococcal infection in men
<b><u>Prevalence rate of HIV infection</u></b>	Seroprevalence of HIV infection in defined populations at high risk of the infection, e.g., pregnant women who abuse drugs
<b>Potential Consumer Satisfaction Outcome Measure</b>	
Rates of consumer satisfaction with STD, HIV, and tuberculosis treatment programs	
<b>Potential Risk Status Measures</b>	
Risk status measures represent intermediate health outcomes.	
Rates of sexual activity among adolescents aged 14-17	
Rates of sexual activity with multiple sex partners among people aged 18 and older	
Rates of condom use during last episode of sexual intercourse among sexually active adolescents aged 14-17	
Rates of condom use by persons aged 18 and older with multiple sex partners during last episode of sexual intercourse	
Rates of condom use during last episode of sexual intercourse among men having sex with men	
Rates of injection drug use among adolescents and adults	
Completion rates of treatment for STDs, HIV infection, and tuberculosis	
<b>Example of process Measures</b>	
<b><u>Program Strategy</u></b>	Reduce barriers to receiving treatment from specific providers
Process Measure	Percentage of patients with insurance coverage for specific treatments
Process Measure	Percentage of patients reporting no transportation barriers to obtain necessary services
Process Measure	Percentage of physicians and other care providers receiving cultural competency training
<b><u>Program Strategy</u></b>	Improve quality of services provided
Process Measure	Percentage of cases followed up after most recent contact
Process Measure	Percentage of known intravenous drug users with access to needle exchange program



<b>Examples of Capacity Measures</b>	
<b><u>Resources</u></b>	Percentage of high-risk communities with nearby testing and screening services from multiple types of health providers and public health organizations
<b><u>Planning</u></b>	Percentage of the state's population who reside in communities that are engaged in formal community processes for assessing and planning for HIV/STD/TB prevention and treatment services

### 7.5. Example: Mental health

Although there is little agreement on linkages between specific process and mental health outcomes, there is some agreement on the dimension that are important in evaluating mental health services; quality assurance, access to services and utilization of services, consumer satisfaction with services, and psychological and social outcomes.

<b>Potential Health Status Outcome Measure</b>
Percentage of persons aged 18 and older receiving mental health services who experience reduced psychological distress
<b>Potential Social Functioning Outcome Measure</b>
Percentage of persons aged 18 and older receiving mental health services who experience increased level of functioning
Percentage of persons aged 18 and older receiving mental health services who report increased employment (including volunteer time)
Percentage of persons aged 18 and older with serious and persistent mental illness receiving mental health services who live in integrated, independent living situations or with family members
Percentage of children aged 17 and younger with serious emotional disorders receiving mental health services who live in noncustodial living situations
Percentage of persons aged 18 and older with serious mental illness who are in prisons and jails
Percentage of children aged 17 and younger with serious emotional disorders who are in juvenile justice facilities
Percentage of homeless persons aged 18 and older who have a serious mental illness
<b>Potential Consumer Satisfaction Outcome Measures</b>
Percentage of adolescents aged 14-17 or family members of children and adolescents or both who are satisfied with: (a) access to services, (b) appropriateness of services, and (c) perceptions of gain in personal outcomes
Percentage of persons (aged 18 and older) or their family members or both who are satisfied with: (a) access to mental health services, (b) appropriateness of services, and (c) perceptions of gain in personal outcomes

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**Examples of Process and Capacity Measures**


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<b><u>Program Strategy</u></b>	Improve access to services/utilization of services
Process Measure	Percentage of adults with serious and persistent mental illness who use health services
Process Measure	Percentage of youth with serious emotional disorders who use mental health services
Process Measure	Percentage of those who use services that are voluntary
Process Measure	Percentage of people requesting services who begin receiving services within 2 week of the initial request
Capacity Measure	Percentage of primary care providers who receive supplemental training in mental health services
<b><u>Program strategy</u></b>	Improve quality assurance
Process Measure	Percentage of service plans that include input from consumers and family members
Process Measure	Percentage of children less than 5 years old who are screened and assessed for mental health intervention
Capacity Measure	Percentage of primary care providers who use standardized screening tools for assessing the mental health status of primary care clients

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### 7.6. Example: Immunization

The vaccine preventable diseases are well understood. Cases are easily identified, and health outcomes are well defined. A strong, causal relationship exists between immunization and disease prevention. Clearly defined process (vaccination rate) and outcome (disease incidence rate) measures are preferred, and they should be responsive to effective interventions within a short period of time.

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**Potential Health Outcome Measures**


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Reported incidence rate of representative vaccine-preventable diseases

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**Potential Health Outcome Measures**


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Risk status measures represent intermediate health outcomes.

Age-appropriate vaccination rates for target age groups for each major vaccine group:

Children aged 2 years; children entering school at approximately 5 years of age

Mumps, measles, and rubella

Diphtheria-tetanus-pertussis

Polio

hemophilus influenza B

varicella

Adults aged 65 years and older

diphtheria-tetanus

hepatitis B

influenza

pneumococcal pneumonia

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<b>Examples of Process Measures</b>	
<b><u>Program Strategy</u></b>	Improve access to immunization services
Process Measure	Percentage of population who do not cite financial resources as a barrier to immunization
<b><u>Program Strategy</u></b>	Increase parent education and awareness
Process Measure	Percentage of parents with children under 18 who believe that the benefits of immunization outweigh the risks
Process Measure	Percentage of parents with children under 18 who report receiving immunization reminders from their immunization providers

## 8. Summary

As stated in the beginning, performance evaluation in the health field is an increasingly important area of study for future government officials, health professionals, and service providers. The essence of evaluation is to isolate causes of particular events or outcomes. If a particular intervention appears to be associated with a beneficial effect, one must find out whether the effects can really be attributable to the intervention or whether they might be the result of some other factors. With this commonality, what distinguishes evaluation of public health action from other fields is the use of rigorous scientific methods involving laboratory frontier knowledge and contextual complexity requiring socio-economic and political awareness.

In order to set up an evaluation system in the field, building infrastructure is required more than anything. The framework for evaluating public health intervention needs to be devised, indicators need to be collected and assessed for future use. Also, to utilize indicators, appropriate data for each indicator should be gathered and organized. Furthermore, since indicators are designed to detect changes in a limited time period, following up data collection should be made within a reasonable time. Although it will take a tremendous amount of resources to accomplish these prerequisite tasks, now is the time for Korea to tackle them in order to remain accountable and to manage surging healthcare costs.

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## **Performance Management in Education: A Call for Paradigm Reform in Korea**

*by*

*Ju Ho Lee, KDI School of Public Policy and Management*

### **1. Introduction**

Foreign institutions have affirmatively evaluated the performance of primary and secondary education in Korea. Such is the case when these assessments are based on outstanding math and science scores achieved during international competitions. However, underlying these superficial results are factors that significantly influence parents and students such as school satisfaction and teacher evaluations, which ranks in the bottom tier among OECD countries.

This paper sheds light on student performance, which rests on the current college-admission system, not the performance-management system. In short, the overall increase in test scores can be attributed to the severe competition characterized by students' will to enter better universities, rather than the notion that a performance-driven system in schools are increasing the quality of students.

Under the college-admission system, performance-management system is not operating effectively. Schools are protesting the sole reliance of college admission-based studies, emphasizing the need for character development. At the same time, teachers and administrators at the Ministry of Education and Human Resource Development are actively dissuading the implementation of scholastic-based performance-management system. However, the absence of such system leads to a vicious cycle, where students continue to seek private tutors through the inadequacy of schools, rooted by skyrocketing demands for college preparation.

As the struggle to provide performance-management system for primary and secondary schools emerge, surveys such as the National-Standard of Education Achievement, City and Provincial Office of Education Evaluation (henceforth "office evaluation"), and the Primary and Secondary School Evaluation (henceforth "school evaluation") are beginning to broach. Hence, this paper will assess the efforts of the current performance-management system in primary and secondary schools and propose a new scheme to improve the current performance-management system in South Korea.

The structure of this paper is as follows. In section 2, a general overview of the performance in schools and the relationship between the results of such performance and the characteristics of performance-management system will be discussed. In section 3, a general overview of the performance-management system in schools will be examined and assessed. Finally, section 4 will propose reforms to improve the performance-management system for primary and secondary schools in South Korea.

## 2. Performance in education

Korean scholastic attainment based on international assessment test is clearly high among OECD countries as depicted in Table 12-1. For each category, Korea scored first for science, second for math, and sixth for reading. However, when taking their distribution into consideration, students below level 1 (1%) and students at level 5 (6%) are quite low, meaning a large chunk of the students are positioned between levels 3 and 4 (39% and 31%, respectively). Although the size of students below level 1 is ideal, the size of students at level 5 only resembles the 20th ranking country among the 27 countries surveyed in this test. Hence, although Korea's small proportion of low-performance students is ideal, the incapability to educate outstanding students poses a serious problem.

Table 12-1. Performance test

(Unit: Ranking out of 31, Percentage)

	Korea	Japan	U. S.	U. K.	France	Germany	Sweden	Canada	Italy	Mexico
Scientific literacy	1	2	14	4	12	20	10	5	23	30
Math literacy	2	1	19	8	10	20	15	6	26	30
Reading literacy	6	8	15	7	14	21	9	2	20	30
Below level 1	1%	3%	6%	4%	4%	10%	3%	2%	5%	16%
At level 1	5%	7%	12%	9%	11%	13%	9%	7%	14%	28%
At level 2	19%	18%	21%	20%	22%	22%	20%	18%	26%	30%
At level 3	39%	33%	27%	27%	31%	27%	30%	28%	31%	19%
At level 4	31%	29%	21%	24%	24%	19%	26%	28%	19%	6%
At level 5	6%	10%	12%	16%	8%	9%	11%	17%	5%	1%

Source: OECD, *Knowledge and Skill for Life*, PISA 2000.

In the results from PISA 2000, student engagement shows us very interesting point.

In Table 12-2, student engagement is illustrated by asking students whether they strongly agree, agree, disagree or strongly disagree to the following statements about their school: I feel like an outsider (or left out of things), I make friends easily, I feel like I belong, I feel awkward and out of place, other students seem to like me, and I feel lonely. Forty-one percent of Korean students reported to demonstrate a low sense of belonging, the lowest out of the 27 OECD participating countries. This is a striking result, which challenges the academic achievement demonstrated in Table 12-1. Furthermore, low participation, which measures how many times in the past week students say they missed school, skipped classes, and arrived late, shows that only 8 percent of students feel that they have low participation. Perhaps pressures from parents to attend classes and competition from colleges that require class participation have contributed to this ironical result.

Table 12-2. Student engagement

(Unit: Percentage)

	Korea	Japan	U. S.	U. K.	France	Germany	Sweden	Canada	Italy	Mexico
Low sense of Belonging <sup>1)</sup>	41%	38%	25%	17%	30%	23%	18%	21%	23%	22%
Low participation <sup>2)</sup>	8%	4%	20%	15%	15%	13%	24%	26%	22%	21%

Note: 1) Percent of students in each OECD country who have a low sense of belonging.

2) Percent of students in each OECD country with low participation at school.

Source: OECD, *Student Engagement at School*, PISA 2000.

However, why is it the case that high scholastic achievement and low sense of belonging coexist in South Korea? One plausible explanation would be the prevalence of privately funded private tutors and remedial classes outside school. The data from Table 12-3 shows that Korea and Japan have remarkably high participation of educational courses outside school. Interestingly, the inclusion of private tutors reduced Japan's participation to 17.3 percent while maintained the Korean numbers to rank first at 57.5 percent.

The low assessment of Korean teachers as shown in Table 12-4, adds to the possibility that high scholastic achievement scores received by students should be attributed to private tutors rather than their schools. In table 12-4, students were asked to indicate the frequency with which teachers in the language of assessment show an interest in every student's learning, give students an opportunity to express opinions, help students with their work, and continue to teach until students understand. Values above the OECD average, set to 0, indicate higher than average student perceptions that teachers are supportive, while negative values indicate below-average student perceptions of teachers' supportiveness. Korean students report the lowest support (-0.67) from their teacher.

Table 12-3. Student participation in educational courses outside school

(Unit: Ranking out of 26, Percentage)

	Korea	Japan	U. S.	U. K.	France	Germany	Sweden	Canada	Italy	Mexico	OECD
Average ranking	2	1	8	13	N. A.	20	21	18	24	3	
Participation <sup>1)</sup>	63.6%	70.7%	24.7%	20.1%	N. A.	10.4%	7.8%	14.4%	5.6%	51.4%	24.9%
Average ranking	1	21	18	19	N. A.	11	16	14	4	6	
Participation <sup>2)</sup>	57.5%	17.3%	28.8%	24.4%	N. A.	36.2%	7.8%	31.6%	48.0%	47.1%	32.3%

Note: 1) Percent of students who have sometimes or regularly attended courses in the language of assessment, courses in other subjects, or extension or additional courses in the last three years.

2) Percent of students who have sometimes or regularly attend courses in the language of assessment, remedial courses in other subjects, training to improve study skills or private tutoring in the last three years.

Source: OECD, *Knowledge and Skill for Life*, PISA 2000.

Table 12-4. Teacher evaluation

(Unit: Ranking out of 27, WARM estimator<sup>87</sup>)

		Korea	Japan	U. S.	U. K.	France	Germany	Sweden	Canada	Italy	Mexico	OECD
By Student <sup>1)</sup>	Ranking	27	18	4	1	19	24	7	6	21	13	
	Mean	-0.67	-0.17	0.34	0.50	-0.20	-0.34	0.21	0.31	-0.28	0.07	0.00
By Principle <sup>2)</sup>	Ranking	26	10	18	13	N. A.	16	5	11	25	3	
	Mean	-0.72	0.14	-0.04	0.02	N. A.	-0.01	0.34	0.08	-0.69	0.39	0.00

Note: 1) Index of teacher support and performance on the combined reading literacy scale, by national quarters of index.

2) Index of principals' perception of teachers' morale and commitment and performance on the combined reading literacy scale

Source: OECD, *Knowledge and Skill for Life*, PISA 2000.

In addition, school principals were asked to provide their views on teachers' morale and commitment. To do so, they were asked to indicate how strongly they agreed or disagreed with statement such as "teachers work with enthusiasm," "teachers take pride in this school," and "the morale of teachers in this school is high." In the case of Korea, teachers comparatively have the lowest levels of morale and commitment by the standards of school principals.

### 3. Performance-management in education

#### 3.1 Performance monitoring<sup>88</sup>

The Central Education Research Center conducted two nationwide scholastic achievement assessments in 1959 and 1963, evaluating 5 percent of 5th and 6th grade elementary students. This helped identify and solve problems associated with teaching,

<sup>87</sup> The index was scaled using a weighted maximum likelihood estimate, using a one-parameter item response model (referred to as a WARM estimator; see Warm, 1985 with three stages: A). The question parameters were estimated from equal-sized sub-samples of students from each OECD country. B) The estimates were computed for all students and all schools by anchoring the question parameters obtained in the preceding step. C) The indices were then standardized so that the mean of the index value for the OECD student population was zero and the standard deviation was one (countries being given equal weight in the standardization process). It is important to not that negative values in an index do not necessarily imply that students responded negatively to the underlying questions. A negative value merely indicates that a group of students (or all students, collectively, in a single country) or principles responded less positively than all students or principles did on average across OECD countries. Likewise, a positive value on an index indicates that a group of students or principals responded more favorably, or more positively, than students or principals did, on average, in OECD countries.

<sup>88</sup> This section is heavily drawn from Lee, Myung-Hee (2000).



improve the curriculum, and collect fundamental resources necessary to encourage learning. Consequently, in preparation for the middle school “admission without examination” policy of 1969, the Central Education Research Center conducted the “basic scholastic assessment for primary school” to test changes in the scholastic ability of elementary students. In this test, 300 classes composed of elementary students from 1st to 6th grades were tested in Korean, Math, Social Science, and Science. The results of the assessment were compared and analyzed by region, grade, sex, and scholastic ability by calculating their average and standard deviation. Furthermore, areas that were affected by the “admission without examination” policy – Seoul, Pusan, and Daegu – were analyzed separately.

In 1974, The Korea Education Development Institute began the “Elementary and Middle School Scholastic Assessment” intended for 1 percent of elementary and middle school students nationwide to evaluate the efficiency in education efforts such as the curriculum and the education methodology and to collect data for future plans. In 1977, in preparation for the nine-year mandatory education program, they conducted the “Elementary and Middle School Scholastic Assessment” to further understand students’ family conditions, school life, and scholastic ability. In 1980, to assess the effectiveness of the new academic system – fifth academic curriculum – primary education assessments were held. Again in 1983, 1984, and in 1985, multiple evaluations of the new academic system were administered to compare and analyze for future development of academic curriculum.

Moreover, in 1973 and in 1980, the Korean Institute for Research in the Behavioral Sciences (KIRBS) oversaw the “Nationwide Evaluation of Korean Education” and the “Evaluation of Korean Primary Education” to survey the academic ability of elementary students. By evaluating Korea’s mandatory education, they were able to produce an analysis of education funding, which was intended to improve the quality of education in the forthcoming academic systems.

With the establishment of the National Institute for Education Evaluation, scholastic achievement surveys were administered in greater scope and at a national level. From 1986 to 1992, 1 percent of all Korean primary and secondary students per grade were assessed; from 1993 to 1997, all students were tested. The assessments administered by the National Institute for Education Evaluation sought to collect and analyze the effects, quality, and level of primary and secondary education from a national level, understand the students, teachers, and other factors that influence scholastic achievement, and finally develop top-notch academic materials to be distributed and utilized for teaching at schools. Although the same institution conducted these evaluations, variations in academic years, curriculum, scope, and content have made it impossible to obtain long-term trends from these surveys.

Korean scholastic achievement tests were administered to understand the academic level and to assess the curriculum and pedagogical methodology of primary and secondary school students. However, it is striking that such national-level test does not directly influence the accountability of primary and secondary education.

In the case of England, tests such as the Standard Assessment Test (SAT) and the General Certificates of Secondary Education (GCSE) have functioned to survey national goals and check for accountability by school or by region. In the U.S., the National Assessment of Education Progress (NAEP) has been analyzed to evaluate student performance by state.

However, Korea still does not possess a concrete scholastic achievement system that is operated at a national level. Furthermore, surveys conducted by the Central Education Research Center, KIRBS, and the National Institute for Education Evaluation have not functioned to receive substantial feedback and to maintain a nationwide

quality. Hence, future assessments must focus on the implementation of education policies from the level of the city and provincial office of education. In addition, evaluations must be modified to objectively assess and monitor education performance of individual schools to understand the scholastic achievement from a national level.

### 3.2. Project evaluations

Project evaluations in the Korean education sector refer to the progress in implementing education policies and their assessments, such as the "City and provincial Office of Education Evaluation" and "Primary and Secondary School Evaluation." Although these assessments are not exactly performance evaluations, the goals outlined by these surveys show that they are, in general, project evaluations.

The background behind the introduction of the "City and provincial Office of Education Evaluation" lies in the progress of introducing the "Institution Evaluation System," enforcing the "Autonomy on Regional Education," and promoting the "May 31<sup>st</sup> Education Reforms" (Kong, Eun-Bae et al., 2002). According to the manual of the "City and provincial Office of Education Evaluation," the goal of these assessments was to strengthen the accountability of the city and provincial offices of education given by their autonomy. In other words, the implementation of the "Autonomy on Regional Education," the increase in autonomy and decentralization from the ministry of education, and the transition from the "Regional Education Subsidy Distribution System" to the "Total Distribution System" have raised the issue of accountability. Moreover, the necessity of increasing competition among suppliers of education to meet the demands of the education system as outlined in the reform agenda of May 31, 1995 have resulted in connecting the outcomes of the "City and provincial Office of Education Evaluations" to the amount of funding. The idea behind this was to increase the quality of education and to promote education reforms.

The "City and provincial Office of Education Evaluation" (henceforth "office evaluations") and "Primary and Secondary School Evaluation" (henceforth "school evaluations") have their legal basis from Article IX Clause 2 of the "Primary and Secondary Education Law" and intended for regional-administrative institutions (usually city and provincial offices of education) and national, public, and private primary and secondary schools. The standard stated in the "Enforcement Ordinance on Primary and Secondary Education Law" includes the composition and application of funds, construction of schools and educational facilities, organization of the curriculum, and personnel maintenance and welfare. Article IX Clause 2 of the "Primary and Secondary Education Law" explicitly states "the execution of school and institution evaluations for an efficient accomplishment of education administration." More specifically, office evaluations were introduced to bring about favorable competition between city and provincial offices of education, promoting accountability, increase in the quality of education, and raise voluntary efforts caused by the financial-support system of the government (Kong, Eun-Bae, 2002). Hence, office evaluations have the following goals: evaluating the process of implementing policies, nationalizing regional differences, increasing education quality through autonomous competition, providing information regarding the distribution of resources, and proliferating excellent cases of administrative methods (Kong, Eun-Bae, 2002).

There are two goals for school evaluations.<sup>89</sup> First, it provokes accountability generated from the increase in autonomy for school management. Second, it provides

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<sup>89</sup> This paragraph is based heavily from Baek, Sun-Geun (1997) and KEDI (2003).

feedback and guidance for various educational activities and maintenance facilities. Thus, it functions to boost efficiency and effectiveness. Finally, the disclosed information provided by the assessment gives consumers of education a better idea about each school's pedagogical activities and management programs to select schools, teachers, and courses. However, as indicated by Baek, Sun-Gun (2003), most office and school evaluations focus on achieving only the second goal outlined above.

### 3.2.1. City and provincial Office of Education Evaluation (office evaluation)

As of 2003, the office evaluation has been conducted 6 times since its introduction in 1996 (administered every year from 1996 to 1999 and biennially afterwards). Office evaluations have been conducted to "expedite efficient education administration," increasing school accountability, and raising issues relating to the quality of education.

As demonstrated in Table 12-5, the areas of evaluation are quite comprehensive, but different each time the test is administered. The vast scope of evaluating standards dictated in the "Enforcement Ordinance of Primary and Secondary Law" and the ability of the Minister of Education and Human Resource Development to include items at his will could lead to differences in testing areas and distribution. As a result, areas of assessment, content, and distribution have in fact changed over the years and have led to problems in its consistency. Furthermore, taking regional differences into consideration, evaluations are conducted by city and province. In addition, as described in Table 12-6, evaluation results are disclosed and categorized according to score and linked to government funding depending on their performance.

Table 12-5. Areas of assessment, number of subjects and items, and distribution of the office evaluation

Round (Year)	Areas of Assessment	Number of Subjects	Number of Items	Distribution (City/Province)	Total Points
1 <sup>st</sup> Round (1996)	<ul style="list-style-type: none"> <li>● Education Policy</li> <li>● Education Reform</li> </ul>	7 15	25 50	100 100	200
2 <sup>nd</sup> Round (1997)	<ul style="list-style-type: none"> <li>● Class Reform</li> <li>● Demand-Based School System</li> <li>● Embodiment of Welfare</li> <li>● Efficiency in Information and Distribution of Administrative and Financial Support System</li> <li>● Will to Promote Education Reform</li> </ul>	9 4 5 4 5	40 19 24 19 17	200 110 130 120 140	700
3 <sup>rd</sup> Round (1998)	<ul style="list-style-type: none"> <li>● Classroom Innovation</li> <li>● Efficiency in Operating Finances</li> <li>● Demand-Based School System</li> <li>● Strengthening the Support System</li> </ul>	3 4 3 5	43 16 12 18	130 130 120 120	500
4 <sup>th</sup> Round (1999)	<ul style="list-style-type: none"> <li>● New School Culture to Improve Classes</li> <li>● Performance-Based Teachers</li> <li>● Student and Parent-Based School</li> <li>● Efficiency in Operating Finances</li> <li>● Strengthening the Support System</li> </ul>	3 4 4 4	39 18 20 19	160 60 140/115 100	600
5 <sup>th</sup> Round (2001)	<ul style="list-style-type: none"> <li>● Major National Policy Project</li> <li>● Autonomy and Special Projects of the City or Regional Office of Education</li> <li>● General Policy Project</li> </ul>	2 3 10	13 6 17	165 125 210	500

Source: Kong, Eun-Bae (2002), p.30.

Table 12-6. Budget distributed according to the results of the office evaluation

(Units: Hundred Million Won)

	1996	1997	1998	1999	2001	Total Amount Subsidized
Total Subsidized Budget	500	800	1,500	1,500	1,000	5,300
Basic/Difference	250/250	100/700	150/1,350	150/1,350	200/800	-
City Average	33.63	52.76	82.35	82.35	67.09	305.83
Provincial Average	33.13	53.71	102.62	102.62	58.93	351.02
Total Average	33.33	53.33	93.75	93.75	62.5	331.25
Maximum	57.36	99.53	171.54	140.436	89.43	496.81
Minimum	17.04	24.49	27.56	41.71	46.87	202.59
Basis for Distribution	- Basic allotment (50%) + Allotment by Project (40%) + allotment to the best Office of Education (10%) - 1 billion Won distributed to each office of education as basic allotment and remaining 10 billion Won according to the Index of Basic Allotment = Student (50%) + Number of Students (50%) - 5 billion Won subsidy increase	- Basic Allotment (12.5%) + Allotment by Total Score Obtained (40%) + allotment to an outstanding Office of Education (45%) + allotment to the overall outstanding Office of Education (2.5%) - Index of Basic Allotment = Student (50%) + Number of Students (50%) - 80 billion Won subsidy increase	- Basic allotment (13.3%) + Allotment by Total Score Obtained (50.7%) + Allotment by Project (33.3%) + Allotment to the overall outstanding Office of Education (2.7%) - Index of Basic Allotment = Student (50%) + Number of Students (50%) - 50 billion Won subsidy increase + special subsidy of 100 billion Won	- Basic allotment (10%) + Allotment by Total Score Obtained (40%) + Allotment to an outstanding Office of Education (50%) - Index of Basic Allotment = Student (50%) + Number of Students (50%)	- Basic Allotment (20%) + Allotment by Total Score Obtained (80%) - Index of Basic Allotment = Student (80%)	

Source: Office Evaluation Committee (for each year), and KEDI (2002).

### 3.2.2. "Primary and Secondary Education Evaluation" (School Evaluation)

There are three types of school evaluations: surveys conducted by the Korea Education Development Institute under the request of the Ministry of Education and Human Resource Development, tests conducted by the city and provincial offices of education, and assessments as part of office evaluations. Surveys supervised by the Ministry of Education and Human Resource Development are conducted by visiting individual schools to identify the conditions – geared toward improving school quality, ameliorating the quality intended by school evaluations, identifying problematic conducts of education, and providing a measure of scholastic achievement and school satisfaction. In other words, this assessment identifies the current status of the individual school from a national level, examines the effects of policies implemented by the government at a grass-roots level, and fosters the exchange of information between teachers, schools, and research centers with the results produced by the ministry (Baek, Sun-Gun, 2003).

Table 12-7. Areas of assessment and contents of the school evaluation conducted by the ministry of education and human resource development

Area Assessed	Research Content
Curriculum / Pedagogical Activity	<ul style="list-style-type: none"> <li>- Instruction through an emphasis on educational goals</li> <li>- Pedagogical activity that reflects student characteristic</li> <li>- Pedagogical activity that develops voluntary study skills</li> </ul>
Pedagogical Activity Outside the Curriculum	<ul style="list-style-type: none"> <li>- Searching and discovering one's specialties</li> <li>- Livelihood guidance/basic attitude toward democracy</li> </ul>
Activities that Support Education	<ul style="list-style-type: none"> <li>- Disguising duty, communication, animosity among coworkers</li> <li>- Assisting the development of a faithful environment. Elevating the specialties of the personnel</li> <li>- Resources necessary to conduct educational activities</li> <li>- Amicable communication between the school and parents and parent participation at school. Supporting and Utilizing regional resources</li> </ul>
Scholastic Achievement	<ul style="list-style-type: none"> <li>- Studying methods</li> <li>- Communication skills</li> <li>- Logic and creativity</li> <li>- Relationship with adults</li> <li>- Ego-identity</li> <li>- Responsibility</li> </ul>
Satisfaction	<ul style="list-style-type: none"> <li>- Students</li> <li>- Parents</li> <li>- Teachers and administrators</li> </ul>
Education Policy	<ul style="list-style-type: none"> <li>- Degree of difficulty involved when administering the 7<sup>th</sup> Curriculum</li> <li>- Class utilizing ICT</li> <li>- Achievement Test</li> <li>- Special ability/aptitude education</li> <li>- Reducing students per class</li> <li>- School Administration Committee</li> </ul>

Source: Ministry of Education and Human Resource Development and Korea Education Development Institute (2003), pp.14-17.

Table 12-8. Contents of the field evaluation conducted by the ministry of education and human resource development to evaluate schools

Areas of Assessment	Major Questions
Introduction of School	What are the basic characteristics of the school (composition of personnel and surrounding environment)?
Curricular-Educational Activities	Do the personnel of the school agree with the goals and plans? Do the curricular-educational activities reflect each student's specialty (student level, interests, abilities)? Are curricular-educational activities developing voluntary studying skills?
Pedagogical Activities Outside the Curriculum	Are pedagogical activities outside the curriculum adequately exhibiting student skill and potential? Do pedagogical activities outside the curriculum help develop qualities possessed by democratic citizens?
Activities that Support Education	To provide better educational activities, is the school operated and administered efficiently? Is the school working to improve its teaching and quality? Does the school possess necessary facilities in conducting educational activities? Are the parents, school, and the local community cooperating to improve the quality of education?
Education Policy	While supervising the 7 <sup>th</sup> Curriculum, to what degree has the school faced difficulties? Are ICT-utilizing classes aiding student comprehension? Are special-skill classes helping the development of student quality? Is reducing class size helping to improve the school quality? Is the Student Administration Committee contributing to the democratic management of the school?

Source: Ministry of Education and Human Resource Development and Korea Education Development institute (2003), p.22.

School evaluations held at the city and provincial offices of education level are conducted periodically every two to three years, using the "Primary and Secondary School Evaluation Manual," of 1997 to inspect the progress of implementing education policies and projects. In addition, these tests are acclimated to the trends and directions of the individual city and provincial offices of education. More specifically, the Seoul Metropolitan Office of Education has the following school-evaluation goals: first, it should trigger the efficiency and the accountability of pedagogical activities, second, it must promote autonomous and creative educational activities to alter the education environment, and third, it should elevate the quality of education by discovering and proliferating an excellent case of educational activity (Seoul Metropolitan Office of Education, 2004). School evaluations administered by the Seoul Metropolitan Office of Education are written and site surveys, composed not of "qualitative tests" but of "effort assessments," measuring the progress of educational activities geared toward students and improvements in lecturing methods.

Table 12-9. Areas of assessment and evaluation tasks for general secondary schools of Seoul metropolitan office of education

Area of Assessment	Distribution	Evaluating Project
Internalizing Character Education based on Family-Related Experiences	160 (16%)	Revitalizing exchange and experience learning. Formulating an autonomous living environment. Creating a school without violence. Promoting thrifty spending and environmental education. Internalizing unification education.
Education to develop special skills to fulfill dreams	150 (15%)	Activating enlightening activities. Invigorating special and unique skills. Internalizing science education. Systemizing career guidance. Strengthening physical education.
Sustaining the innovation of classroom and evaluation	290 (29%)	Improvement of class to increase creativity. Reforming evaluation to elevate logic and problem-solving skills. Establishment of guidance for responsibility to increase ability. Promoting effective reading.
Developing knowledge and information skills	120 (12%)	Spreading English education. Increasing computer skills and educating information-technology ethics. Provoke information-utilizing skills for teachers. Use and developing a school homepage.
Constructing a school community for all to participate	280 (28%)	Promoting an autonomous specialty project for each school. Increasing opportunities for parents to join school activities. Internalizing the management of the school's administration committee. Improving student welfare. Developing teachers' specialization and working conditions. Enforce an appropriate and efficient budgeting of school funds.
5 Areas of Assessment	1,000 (100%)	25 Projects and 25 Items.

Source: Seoul Metropolitan Office of Education (2004), pp. 10-72.

The problems associated with the current office and school evaluations are their ambiguity: the vagueness of their secondary goals (Kong, Eun-Bae, 2002). More specifically, the extravagance of evaluating items and the lack of consistency has also been pointed (Baek, Sun-Geun and Baek Sung-Joon). Moreover, there has been negative feedback regarding the inadequacy in actively using the test results. However, in this case, the problem lies in examining the survey as a source of spreading excellent cases and correcting bottlenecks as a reflux mechanism. Thus, rather than limiting the assessment to disclosing outstanding cases, there must be successive measures under the auspices of the Ministry of Education and Human Resource Development or by a regional office of education. Therefore, through rigorous project evaluations, modifications must be made to the project and its affected budgeting system. For evaluation results to influence the performance-management system, achievement goal and indices must first be developed, while redefining the content and procedure of assessment.

### 3.3 Performance-based budget

Education budget falls under the jurisdiction of the Ministry of Education and Human Resource Development. The annual revenue for 2004 increased by 6.1 percent (compared to the annual revenue of 2003) to 4.6 trillion won of which general-accounting revenue increased by 5.7 percent to 252.7 billion won and special-accounting revenue increased by 6.1 percent to 4.4 billion won (both figures compared to 2003) (Ministry of Education and Human Resource Development, 2004). Annual expenditures were 4.0 trillion won for central-education finances and 22.4 trillion won for provincial-education finances (84.9 percent of total budget).

In the process of producing the education budget, the city and provincial offices of education present their annual revenue and expenditure budgets to the Minister of Education and Human Resource Development. Consequently, the minister analyzes the budget; for cities or provinces that have conspicuous declines in efficiency and financial health, the minister is authorized to order inspections of the respective office of education, disclose all results, and provide guidance and maintenance to retain financial stability (Ministry of Education and Human Resource Development, 2002). Furthermore, to determine whether funds were used according to their respective proposals, evaluations are conducted annually before the distribution of resources to increase transparency, performance, and administrative skills. However, a large portion of the budget is spent on personnel expenses and on school administration, making performance management only possible for policy projects.

The long-term plan of the government is to sustain a sound financial basis, construct performance-based financing, and maximize autonomy and participation (Ministry of Education and Human Resource Development, 2003a). Much attention has been given to the construction of performance-based financing that the government proposed, since it will foster performance analysis and evaluation of financial projects, which will be reflected in the distributed budget.

The forecast for provincial finances look rigid due to projects improving education environment, constructing facilities for the 7<sup>th</sup> Curriculum, executing the overall policy to improve teaching professions, and promoting information and technology. Moreover, with the implementation of new policies from the current administrating government, difficulties are expected to be forthcoming in the finances of provincial education (Ministry of Education and Human Resource Development, 2003a). Making efficiency and performance-lead finance system the main priority of the provincial education finance, the introduction of performance-based budgeting and its simulation will be conducted (Ministry of Education and Human Resource Development, 2003a). Furthermore, an analytical index of efficient investment on provincial education finances will be developed and applied to promote soundness, efficiency, fairness, investment return, and autonomy for individual schools.

According to the Special-Accounting Education Budgeting Proposal (Ministry of Education and Human Resource Development, 2003b) to maximize financial management and trigger efficient financial investment of performance-based financing simulation, ten to twenty projects will be selected by each city and provincial offices of education, compose performance index and proposal, which will be used for the following year. In preparation, a budget-assessing committee will be formed to evaluated and analyze financial priorities.

Performance-lead budgeting links projects and resources to performance. By giving autonomy to each division's expenditure and evaluating their performance, they



can assess the amount of money that can be distributed. Moreover, by disclosing performance goals and actual results, this method generates transparency and accountability.

At the moment, there are 27 performance-based budgeting projects administered by the Ministry of Education and Human Resource Development via performance index developed by the Ministry of Budget and Planning. For instance, the goals of the “curricular reform and continued support” project have two goals: implementing a national curriculum and developing specific performance goals and indices to support research related to curricular improvement. Although the Ministry of Education and Human Resource Development planned partial implementation of performance-based budgeting, no specific strategic and performance goals and indices have been developed.

To successfully introduce performance-based budgeting, transparent budgeting and execution, complete disclosure of the entire process, and performance goals and indices must first be developed. However, even with the planned simulation of performance-based budgeting in 2004, the Ministry of Education and Human Resource Development has not even developed a performance index. To include performance-based budgeting to individual schools, an assessing body and evaluating methodology must also be constructed.

Since 1999, the Ministry of Education and Human Resource Development has simulated performance-based budgeting for the “life-long education” project, but did not reap the results it wanted. The difficulty in assimilating an econometric and performance index, unclear achievement results within a fiscal year, and the unwillingness to cooperate to assess school performance by scholastic achievement, academic level per school, and the rates of matriculation and employment, have contributed to its failure. In any case, with high fixed cost associated with the budget of city and provincial offices of education and the Ministry of Education and Human Resource Development there are hopes that performance-based budgeting will be implemented partially for national policy projects and projects at a city and provincial offices of education level.

#### 4. A call for paradigm reform

Primary and secondary school education policies in Korea have focused their efforts to unify the school curriculum and evenly distribute funds rather than managing and improving the performance of education. Their root causes could be found in the equalization policy, which stresses the equal distribution of funds, and the difficulty that follows the assessment of performance in education. However, education, like other public<sup>90</sup> and private sectors, needs to maximize its goals and performance via an efficient allocation of resources.

Hence, this paper proposes the implementation of an “Accountability-Strengthening Program,” which links funds to the achievement of pre-selected goals designed to foster performance in primary and secondary education that will increase student selectivity, maximize efficient fund allocation based on education demands, and diversify the school system and its curriculum. Furthermore, improving the

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<sup>90</sup> Since the year 2000, the Ministry of Planning and Budget is overseeing the performance-based funding system for institutions capable of implementing such system and is increasing their targets (Ministry of Planning and Budget, 2001).

diversity of the education system, increasing the scholastic ability of low-income and low-performing students, and financially rewarding education institutions that have attained the goals set by the government and objectives of the “Accountability-Strengthening Program” are intended for all public and private schools. However, before such programs can be implemented, research pertaining to measuring student achievement and school performance should be conducted to set a standard for assessing school accountability.

#### 4.1. Elevating the Education Performance Evaluation

Prior to implementing a performance-managing policy that fosters the performance in primary and secondary school education, a methodology that systematically measures student achievement and education performance for each individual school needs to be researched and developed. Hence, creating a standard and methodology to quantitatively assess student achievement, which could be used to calculate individual school performance must first be made. Moreover, the construction of such system must consider the following.

First, student achievement must be assessed via scholastic achievement and character development, because these two are the functions of school education. Furthermore, this paper proposes the implementation of a national or a regional achievement evaluation held periodically. In addition, such evaluation must disclose all results as a way of producing an unbiased and objective survey of school performance. Likewise, a quantitative indicator of character development must be developed and used to assess students periodically; the regional office of education should use the results of such findings to construct new programs to foster character development and support their implementation.

Second, there are three ways of evaluating student achievement: using the absolute achievement, the change in achievement, and the success in improving student achievement, which fell previously below the lowest standard. The first method uses a student’s absolute achievement as a basis for evaluating performance for an individual school’s education. The second method uses the amount of change in achievement, rather than their absolute values to determine educating performance.<sup>91</sup> The third method uses the success or failure of improvement for students whose achievement falls below the lowest standard to assess performance.<sup>92</sup> As to which program a school chooses to participate depends on the type of education program for each school. In the case of primary and secondary public schools in Florida, it incorporates the three methods outlined above.

#### 4.2. Introducing an “Accountability-Strengthening Program”

This paper proposes the implementation of an “Accountability-Strengthening Program” for all public and private primary and secondary schools receiving government aid. The “Accountability-Strengthening Program” calls for diversifying primary and secondary education, evaluating accountability tests for the diversified

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<sup>91</sup> Charter Schools in the US use this method to evaluate school performance.

<sup>92</sup> In the case of the “No Child Left Behind Program” in the US, which began in January 2002, success or failure to improve student achievement make the basis for determining performance, intended for students in the bottom 30 percent.

education program, and systemizing funds to be rewarded for education programs that are more successful than others, which could be classified into three categories:

- Strengthening accountability through diversifying the school system,
- Strengthening accountability through the improvement of student achievement for students of low-income and low-ability, and
- Strengthening accountability by rewarding institutions that have fulfilled predetermined goals

Diversifying the school system via strengthening accountability has been restricted as a supplementary issue to other reform agendas, pursued by education reform committees. Thus, the central idea underlying the strengthening of accountability through school-system diversification lies in the increased selectivity of schools for students and the competition among schools, which ultimately leads to improvement of performance of education in schools. The Charter School system in the US and the system outlined in the FKI-CEPRI<sup>93</sup> report are specific examples of this program. By providing individual schools comprehensive jurisdiction over school management and curriculum, thereby diversifying education, accountability of education is strengthened through enabling<sup>94</sup> student selection. More specifically, by implementing a formula-funding system<sup>94</sup> concurrently with the accountability-strengthening program, funds will be efficiently allocated to schools where students choose attend, increasing primary and secondary education performance.

Furthermore, this paper proposes the implementation of accountability-strengthening program via increasing student-achievement performance for students of low-income and low-ability. This proposal is different from the first, because it is intended for all public and private schools, including charter schools. The focus for this program lies in remedial classes,<sup>95</sup> which will increase the scholastic performance of low-income and low-performing students. Policies for students of low-income are geared toward financial assistance (tuition grants and the provision of meals at school) and only directed toward the extreme poor. Moreover, remedial classes for low-performing students were focused on assisting the extremely poor-performing minority. In other words, programs intended to increase performance for low-income and low-performing students are almost nonexistent.

This paper proposes government provision of assistance for programs geared towards increasing scholastic performance for low-income and low-performing students. In doing so, a systematic research pertaining to improve student performance must be conducted beforehand. The “No Child Left Behind Program” of the US that

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<sup>93</sup> The FKI-CEPRI report proposed the implementation of a charter school operating along the following principles: increased student selectivity of schools, provided comprehensive authority over school operation and funds, and issued discriminated government funding contingent upon student size.

<sup>94</sup> Formula Funding is the specification of the “government-discriminated funding system based on student size” often used by charter schools. Formula funding can be divided into four categories – basic student costs, curriculum costs, remedial-educational costs, and school-operation costs – and the calculation involved for each category involve detailed conditions.

<sup>95</sup> Remedial education refers to remedial classes aside from regular courses and livelihood guidance, excluding curriculum guidance.

began in 2002 could be a good case to model. In addition, the government must also provide assistance for remedial programs in each school, geared towards students whose household income and scholastic performance is below a substantial level. Furthermore, schools receiving aid from the government must provide remedial education for low-income and low-performing students;<sup>96</sup> continued government aid must be contingent on the performance of the remedial program.<sup>97</sup> Active student and parent participation must also be considered, and research must also be conducted to attract participants.<sup>98</sup>

Finally, this paper proposes an accountability-strengthening program that utilizes a rewarding system. In this program, individual schools that have accomplished goals outlined by the government to improve education performance will be rewarded to promote school effort to ameliorate their system. More specifically, the government will set achievement goals<sup>99</sup> and recruit schools that want to compete within this condition. Among the participating schools, the government will financially reward the school and its participating members. To strengthen accountability through a rewarding mechanism, this paper proposes the following.

First, regulations pertaining to school affairs should be temporarily exempt for participating schools so that they could conduct various experiments to achieve the goals outlined by the government. If schools are restricted by regulations, their attempts for experimenting will be limited. In other words, the director of a regional education office may function as an exogenous variable, affecting education performance. Thus, a temporary exception for regulations related to school affairs could be implemented in the same manner as charter schools.

In regards to the reward bestowed by the government, there must also be benefits for the members of the school, including teachers and students. Without the active participation of teachers and students, it is difficult to conduct experiments to attain performance goals. Hence, providing direct rewards (incentives)<sup>100</sup> will promote the active participation to achieve these goals.

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<sup>96</sup> Because remedial education could be operated separately from regular classes, accountability-strengthening program must be intended for all public and private schools receiving aid from the government.

<sup>97</sup> In the case of the American "No Child Left Behind Program," direct selection of teachers and curriculum by students and assessment of scholastic improvement have contributed to the strengthening of school accountability.

<sup>98</sup> In a society that stresses academic attainment, students may feel embarrassed to participate in a program for low-income and low-performing students. (Stigma effect) Thus, to encourage active student participation, direct and indirect incentives must be provided.

<sup>99</sup> The government can choose diverse goals such as improving of scholastic achievement and curriculum, innovating class lectures, and developing character.

<sup>100</sup> Rewards for teachers could be a bonus in their salary or additional benefits; for students, scholarship could be considered.

Table 12-10. Accountability-Strengthening Program

<p><b>Diversifying the School System to Assess Accountability (for Charter Schools)</b></p> <ul style="list-style-type: none"> <li>● Diversifying the school system through the introduction of charter schools. (Guarantee school selectivity, provide autonomous operation rights, and financial assistance through formula funding)</li> <li>● Test the accountability of the charter school by evaluating its education performance and assessing the possibility of charter extension.</li> </ul>
<p><b>Improving Scholastic Achievement for Low-Income and Low-Performing Students (for all public and private schools)</b></p> <ul style="list-style-type: none"> <li>● Implement a remedial education program to increase the performance of low-income and low-performing students.</li> <li>● Implement an achievement-evaluating system to assess the quality of remedial education.</li> <li>● Test for accountability based on the improvement of student achievement.</li> </ul>
<p><b>Promoting Competition Among Schools via a Rewarding System (for Schools that desire competition)</b></p> <ul style="list-style-type: none"> <li>● Government will outline performance goals and recruit schools that want to participate in this competition.</li> <li>● Bestow autonomous operation rights for schools participating in the competition, comparable to the level provided to charter schools.</li> <li>● Direct rewards for the school, teacher, and students involved.</li> </ul>

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## **Establishing a Performance Management Strategy: Governing for Results**

*by*

*Harry P. Hatry and Ritu Nayyar-Stone, The Urban Institute*

### **1. Introduction**

#### **1.1. Rationale for performance management**

Government agencies can achieve several important benefits if they regularly (such as quarterly or monthly) track the performance of their programs. Program managers and other public officials need information on both the outputs (the physical products they produce, such as meters of road repaired and number of clients treated) and the outcomes (the effects the program has on their customers, generally, citizens) of their work. This is needed to help managers and other public officials identify problem areas, identify needed improvements, and later assess the results of the actions taken.

Principal benefits of implementing a performance management system are as follows:

- Performance information can be used to improve service quality and results. Over the long run, this is likely to be the most important benefit of performance management.
- Performance information can be used by program managers and other public officials to help them develop and justify their budgets.
- Performance information, particularly outcome information, can help motivate public employees to make improvements and can also make their jobs more interesting, especially if the outcome information (and not only workload information) is regularly made available and discussed with them.
- Performance information is also an important part of a government's accountability and transparency processes. Performance information adds accountability, not only for financial probity but also accountability for using public funds to accomplish important results.

Despite these benefits few countries have implemented a comprehensive performance management system across most, if not all, all agencies at the national level. Some possible reasons are as follows. Implementing a performance management process will usually be quite new and perhaps strange and threatening to public employees. It requires some changes in approach, and some new data collection procedures (such as regular surveys of program customers). Making the transition is not easy and takes time. The results, however, over the long run are likely to be well worth the effort, especially in terms of improved services to the nation's citizens.

Performance management appears to be more prevalent in local government, where the connection between government agencies and citizens is closer and more easily seen. The City of Baltimore (Maryland in the United States), is a recent example of successful implementation of performance management - see the text box insert.

#### **Baltimore's Citi Stat, U.S.A.**

Over the last several years, the Mayor of Baltimore has adopted the "CitiStat" approach as a primary management tool for several of the city's agencies. Supervisors from different agencies appear before the mayor's cabinet every two weeks to discuss their agencies' performance data. A number of improvements were noticed very quickly.

- In the first three-month period there was a 25 percent decrease in overtime in the Water and Waste Division.
- During the regular meetings, department performance graphs are displayed for all to see, and trends of either good or bad performance are usually easy to see.
- City officials note that there is no longer any stigma of having to visit and respond to questions from city leadership.
- There are more opportunities for interagency collaboration and for identifying and sharing better practices.

Once it was decided to implement CitiStat it took three months to collect and analyze the performance information and make a presentation at the Mayor's office. Currently 14 agencies are involved in the CitiStat process. The first agency (solid waste collection) made its presentation on June 2000. Within four months seven agencies were included in the process - regularly reporting data to CitiStat and having bi-monthly meetings to use the information in improving service quality.

The mayor's office estimates a start-up cost of \$20,000 that mostly includes infrastructure and overhead cost and not staff salaries. Agencies can collect data with any software and in any format. However, they all use a similar format in reporting the information to the Mayor's office.

## **1.2. Categories of performance information**

Table 13-1 presents the categories of performance information that are relatively familiar to agency managers. Data on the amount of resources expended for particular programs (inputs), and the products and services that a program has completed (outputs), are regularly used by governments to track program expenditure and service provided. Results-based information (outcomes) is rarer, even though it is considerably more helpful in determining the results and accomplishments of the service. Finally, information that relates the amount of input to the amount of output or outcomes measures efficiency (or its reciprocal) productivity.



Table 13-1. Performance information definitions and sample indicators

<ul style="list-style-type: none"> <li>■ Inputs: Resources used to produce outputs and outcomes. <ul style="list-style-type: none"> <li>● Number of full-time equivalent person-years were spent on the program</li> <li>● Program Expenditures</li> </ul> </li> <li>■ Outputs: Products and services delivered. <ul style="list-style-type: none"> <li>● Number of people served</li> <li>● Number of applications processed</li> <li>● Number of inspections made</li> </ul> </li> <li>■ Outcomes: Results and accomplishments of the service provided. <ul style="list-style-type: none"> <li>● Employment rate for persons that completed the program</li> <li>● Percent of youth graduating from high schools in schools supported by the program</li> <li>● Infant mortality rate in areas targeted by the program</li> </ul> </li> <li>■ Efficiency and Productivity: The amount of input to the amount of output (or outcome). The ratio of the amount of input to the amount of output (or outcome) is labeled "efficiency." The inverse, the ratio of the amount of output (or outcome) to the amount of input, is labeled "productivity." <ul style="list-style-type: none"> <li>● Cost per gallons of drinking water delivered to customers (output based)</li> <li>● Cost per number of roads that were improved from "poor" to "good" condition (outcome based)</li> </ul> </li> </ul>
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Sources: Adapted from Hatry (1999), and Nayyar-Stone, Mark, Cowen, and Hatry (2002).

### 1.3. Content of report

This report provides recommendations for a multi-year strategy and specific steps for providing and using performance information to produce a truly citizen outcome-oriented government. It provides a framework for the introduction of a performance measurement/performance management system in governments throughout the world. The basic assumption is that the purpose of government is to support its citizens in achieving the highest quality of life for the funds that the government is spending.

Performance measurement/performance management systems basically serve two purposes: providing accountability and improving programs and services so as to make them more efficient and effective. The key question for accountability is: What are citizens getting for their money? The key question for improving services is: How can we make programs and services better?

Throughout this report the term "performance measurement" is used to cover measurement of both outputs and outcomes. However, the report focuses primarily on the need to measure and manage outcomes, the most neglected, and most important category of measurement. Outputs are important to measure since they provide basic information as to the government's physical products. The relation of outputs to expenditures is much easier to assess than the relationship of outcomes to either outputs or expenditures. However, outputs tell little about the success of government programs and services in achieving results important to citizens.

“Performance management” occurs when managers use the information from the performance measurement process to help them manage and improve programs and services. Performance management, it can be argued, is the most important reason for performance measurement, even more important in the long run than use of performance measurement to make government accountable. Fortunately, a good performance measurement system can simultaneously provide information useful for both purposes: achieving accountability and improving services.

Government also involves elected officials. They play a major role, as will be discussed, in moving a government to performance measurement and performance management. They should be considered to be an integral part of Governing For Results—both by their support for the effort and by themselves using the information from the process.

This report does not discuss fiscal or financial planning. These, of course, are of major importance for successful governing but are beyond the scope of this paper.

Section 2 provides a sample of a time-phased set of actions needed for implementing a performance management process. Section 3 identifies the roles and responsibilities of the major participants, such as: (a) national offices such as the Ministry of Planning and Budget; (b) the line ministries and agencies; (c) the supporting ministries and agencies; and (d) the legislature. Section 4 discusses a number of key elements relating to designing a performance management system. Section 5 discusses a number of important elements in implementing the design.

As of this time, many national governments have begun introducing some form of performance measurement. However, few appear to have made major progress in introducing performance management. Even these efforts have tended to focus on outputs and not on the results of those outputs. In addition, the focus in almost all national governments of which we are aware, has been to move as soon as possible, if not immediately, into performance budgeting.

Much less attention has been focused on helping managers use the information to improve their services to citizens. This, unfortunately, means that examples of good performance management practice by national governments are rare. We have, thus, had to draw from the experiences of sub-national governments, such as local governments, where more active progress has been made. Overall, however, the reader needs to recognize that while “lip-service” on performance management has been present for years, the actual practice at any level of government, while growing considerably, is still rare.

## **2. Time-phasing of basic steps in implementing performance management**

This section provides a “model” schedule for the first three years of implementing a performance management process for a national government. A three-year period is likely to be required for initiating such a process. However, full implementation is likely to take many more years.

Countries such as Australia, Canada, Sweden, United Kingdom, and the United States have each taken a number of years including periodic shifts in direction of their processes. As noted at the beginning of this report, country initial efforts have focused on performance measurement, performance budgeting, and sometimes strategic planning. The use by agencies and their programs for improving services, and not merely for budget preparation and justification, appears to be rare and a much more recent development (It is not clear to us that this has yet been accomplished in a comprehensive way). Local governments, particularly a number in the United States

have made more progress in using performance information for internal management uses, but this also has not happened overnight.

## 2.1. During the first year or so:

### Step 1: Initial implementation steps – Establish an oversight committee, develop a multi-year plan, and identify the resources needed

Establish a government-wide Performance Measurement/Performance Management Steering Committee to provide comprehensive support, guidance, and advice on performance management and measurement efforts throughout the government. Agencies face many common issues implementing performance management successfully. Each agency should not have to “start from scratch.” Table 13-2 provides suggestions on the committee’s composition. This will also help to build support for the performance management process. Each ministry and each agency might form a similar steering committee.

Table 13-2. Possible composition of a national oversight steering committee

<p>The Steering Committee might include representatives from the following types of organizations:</p> <ul style="list-style-type: none"> <li>● Budget Office, e.g., ministry of planning and budget</li> <li>● Finance Office.</li> <li>● National Planning office.</li> <li>● Ministerial offices, perhaps up to three</li> <li>● Operating agencies (at least three)</li> <li>● Civil Service/Human Resource office.</li> <li>● Office of the Auditor/Inspector General</li> <li>● Outside expert</li> </ul>
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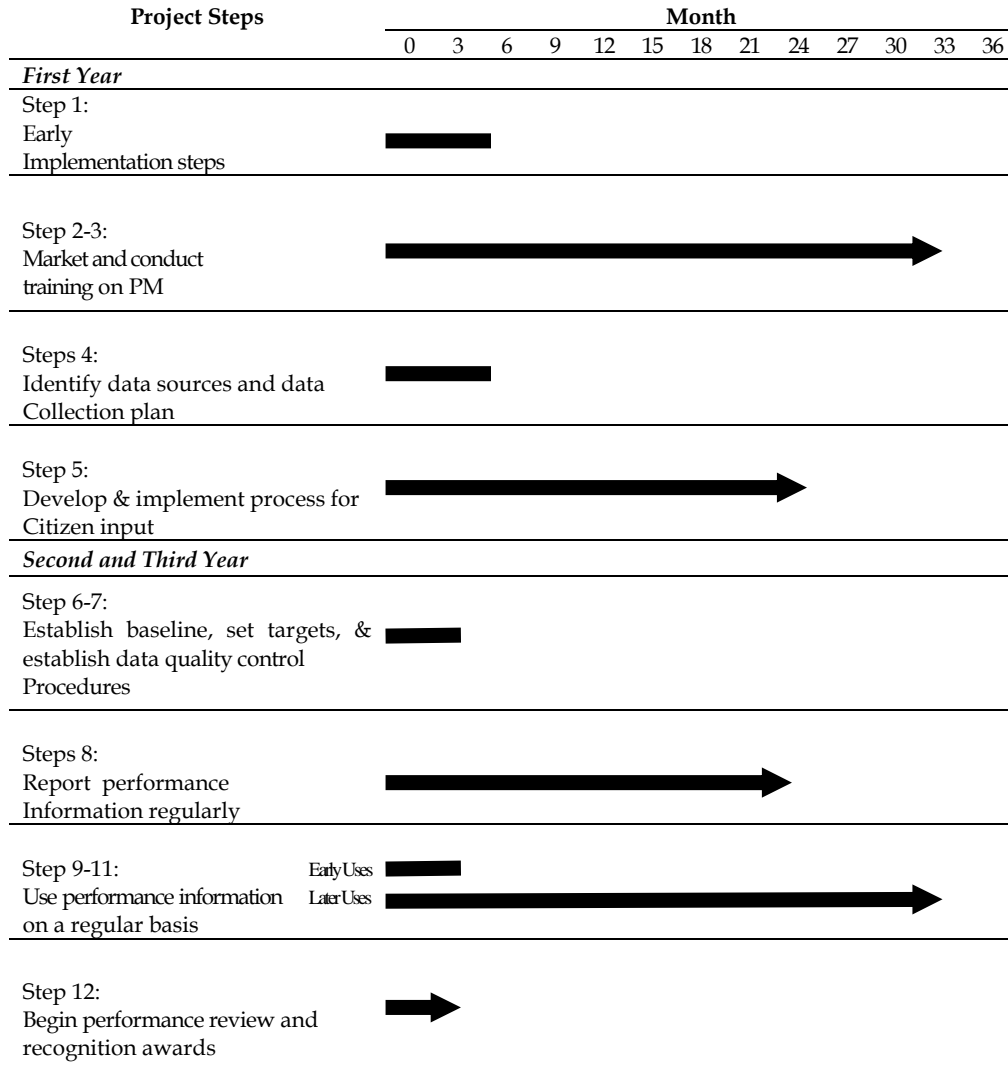
The Ministry of Planning and Budget in Korea is planning to establish a “Central Performance Management System Advisory Group” one at each ministry. Advisory groups are to consist of officials from the MPB and line ministries and private sector professionals.<sup>101</sup> High-level officials need to be fully supportive of this performance measurement/management-by-results approach – for it to be fully implemented and sustainable over time.

Develop a multi-year implementation plan for performance measurement/performance management (perhaps covering the next 3-5 years). The plan should identify which organizations should do what and by when (for example identification of indicators, data

<sup>101</sup> Kim, Jay-hyung (2003), p. 8.

collection, and analysis). Figure 13-1 provides a sample three-year schedule that focuses on the “technical” steps for any single agency or program within the agency.

Figure 13-1. Sample Performance Management System schedule for each program/service – 36 month schedule



Estimate the start-up costs and subsequent on-going implementation costs for the performance management system. Seek funding for any significant added start-up costs. Over the long run, performance management is expected to become a basic part

of the work of public managers and be routinely financed by regular operational funding. (Note: this step may need to be delayed until development of the data collection plan described in step 4 below.)

## **Step 2: Market performance management among employees**

Market performance measurement/performance management among government employees. Disseminate the reasons for regular outcome monitoring throughout the government. Make it clear that this has high level and widespread support. Seek support from elected officials, the business community, and the general public.

A key “marketing” approach is for upper- and middle-level managers to require regular performance reports and to use them as an opportunity to hold program performance review meetings. If program outcomes are a major subject of those sessions, this will indicate to other government personnel that results are of key importance. This type of meeting is discussed in more detail in Step 12.

## **Step 3: Develop guidance materials and a training plan for performance management**

Develop and disseminate guidance materials on performance measurement/performance management for use by both management and non-management personnel. Include definitions of key terms relating to performance measurement, such as “outcome,” “result,” “output,” etc. — needed to avoid confusion in terminology among agencies and their programs. This includes developing a manual on performance measurement and on the constructive use of performance information (transforming performance measurement into performance management) for use by individual agencies and their programs.

Develop a plan for performance measurement/performance management training programs and technical assistance. Estimate who will need training (e.g., what levels and what functions) and when, and how many persons need to be included. Assign responsibility for this step.

The training on performance measurement might include information on:

- What performance measurement is (focusing on measuring outcomes).
- How performance measurement can be used for managing performance.
- The types of data collection procedures (especially customer surveys, trained observer ratings, and use of agency records).

Trainers in practical outcome-based performance measurement are likely to be quite scarce. An option is to consider participants in the government's early performance measurement programs efforts as candidates for trainers, even if the training is for other programs or other agencies.

If the country has chosen to adopt a pilot approach to implementing performance management (see section 4), ask personnel who participated in successful early trials of outcome-based performance measurement systems to help with performance measurement training. When feasible, also ask those personnel to provide technical assistance to other agencies in their performance measurement development efforts.

**Step 4: Identify current data availability and develop a data collection plan**

Identify the current performance data available and the major performance data gaps in what performance information managers need. Ask agencies to identify performance indicators for which regular data are desirable for each of their major programs. The indicators should include both outputs (the amount of work accomplished) and outcomes (the quality and effects of the program's work on citizens). The indicators should include both those for which data are currently available and those for which data are not currently available but can be obtained in the future. (Many programs will probably not currently be systematically obtaining outcome data.) Customer surveys and "trained observer" procedures are both likely to be useful to many agencies for collecting outcome information for their performance measurement systems.

Request that each agency develop a data collection plan for the performance indicators, particularly the performance indicators for which data are not currently being collected. The data collection plan should: define thoroughly each performance indicator; identify how the data will be collected (the data collection procedure that is expected to use); the timing and frequency with which the data for each indicator will be collected and reported; who will be responsible for obtaining the data on each indicator, and any special resources needed for collecting the data.

Given the considerable potential usefulness of customer surveys for many agencies, the government should consider providing some national technical assistance in customer survey procedures to agencies and their programs. Any agency, and any program within an agency, that plans to use regular customer surveys will face a set of common issues.

**Step 5: Develop a process for citizen input**

Develop and implement a process for the government and its individual programs for obtaining input from citizens on the quality and effects of the agencies' services. First, develop and implement a process for obtaining input from citizens for selecting the outcome indicators, such as through the use of focus groups or hearings. Second, consider using citizens to help with data collection, such as doing "trained observer" ratings of educational or health facilities, roads, or landfills in their city.

**2.2. During the second and third years:****Step 6: Establish a baseline and set targets for improvements**

First obtain data for performance indicators to establish a baseline. This is vital for future target setting by program managers. Such targets, of course, need to be related to the resources expected to be available to the program.

Begin holding regular (perhaps quarterly) performance reviews whereby a manager, at any level, meets with staff to discuss the findings and what needs to be improved and how – shortly after the performance report for the latest reporting period has become available. In subsequent meetings assess the extent to which changes have led to desired improvements.

**Step 7: Develop procedures for data quality control**

Develop procedures for data quality control. Such offices as those of an Auditor General and any Agency Comptrollers might be encouraged to incorporate performance data collection procedure reviews in their work. The purpose here is to encourage, and ensure, that the outcome data are of satisfactory quality.

**Step 8: Report performance information regularly**

After the performance measurement process has been underway for a year or so, ask each operating agency to develop annual reports for the public, ones that include outcome information. Whenever possible, break out (disaggregate) outcome information to show outcomes for different customer groups. Some examples of candidate breakouts are income, age, gender, and location.

Involve citizens in group meetings to discuss the findings from the outcome reports. These meetings would include discussion of customer/citizen responsibilities in producing successful outcomes, as well as the role and improvement actions needed by government programs.

**Step 9: Use performance information in budget submissions**

Begin calling for agencies to provide performance information in budget submissions at the beginning of the second year of implementing a performance management strategy. This is an early use of performance information. The Government and its Budget Office can begin to request (and, at a later stage, require) outcome information from agencies as part of each agency's budget submissions. Budget-year targets for each performance indicator should also be requested for agencies for each program. The budget requested for each program is that expected to be needed to help produce the outcomes targets that the program proposes for the budget year for each of its performance indicators.

Budget reviews by the Budget Office and, internally, by the agencies themselves, should include reviews of past achievement of outcomes and reviews of the outcomes that agencies hope to achieve in the new budget year (with the resources requested by the programs).

If the government reviews outcomes as part of its review of agency budget proposals, this will be a major motivator to encourage agencies and their programs to obtain and use outcome information.

**Step 10: Use performance information to make service improvements**

Only by using performance information can each agency get the full benefit of implementing a performance management strategy at the national level. Governments initiating such a process often spend considerable time collecting data and then stop at reporting the performance information – the use of such information does not get sufficient attention. One approach is to develop and implement service improvement action plans. These focus attention on priority improvements by using performance indicators to establish improvement targets and then track progress towards those targets. This can be done towards the end of the first year after implementing a performance management system.

A service improvement action plan is usually developed and implemented through a working group created within the agency. This group can include senior

management, technical, and line staff. Researchers or external experts (from the business or academic community) can also be members. The working group starts by assessing the critical issues facing their agency. It then selects outcomes and indicators, establishes baseline data, and sets improvement targets, develops and implements an action plan with clear roles and responsibilities to achieve the targets, and collects data again – in 3, 6, or 9 months – to identify the extent to which the desired improvements in service outcomes have occurred.

As shown in the text box insert, a municipality in Albania has used these action plans.

#### **Improving Roads and Footbridges in Baldusku, Albania**

In 1999, Baldusku – a rural commune consisting of 14 villages (average population of 400) – decided to prioritize the improvement and building of new roads and footbridges that connect the villages to the main road. They did the following:

- Developed outcome performance indicators. For example, (1) increase the percent that rate the condition of access roads as adequate or better from 37 percent to 45 percent, and (2) decrease the number of footbridges rated in bad or worse condition.
- Undertook a citizen survey to obtain a satisfaction rating on roads and footbridges in different zones of the commune. Survey results were distributed to all 14 villages via a newsletter.
- Launched a public awareness campaign for citizen contributions to the building of three footbridges.
- Obtained donor funding (World Bank, Soros, and International Organization for Migration) to purchase road and footbridge maintenance equipment.

### **Step 11: Include performance measures in contracts**

Consider using “performance contracting” when contracting for important program services – whether to non-government organizations (NGOs), for-profit businesses, or other public agencies. Performance contracts include outcome indicators and outcome targets in the contracts. Thus, performance contracts identify what outcomes are required and how much outcomes are expected, rather than specifying in the contract how to do the service. Performance contracts sometimes detail specific monetary rewards and/or penalties for particular levels of outcome. (For example, contracts for employment programs might pay the contractor a specified number of money for each client for whom a job was found.)

The use of performance information in contracts can be initiated after the agency and its program have sufficient performance data to establish performance targets for the contract.

Agencies should encourage government contractors to use outcome measurement procedures. Outcome data will help contractors regularly assess how successful their activities are and help them identify elements of their services that need improvement. Subsequently, the outcome information can help them assess the extent to which those improvement actions have been successful.



## **Step 12: Begin annual performance reviews and recognition awards to motivate staff**

Begin providing good-performance recognition rewards for agencies, or programs within agencies, for excellence in helping produce high outcomes. Such awards would reward agencies or programs that have achieved high levels of outcomes and those whose outcomes have improved significantly in the past year.

Begin including in annual performance reviews of program manager, and other key staff, a review of the most recent available findings on program outcomes. If the program has not yet implemented an outcome monitoring process, the performance reviews of the manager and key staff would include, as one of the elements being appraised, the extent to which they are making progress in implementing such a process.

### **3. Roles and responsibilities**

#### **3.1. The role of the national oversight office (such as a ministry of planning and budget) and its relationship to the line ministries**

This is a key, if not the key, relationship needed to develop an effective performance management process. The national ministry should provide basic guidelines and ground rules for the overall process. At the same time, the challenge is to provide enough flexibility to the individual line ministries and their agencies to develop performance indicators, data collection systems, and reports appropriate for their own needs. Providing common definitions of key performance measurement terms and basic performance reporting formats that all agencies need to use in reporting to the center is desirable — to avoid confusion and inconsistent reporting. See the Philippines example in the text box insert as a sample national government initiative.

#### **Piloting Local Government Administrative Reform in the Philippines**

Within the context of the Medium-term Philippine Development Plan 1999 to 2004, the national government has implemented the Local Development Administrative Measurement System (LDMAS). The LDMAS was developed in consultation with national and local government agencies, civil society groups, donors and academics and is organized around 11 key local government performance 'domains' (e.g., fiscal management, service delivery, land use, infrastructure, etc.). These domains are measured through 67 input, process, output, and outcome indicators, and have been recently pilot tested in 6 municipalities with the following impact:

- Each of the six municipalities reported that the indicators provided administrators with important measures of performance that were previously not accessible.
- In the small GoA municipality, the indicators directed attention to poor fiscal performance of the city administration, leading to the initiation of a series of measures to improve the fiscal performance.

The national office would call for ministries and their agencies to provide data on their major outputs, outcomes, and efficiency indicators. This would be a requirement in budget submissions. The national office probably would also call for reporting on these indicators at regular intervals throughout the year, such as quarterly. The latter is particularly important for moving from a purely performance measurement system to performance management. These regular reports provide a basis for program reviews, permitting more timely mid-course modifications throughout the year.

The national office should establish basic common reporting formats that it needs to review performance. For budget submissions, it might call for separate reports on each agency's performance indicators. Or – more commonly done – it might call for identifying the indicators and their values along with the funding information for each program. The national office might request that indicators be reported by category of indicator (such as whether the indicator measures an output, an intermediate outcome, an end outcome, or efficiency). The form might contain separate columns for reporting indicator values for some number of past years, columns for the budget-year performance targets for each performance indicator. (The form might also call for reporting anticipated values for performance indicators for programs whose budgets are expected to produce products in years beyond the budget year. This appears to be rare in current performance budgeting systems, at least as a formal requirement.) The national office should also include requirements for agencies to provide explanations when the indicator values are considerably worse, or better, than the targets. See the Texas and Louisiana example in the text box insert.

#### **Requiring Explanatory Information: Texas and Louisiana, US**

The states of Texas and Louisiana in the United States have required formal explanations for any performance indicator values that are not within either plus or minus five percent of the target that the agency had set for the performance indicator for the reporting period.

Both states require quarterly reporting on performance to the governor and legislature, and have established web-based reporting systems, so that agencies can easily enter their results every quarter. For example, see the Louisiana Performance Accountability System (LaPAS) at <http://www.state.la.us/opb/lapas/lapas.htm>

A key element for governments that have performance measurement systems is that providing the data is likely to be perceived by many managers as being threatening. This is not an unreasonable concern by managers. This fear can lead to various forms of non-cooperation, playing games with the numbers, reporting only on indicators that have had favorable values. The national office needs to take some steps to alleviate this problem, for example, by establishing a constructive rather than punitive framework in using performance information.

The national office would review the indicators provided to it by ministries and their programs to make sure they are sufficiently comprehensive and appropriate. When not satisfied, the office would work with the ministry and agency to work out a more satisfactory set of indicators. The national office also will be concerned about the quality of the data. Suggestions for alleviating this concern are discussed later in this report.

The national office also must be careful not to over-react to worse than expected performance figures. It should avoid automatically blaming agency or program management. Before acting, any reviewing office needs to first seek to determine the reason for the poor results. For example, weak outcomes may have occurred not because of any inherent problem with the program concept management but because of external factors (such as worsening economic conditions that hampered the ability of government employment programs to find jobs for unemployed workers).

Preferably the national office would act as a helper to line ministries and their agencies in developing their own performance management processes. This is likely to be a different perspective than is typical for national budget offices that consider their role as solely to review agency budgets to keep them as low as possible.

The government is likely to need a separate unit from the unit that examines budgets to develop the performance management guidance and provide assistance to agencies (such as the “management” part of the Office of Management and Budget). Each ministry and each operating agency will have its own special performance measurement problems. The use of an across-the-government oversight group, as discussed elsewhere in this report, can be used to help work out conflicts when they arise between agency flexibility and the oversight offices needs for common reporting. It is likely highly desirable for the national ministry to select the terms for the various types of indicators, define them carefully, and provide examples. Unfortunately, considerable confusion has resulted in many governments because of lack of at least some attempt at standardization.

As noted in section 2, implementation is likely to be eased considerably, and ministry and agency resistance reduced, if the government establishes a government-wide oversight group that involves ministries and agencies in guiding implementation.

Table 13-3 summarizes the key responsibilities of the national oversight office.

Table 13-3. The responsibilities of the national oversight offices

1. Establish ground-rules and guidelines for required regular reports and for budget submissions (such as: definitions of required types of performance indicators; guidelines for presenting budget period targets for individual performance indicators; number of prior years for which data are to be reported, requirements for providing explanations for unexpected numbers; and the format for presenting this information).
2. Provide training to budget examiners in performance analysis.
3. Establish requirements, if any, for long-range strategic planning (including the number of years to be covered and the content – see Table 13-6 for suggestions on content).
4. Provide support and at least some resources for initial agency training and technical assistance in performance measurement and performance budgeting.
5. Design incentives to agencies for performance measurement and performance management (with an emphasis during at least the initial years in non-monetary rewards for good performance, such as recognition awards for agencies and programs with sustained good outcomes).

### 3.2. Role of ministries and agencies<sup>102</sup>

The work of ministries and their agencies are, of course, essential to the successful implementation of a performance management system. Each Ministry will have to make a number of decisions specific to its own implementation of the system. These decisions are listed in Table 13-4. Each decision is discussed below.

Table 13-4. Decisions at the ministerial and agency levels

<ul style="list-style-type: none"> <li>• Who will take the lead in establishing a performance management system in the ministry?</li> <li>• Who will take the lead in establishing performance management in the agencies?</li> <li>• Who is responsible for what (strategic missions and policy objectives; agency objectives, indicators and targets)?</li> <li>• Who will select the performance indicators?</li> <li>• Will there be a strategic plan and when?</li> <li>• Who will be trained, in what, and by whom?</li> <li>• What resources are needed and available to implement the process?</li> <li>• What reporting requirements will be assigned?</li> <li>• How will performance information be used in preparing and justifying budgets?</li> <li>• How will internal performance targets be established?</li> <li>• What kind of IT support system will be necessary?</li> <li>• What kind of incentives will be used to encourage improved performance?</li> <li>• What is the role of performance information in contracting for services?</li> <li>• What will be the role of local governments?</li> <li>• What will be the role of customers, businesses, and nongovernmental organizations in performance management?</li> <li>• What quality control procedures will be used?</li> <li>• When and in what form should performance information be shared with the public?</li> </ul>
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#### 3.2.1. Who will take the lead in establishing performance management in the Ministry?

Each minister will need to designate a senior person to lead in establishing a performance management system at the ministry. The day-to-day management and supervision of this system will usually not be feasible for the minister. If possible, the designated individual would be a non-political appointee, to assure continuity to the system even with a change in government. This person should have sufficient authority to make some key decisions on behalf of the minister. (Management and supervision of full-scale performance management within a ministry might require, perhaps, 40 percent of this person's time over a one-to-two year period.)

Each ministry will likely find it very useful to establish a ministerial oversight committee of, say, 8-12 individuals to oversee development and implementation of performance management. In addition to the person appointed by the minister to guide this process, the committee might consist of:

<sup>102</sup> Some of the issues discussed in this section are drawn from Hatry (2002) and Nayyar-Stone, Mark, Cowen, and Hatry (2002).

- High-level officials of a few agencies within the ministry
- Representatives of the planning and budgeting office in the ministry
- Representatives of the ministry's human resources office, such as the official in charge of training
- A leading expert in evaluation or performance measurement, whether inside or outside the ministry and government
- A representative from the national ministry of planning and budgeting (to provide a broader perspective)
- A representative from the information technology office
- Possibly, one or two persons from outside the government who represent the sector that the ministry serves.

Korea, in addition to establishing a national performance measurement system advisory group, also is planning to establish a performance management advisory group in each ministry.

### **3.2.2. Who will take the lead in establishing performance management in the agencies?**

Each agency will need to identify personnel who will lead the agency's effort. The agency head will need to designate that individual. Probably the agency should also form an overall coordinating/oversight group consisting of representatives from a number of programs, if not all major programs, in the agency that would work together. The group would recommend agency strategies for such performance management elements as developing an overall schedule, training of staff, common reporting formats that supplement those required by the ministry, and obtaining resources where needed.

### **3.2.3. Who is responsible for what?**

Clear responsibilities and timelines will need to be developed for each of the following:

- Developing an overall mission for the ministry and specific missions for the individual agencies and their individual programs.<sup>103</sup>
- Identifying the outcomes sought by each agency and each program, developing the specific performance indicators needed to track progress of each desired outcome, and who and how will targets be developed for each performance indicator.
- Prioritizing and defining the agencies and programs that will be the initial pilots adopting performance management – if the government decides to start with a pilot rather than full-scale adoption of performance management. (It is probably preferable to cover the entire ministry from the start, rather than specifying a few agencies as a pilot. This issue is discussed further in Section 5.)

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<sup>103</sup> It is very difficult to define the word "program" very specifically. In general, a program is a group of government activities that has a particular mission and is sufficiently substantial to warrant being identified as a specific entity with its own budget. Each government needs to establish its own set of programs. Some examples of what might be separate programs are: road maintenance, road construction, communicable disease prevention (but the health agency might want to have separate programs aimed at particular diseases, such as AIDS-prevention), water pollution control, and foreign trade development.

The overall mission for the ministry and its strategic/policy objectives are a major basis for agency goals, objectives, performance indicators and targets. Therefore, it is important that they are clear and specific enough to provide guidance to the agencies.

#### *3.2.4. Who will select the performance indicators?*

Generally, the individual agency programs are asked to develop the set of performance indicators for the program. However, the ministry and agency need to determine what reviews will be made of the program's choices (A national ministry, such as the Ministry of Planning and Budget, should also later review the performance indicators, at least the key performance indicators that it believes it needs for its reviews and should be provided to elected officials).

Programs tend to focus on outputs (and to a lesser extent, unit-cost), indicators over which they have most control, with little focus on outcome indicators. However, a key principle of performance management is that a major focus is to assess and attempt to improve outcomes important to citizens. Thus, upper-level reviews of the program's choices of performance indicators will almost certainly be needed to assure that the program includes an adequate balance of outcome, as well as output, indicators.

The identification of a clear set of clear mission/objectives and valid indicators that can assess results is a critical foundation for a performance management process. Shortcomings in these have led to many problems in implementing useful performance management.<sup>104</sup>

#### *3.2.5. Will there be a strategic plan and when?*

The concept of strategic planning is excellent. It is highly desirable that each government agency periodically undertake an extensive examination of what its missions is, what the agency wants to accomplish in the future (its objectives), what the future is likely to look like, and what steps the agency needs to undertake to reach its future objectives.

However, it is not necessary to carry out a full blown strategic planning exercise in order to start implementing performance management. It likely would be better for the agency to focus initially on determining what the agency's mission is, what type of outcomes it seeks, and what outcome indicators should be tracked to assess progress in achieving those outcomes. It probably should wait until it has gained experience in performance measurement, after which each ministry may want to prepare strategic plan.<sup>105</sup>

Once a ministry has an established performance management system and a strategic plan, they will have very strong synergies and complement each other very well. For example:

- The mission statement, objectives, key outcome indicators included in the strategic plan can also be an integral part of the performance measurement system.
- The performance measurement system can be constructed to track the key outcome indicators for assessing progress towards the objectives included in

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<sup>104</sup> This was noted by Gustafsson in this conference volume in describing the Swedish system. It appears to apply equally to most, if not all, the other major country efforts to date.

<sup>105</sup> One form of strategic planning is "appraisal or situational analysis" (also known as a strength, weaknesses, opportunity, and threat analysis (SWOT)).

the strategic plan—as well as providing other, more detailed, indicators needed for program reviews and to help in program improvement.

- The first year of the strategic plan should be the basis for establishing the budget for that year.

The strategic plan provides an appropriate opportunity to stress that service to customers is a key issue for the ministry, even for line staff. It can also serve as a public information document for the public. The main concern with strategic planning is the time and effort needed to develop a thorough and useful strategic plan. Many government organizations that have prepared strategic plans only prepare complete new plans every few years. They do, however, update them perhaps every other year. If this is not done, plans can quickly become obsolete and irrelevant.

Probably the main value is not the strategic plan itself but rather the strategic planning exercise, forcing the government to think about and evaluate new strategies, new approaches, especially in the face of changing environmental and technological conditions. Many, if not most, strategic planning exercises, and the strategic plan that results, have fallen far short of being thorough examinations of the agency's mission, the future, and alternative strategies. This issue is discussed further in Section 5.

### ***3.2.6. Who will be trained, in what, and by whom?***

Adoption of performance management requires adequate staff training to ensure they have the skills and understanding of performance measurement and performance management concepts and procedures.

Several levels of training are required — for senior managers in the ministry headquarters, for managers and supervisors in individual line agencies, and for many, if not most, line and support staffs. It can be argued that every one in the government should have exposure to the concepts of citizen-focused services, a central concept of performance management. Probably the most efficient way is to first train senior managers at the ministry and agency level using external trainers and any training materials developed by the Ministry of Planning and Budget.

Following this, the ministerial staff should adjust the material so that it is specific to the ministry and its agencies. Training for managers and professional staff in the agencies might be provided initially by staff at the ministry. However, in the long run, such training should be considered to be the responsibility of each agency. Performance management should be considered to be just part of good management. At the beginning of training for line staff, a one-hour presentation by the Minister and head of the agency, indicating their support for performance management, can be very effective in clearly indicating that these high-level officials take performance management seriously.

It is important that training is done not only at the start of the Performance Management Strategy, but also on an ongoing regular basis to reconfirm techniques and learn new approaches. Training will also be required for new staff joining the ministry. The content of the training is discussed in Section 5.

### ***3.2.7. What resources are needed and available to implement the process?***

The ministry with its agencies and programs will need to consider what added financial costs and time will likely be needed. Then it will need to consider where that cost and time will come from. Some initial assistance preferably would come from the national ministry sponsoring the performance management effort, such as for initial training. Some might come from outside funding sources such as the multi-lateral banks and bilateral organizations.

Over the long run, however, the ministry and its agencies will need to be responsible for their own performance management efforts. Performance management should be considered to be just a part of good management. The potential costs of a performance management process are discussed further in Section 5.

### ***3.2.8. What reporting requirements will be assigned?***

The ministry will want to specify reporting requirements for its agencies – and in a manner compatible with the requirements specified by the national budget ministry. The agencies will want to specify reporting requirements for its programs. Reporting requirements include:

- What types of performance information is to be reported;
- What explanatory information should be provided if actual performance levels miss or considerably exceed, the targets for the performance indicators – and steps being planned or undertaken to correct the problem;
- In what formats;
- When they will be required.

While each agency and each program may choose to track a relatively large number of indicators for internal use, each will need to select a shorter list for “external” reporting.

In addition, the ministry and/or agencies, with their programs, need to develop guidelines for analysis of the performance data, especially outcome data. The raw data are rarely useful to managers and staff. Data on individual events need to be aggregated and then grouped in ways that can be really useful. For example, outcome data will usually be considerably more useful to managers if the performance data are grouped by such characteristics as the following:

- By demographic groups, such as: age group, gender, race/ethnicity, and income group
- By geographical areas, such as: regions, districts, and municipality
- By the particular office or facility providing the service (it is a basic principle of performance management that each manager should be provided performance data related to each manager's own area of responsibility).

A major use of such groupings of the outcome data is to provide benchmarks against which managers and others can assess progress. (Other benchmarks include comparisons to outcomes in other similar countries. This is already commonly done for a number of basic countrywide indicators, such as infant mortality rates. This requires that reasonably similar data are being collected.)

### ***3.2.9. How will performance information be used in preparing and justifying budgets?***

Budget preparation and justification is of major concern to ministries and their agencies and programs. Some budget instructions will come from the national budget ministry. In a performance management system, a major new budgeting element is performance budgeting – the inclusion and consideration of output and, particularly, outcome information as part of budget submissions.

However, each ministry and its agencies will likely want to determine the way budgets will be prepared and submitted in more detail than that included in the guidance provided to it by the national budget ministry. The ministry and agencies will want to select those performance indicators that are most appropriate for inclusion in budget submissions. Agencies and their programs will inevitably need for internal



management purposes considerably more output and outcome information than is likely to be needed by the national budget ministry.

A major requirement in performance budgeting is to set targets for each reported performance indicator for the budget year. The ministry and its agencies will need to develop guidelines rules as to how these might be chosen. We note that choosing targets for outcome indicators is likely to be more of an art than a science. While often it will be possible to relate outputs to budget size, this is seldom, if ever, true for outcomes. Seldom, if ever, will formulas become available that permit precise forecasts of outcomes from budget size.

### ***3.2.10. How will internal performance targets be established?***

Setting performance targets for each output and outcome indicator at the beginning of each year, and then reviewing performance against those targets periodically throughout the year, are basic elements of performance management. As noted above, establishing annual targets is usually required as part of budget submissions. However, for internal management purposes, it is good practice to also set targets for shorter reporting periods, such as for each quarter of the year or for each month. Following are some ideas for selecting targets:

- First, consider previous performance.
- Consider new internal developments such as new technologies likely to affect future performance.
- Consider external factors that can be expected in the future, such as population and economic changes
- Consider benchmarking against the best, such as the outcomes achieved by the program's best performing regional offices.
- If benchmarking against the best is considered too great a challenge, use the average performance of all units.
- Make sure the targets chosen are feasible, given the agency's budget and staffing plan for the year.
- Consider seasonal factors.

### ***3.2.11. What kind of information technology (IT) support system will be necessary?***

Computerized data-processing capability and skills in the ministry and agencies will make it much easier to collect and analyze performance information and in a timely manner. The extent of technical assistance from IT offices (whether coming from the national level of government and/or from the ministry) will likely be important to each program attempting to provide accurate and timely performance data on many performance indicators.

If possible, information on each agency can also be placed on the world-wide-web for easy accessibility and update.

### ***3.2.12. What kind of incentives will be used to encourage improved performance?***

Performance data can be used to help motivate agencies, programs, and their staffs. A list of incentives that include performance as a major criterion, and have been used in the past by governments, is presented in Section 4.

The incentives available will likely be largely determined by national, not the line, ministries, especially monetary incentives. However, line ministries and their agencies will likely have some flexibility in their application. Ministries and their agencies are likely to have authority to decide for themselves whether to use non-monetary incentives. These include:

- Recognition awards, whether awards are to be made to whole agencies, whole programs, teams of workers, or individuals.
- Regular program performance reviews, perhaps held with staff shortly after each performance report has been issued and disseminated to staff. At these sessions, staff would discuss where performance was very high and where performance was disappointing, discuss why, and suggest actions to improve performance in the future. Note that this motivational approach does not use awards to motivate. Rather, this approach motivates by establishing that management is taking performance information seriously and wants to use the information in a constructive way to improve public services. Regular performance reviews may be the most effective motivator, non-monetary or monetary! (Some large cities in the United States, especially New York City and Baltimore, have begun using this approach in recent years with what appears to be considerable success.)
- Allocating discretionary funds to agencies (or to individual agency programs) for programs with high performance (such as providing extra resources for training, for other professional development opportunities, or for new equipment).

### **3.2.13. What is the role of performance information in contracting for services?**

If an agency contracts or provides grants to other organizations for services to customers, it can include performance targets in the agreements, especially outcome targets, and then compare actual performance to those targets. This is called performance contracting. The agreements can also include specific rewards and penalties for meeting or exceeding targets and for failing to meet the targets. (One of the first uses for performance contracting has been in road construction where bonuses are provided for completing construction projects ahead of schedule and for reduced fees for missing the schedules completion dates. In recent years such contracts have been used for a wide variety of services, such as employment and adoption services).

An additional motivator for contractors to perform well is to include past performance history as a criterion for future awards. Outcome-based performance contracts will be made attractive for contractors, and reduce their resistance to them, by exchanging this greater accountability for more flexibility in how the work is performed.

Government agencies need to consider a number of important issues when using performance contracting:

- The agency needs to have capacity to establish such contracts so they are fair to both the public and the contractor.
- The agency needs to have the capacity to monitor contractors carefully to obtain the info it needs to determine the extent to which contractors have met their targets – and be able to judge the validity of claimed reasons outside their control preventing them from meeting their targets.
- Performance targets should be compatible with, and support, the performance indicators in the program's performance measurement system.
- The program will probably need to encourage, and help, contractors maintain their own performance measurement processes but require them to allow the program to undertake periodic quality control audits of the contractor's data systems.

### **3.2.14. What will be the role of local governments?**

Ministries and agencies that provide resources, or regulate, services provided by regional or local governments, need to consider what performance information they need for their oversight work. The ministries and agencies will need to work with those governments to determine the reporting requirements. This includes identifying what data on what performance indicators will be needed and the reporting timing. (Local governments are likely to find the performance data useful as well.)

### 3.2.15. *What will be the role of customers, businesses, and nongovernmental organizations?*

These stakeholders have important role in at least three stages of implementing a performance management system. Here are some potential roles:

- They are important sources of ideas for determining what outcome indicators the program should track. This information can be obtained by holding focus group meetings with customers, businesses, and NGOs.
- They can be important source of data for measuring outcomes. Reliable feedback can be obtained from citizens and businesses by sponsoring quality surveys.
- They are important potential customers for performance reports. They can become supporters of the activities of the ministry – if the reports focus on outcomes (and not outputs) and provide clear, understandable, information of interest to them.

NGOs can also join together in identifying the principal interests of their constituents, and prepare report cards (see text box insert) to monitor the government's performance.

#### **Using Citizen Report Cards in Bangalore, India**

In 1993 and 1994 the Public Affairs Center (an NGO), concerned about the deteriorating quality of public services, developed and implemented a citizen satisfaction survey that measured user perception on the quality, efficiency and adequacy of basic services extended by 12 municipal agencies. The results of the survey were translated into a quantitative measure of citizen satisfaction and presented in various media in the form of a 'report card.' The 1994 survey was followed up in 1999.

- Eight of the 12 agencies covered in the 1994 report card made attempts to respond to public dissatisfaction. The worst rated agency – the Bangalore Development Authority – reviewed its internal systems for service delivery, trained junior staff and began to co-host a forum for NGOs and public agencies to consult on solving high priority civic problems such as waste management.
- The report cards were also successful in generating political momentum for reforms. Popular local and regional media carried regular stories on the report card findings. Citizens have also been inspired to take initiative towards improving services and have subsequently engaged in the state-citizen Swabhimana partnership in Bangalore – a program to arrive at sustainable solutions to longstanding city-level problems. The Chief Minister of Karnataka has also established a Bangalore Agenda Task Force of prominent citizens to make recommendations for the improvement of basic services.

Report cards have also been used as an effective tool in Ukraine, US, the Philippines and elsewhere.

### **3.2.16. What quality control procedures will be used?**

When implementing performance measurement, ministries and their agencies and programs need to consider ways to ensure reasonable quality of the performance measurement information. Data quality may not become a major issue until the performance measurement information has begun to be used for high stakes purposes, such as in making major decisions. However, attention should be given to data quality from the beginning – when important new and modified data collection procedures are being introduced. Data quality should also be a topic included in performance measurement and performance management training programs.

Periodic external, more independent, quality control reviews are highly desirable. Audits may include random checks of data at 2 or 3 randomly selected agencies. However, ultimately the responsibility for data quality belongs to the level where the data originates. Responsibility will usually reside with the individual programs in agencies. (An example of an exception would be citizen surveys conducted by higher level organizations and seek performance information from multiple programs in the survey.)

### **3.2.17. When and in what form should performance information be shared with the public?**

Depending on the agency (and type of service), performance information can be communicated to citizens on a quarterly, half-yearly, or annual basis. Reports should not focus only on agency missions and activities, but also on service quality and outcomes. Performance information is also most useful when adequately broken out into categories such as gender, income, age, education levels, and geographical location (rural or urban for example, or district/zone within a city). For external reporting – such as to the public – it is important to keep in mind the following:

- Be selective as to how many and which indicators are included. Ministries and agencies will internally track several more performance indicators than are reported to the public. However, when selecting indicators for external reporting, include the data on pre-selected performance indicators whether performance has been good or bad. This will help establish the credibility of the information.
- Make the reports easily understandable. As appropriate, use charts, graphs, and diagrams to supplement tables and descriptive information.
- Obtain feedback from the public about the usefulness and readability of the reports.
- If performance has been poor, consider attaching information identifying plans for improvement.

## **3.3. The role of the legislature**

The legislature is both a major motivator for, and a major user of, performance information. Having legislation that requires the government to report performance information provides one basic building block for performance measurement and performance management.

Whether, and how, the legislature uses the performance information that it receives can also have significant effects on the success of a performance management system. Legislatures in some countries may have little real power so they cannot make much use of such information even if they had good relevant results-based information. In a parliamentary government the executive and legislative functions tend to blend together. Nevertheless, most of these same issues apply.

Whether or not the government has a parliamentary system, line agencies usually are reluctant and apprehensive about providing performance information to the legislature. And many legislators may not be interested in, or may not trust, the quantitative data provided by line agencies. Agencies may provide too much data on too many indicators, many of which may not be very important (usually being output, not outcome, data). For all of these reasons, thus far, use of performance information by legislatures to make policy or even appropriation decisions seems quite sparse. The lack of such use, while perhaps acceptable to the line agencies, also means that the legislature is not motivating the agencies to strengthen their performance measurement and performance management processes.

At some point, we expect that legislatures will become more interested in performance information, especially information which represents important outcomes for their citizens. Legislatures are likely to be interested, when good data on these become available to them, in such data as that on educational achievement, on indicators of health, on crime statistics, on measurements of air and water quality, on transportation safety indicators.

## **4. Designing a performance management system**

While designing a performance management system at the national level several issues should be addressed. These are discussed in some detail below.

### **4.1. Need for cultural change**

The concepts of outcome management are quite straightforward and common sense. Nevertheless, outcome management does appear to require a shift in thinking for government employees. Government managers have traditionally focused on their budgets and expenditures – that is, inputs. When they think of their products, government managers have typically focused on the physical outputs they produce. This is understandable since this is what managers can most readily count and perceive as being their product. To switch to a focus on a customer/citizen orientation – that is, outcomes – agencies need to change the way they think. Such an orientation means that public services need to focus much more on what good they can do for citizens, information much less currently available. The shift towards a performance-oriented culture requires the following:

- That staff adopt the values, beliefs, and behavior that enable the government to achieve its goals.
- That performance improvement becomes a way of life.
- That the various parts of the government begin to use the performance information to help them operate their agencies and programs (for example, by using regular program reviews and recognition awards to motivate employees and underpin the performance culture).

Another major barrier to altering public manager culture is managers' (legitimate) concern that "performance" information will be used against them. If the government emphasizes the use of performance information to make service improvements, to make the organizations into "learning organizations," this problem will be alleviated. See the text box insert of the use of performance information by North Carolina, US.

Performance information can be used not only to identify problem areas, but also to provide appropriate commendations or rewards to staff for high performance in the face of adverse external factors. Problem areas can also be viewed as a signal for a need for greater training and/or technical assistance. This, rather than the punitive element of performance information, needs to be stressed to make managers less wary about collecting performance information.

#### **Using Outcome Information to Identify Technical Assistance Needs, North Carolina, US**

The North Carolina Women's and Children's Health Division reports on performance to all 100 county health directors. Outcomes are compared, and used to identify those that need most technical assistance (provided through regional consultants). Indicators include adolescent pregnancy rate and percent women with short birth interval.

Another, important, way to alleviate such concerns is to explicitly include in any performance management system the opportunity for agency and program managers to provide explanations as to why particular performance levels have not met expectations. This can be quite important because of the many external factors over which managers have little or no control. They do not want to be blamed for poor performance if it occurred because of factors outside their control.

In some instances, national service providers may be monopolies and not face competition. They may be fully comfortable about their "outputs" and unwilling, or not see the need, to focus on outcomes. In this situation the Steering Committee could stress that (even though the agency does not need to worry about competition) performance information can help agencies use limited resources more efficiently, improve service delivery, and develop a better relationship with citizens.

#### **4.2. Take advantage of existing public sector strengths**

National governments, of course, differ in many ways. They can have different cultures, different levels of resources, different degrees to which managers have authority to take various actions, different degrees to which staffs have had training or other background in analytical processes, different levels of IT capacity, different histories as to the collection of performance data, different degrees of "red tape" that reduces managers' ability to implement performance measurement and use the performance information to make changes, and so on. In addition, agencies within a national government can also differ considerably in all these elements.

The features of performance management described throughout this report apply in general to all governments and agencies (and programs). However, the degree to which these elements can be accomplished, and when, can differ considerably. For example, some countries, some programs, will need considerably more time before they can obtain important outcome data. In such instance, these programs will need, at least initially, to use less sophisticated data collection procedures, with less detailed coverage, and less frequent data collection than are preferable. Manual data processing procedures may need to be used until adequate computer technology and the training to use it are obtained.

In some countries, or some agencies, managers may have little flexibility to use the data to change service procedures or even suggest such changes. This can significantly reduce the value of the information collected.

Some agencies in some countries already are collecting data of reasonable quality useful for performance reporting. For example, agencies may be collecting data on infant mortality, unemployment, incidence of various diseases, school dropouts, school attendance rates, etc. (Even if such data are being collected, countries may not be using this information for management purposes. Also, data collected are usually not broken out by age, gender, location, income, education, etc. – information likely to be especially useful for identifying needed improvements.)

To the extent that outcome data are being collected on a regular basis, countries can use this as a model for initiating performance management in the collecting agency and other agencies. A national government might start its performance management effort by identifying programs that already collect data that can be readily adapted to performance information. Similarly, some programs, some agencies, might have expertise in particular data collection procedures. For example, some agencies, and programs, might be undertaking at least periodic surveys of citizens. The persons knowledgeable about the procedures might be able to help other agencies, and programs, use surveys, say of their own customers, to obtain outcome information. (For example, if the National Statistics Offices already undertakes periodic national surveys of the population, the staff of these offices might be able to provide training or technical assistance to other agencies, or might be able to undertake the survey work for the other agency.)

Other public sector strengths and skills that can be taken into consideration while designing a performance management system are:

- Accounting system. A good accounting system that can be flexible enough to provide cost accounting by program (as a primary basis for performance budgeting and measurement of program efficiency) would put that government far ahead for these components of performance management.
- Working relations across various departments and agencies.
- Business community. In countries in which the national government has good, constructive, relations with the business community, they might be able to provide – whether voluntarily or under contract – help in some of the techniques and procedures of performance measurement.

### **4.3. Incentives to encourage performance management**

A major issue in performance measurement and performance management is the need to encourage government personnel to take the effort seriously. A number of incentives can be used to help motivate public employees to focus on results and service quality that citizens receive. These include:

#### **4.3.1. Non-monetary incentives**

- Offering more flexibility to ministries, agencies, and their programs in exchange for achieving results. Managers might be given more control over procurements, personnel changes, or more flexibility in use of their funds – if, for example, they had met their performance targets for some previous number of reporting periods. This can have major appeal to agency and program officials.

- Providing recognition awards to programs or agencies that, for example, had met their performance targets for some previous number of reporting periods.
- Providing added opportunities for outside training
- Distributing the performance reports to program personnel so they are kept aware of the progress their programs are making.
- Calling for agencies and their programs to report the outcomes of their programs to the public.
- Holding regular program review meetings with program staff in which performance is a major topic. Such “How-Are-We-Doing?” sessions can be the most effective way to motivate public employees. They can demonstrate to staffs that management is taking the results-oriented approach very seriously. Such sessions would be held shortly after each regular performance report was prepared. At the meetings, the group would assess where the program’s results were good and where not so good. The group would attempt to identify why unexpectedly good or poor results had occurred and then come up with an action plan for improving future program results. If the group could not identify the reasons, the program might assign individuals to seek such reasons and report back on their findings. In later meetings, after changes had been made, the group would review the latest performance information to assess whether the changes had achieved the results expected.
- Including performance criteria as part of annual individual performance appraisals (if the government has such an annual performance appraisal process).
- Recognizing good performance in one part of the program by asking staff to provide technical assistance to another part of the program.

#### **4.3.2. Monetary rewards**

- Providing monetary awards to programs or agencies that, for example, had met their performance targets for some previous number of reporting periods. The use of such additional funds would might be limited to such activities as special staff training, attending conferences, computer upgrades, and the like.
- Linking individual salary to performance. However, such attempts in the past have often back-fired, causing problems and resentment by those not receiving the added pay. This approach requires very careful design.
- Providing one-time bonuses to individuals or to teams who have achieved high levels of performance.

#### **4.4. Use of pilots or complete coverage**

When starting up a performance measurement or performance management system, a government may choose to pilot the process in a few agencies and programs or call for coverage across all, or at least most agencies, especially the line agencies.

In our experience, across-the-board coverage is likely to be the better option. Pilots suggest that the government does not have a full commitment to performance management and represents only a half-hearted commitment to a performance oriented culture. Using a pilot process will also likely stretch out full government implementation for many years – and the momentum from the initial support may dissipate by the time the pilots are concluded. In addition, some agencies and programs not covered are likely to take the position that their programs are different,



and more difficult, than those in the pilot. Thus, they will argue that the pilot was not helpful to them, even if the pilot has been successful.

The Government of Thailand in the mid-1990s experimented with pilots in three of its agencies, but without a wider level of support the initiative waned by the time the pilots were completed, even though the pilots appeared to be successful.

The United States in 1993 passed performance measurement/performance budgeting/performance management legislation that was also agreeable to the executive branch – with reporting by all agencies to begin in fiscal year 1999. A three-year pilot effort was called for by the legislation, involving a small number of federal programs. Most other agencies and programs stood by and waited, probably expecting the new requirements to go away. The pilot effort appears to have delayed many agencies from taking the effort seriously until it became clear that the government was serious about the requirement. The pilot did have the advantage of providing time for getting across the basic concepts. However, the initial reports from most federal agencies were quite weak, probably because the non-pilot agencies and programs delayed full-scale effort.

Clearly, different agencies, and different programs within agencies, will have different levels of implementation success. It is very hard to tell in advance which agencies and which programs will readily take to performance management and develop more sound processes. Starting with wide coverage will at least get each agency moving towards performance management even though, as expected, wide differences in implementation quality occur.

One possibility that might be considered is – while starting with a government-wide implementation – to select 3 or 4 agencies with whom to work intensively so as to accelerate the process. This can have several beneficial results: more quickly yield results in order to show other agencies the promise of the system; reveal problems with the system that could then more swiftly be fixed; serve as a source for examples – and trainers – for the rest of the government.

#### **4.5. Projects vs. programs**

Some governmental activities can be labeled projects. Projects have a fixed time period and, usually, a somewhat narrow focus (such as individual road or wastewater treatment construction projects). Many donor-funded activities fall into this category. But much of what government and its agencies do are continuing activities, such as maintaining roads, educating children, providing health care, regularly inspecting business and natural resources for environmental problems, etc.

Performance management is an important approach for both programs and projects.

#### **4.6. Relation to in-depth program evaluations**

In-depth program evaluations can be very useful in providing evidence as to the success of a program and the factors that have contributed to the success or lack of success of the program. Outcome measurement by itself will seldom provide sufficient information as to the extent to which the program contributed to the outcomes or the factors that have affected the outcomes. The manager of any sports team, such as soccer, needs to know the running score, whether the team is winning or losing and by how much. This is information that is provided by an agency's performance measurement process. But the score does not tell why the team is winning or losing. To

determine that, the manager, whether of a sports team or of a government program, needs to undertake more of an in-depth evaluation.

However, in-depth program evaluations require special resources and require considerable time and effort. Governments that have resources may want to introduce in-depth program evaluations from the start. In any case, few governments, and few ministries, will be able to undertake more than a very small number of such evaluations in any given year. Thus, only a small proportion of programs can be the subject of in-depth program evaluations in any year.

For governments with limited resources, or just getting into the area of "evaluation", it is probably better to learn to walk first before trying to run. That is, such governments and their agencies are likely to be much better off by focusing on obtaining outcome information from a variety of their programs and services in their line agencies. Such regularly-collected outcome data will often be quite useful for later in-depth program evaluations. Most evaluations are done after the fact, and thus may depend on the extent to which outcome data were earlier available so that the current accomplishments can be compared to the outcomes before the program was initiated or in past time periods.

Over the long run, however, it is desirable that government ministries develop capacity to undertake in-depth program evaluations on a select number of particularly important programs. Table 13-5 provides a set of criteria that a ministry might use to help it select which programs and services that will be the subject of an in-depth program evaluation in any particular year.

A good step is for each ministry annually to prepare a program evaluation plan, or at least update its most recent plan. Because such evaluations often will take more than one year, such plans might cover at least two, if not three years into the future. Ministries are likely to use outside contractors (such as universities or other non-profit organizations) to undertake at least some of these in-depth evaluations – so the ministry does not have to maintain, and pay for a continuing in-depth large-scale program evaluation capability. However, even if the Ministry contracts out all its in-depth program evaluations, it will need to have staff to properly write and monitor these contracts.

Table 13-5. Criteria for selecting issues for program evaluations

<p><b>1. Can the results of the evaluation influence decisions about the program?</b></p> <ul style="list-style-type: none"> <li>- Programs for which a decision regarding continuation, modification, or termination needs to be made are obvious candidates.</li> <li>- Poor candidates are those about which decision makers have strong preconceptions of program value or for which there is considerable support by influential interest groups if these circumstances make it very unlikely that the program would be altered. In some cases, however, the program may be of such great importance to a community that government officials may proceed with the evaluation and be prepared to seek changes despite political risks.</li> <li>- Can the evaluation be completed in time to be helpful to decision makers? Evaluations completed after public officials become committed to a decision are useless.</li> </ul> <p><b>2. Can the evaluation be done?</b></p> <ul style="list-style-type: none"> <li>- Are sufficient data obtainable on important effects of the program? Program evaluations can never cover all effects, but before an evaluation is begun it should be clear that it will be possible to gather meaningful data on significant aspects of the program. For example, the long-term impacts of job training, health, or education programs may not appear for many years. In most cases, governments are unable to wait this long. Nevertheless, <i>intermediate</i> results can often be made available and thus provide significant information for interim decisions.</li> <li>- Can sufficient resources be obtained to meet the time schedule and technical requirements of the evaluation?</li> <li>- Is the program actually in place, and is it being implemented as originally planned? If not, an evaluation may not be appropriate.</li> <li>- Has the program been stable enough so that an evaluation will provide relevant information? A program that is constantly changing or is about to change in significant ways is not a good candidate for evaluation.</li> </ul> <p><b>3. Is the program significant enough to merit evaluation?</b></p> <ul style="list-style-type: none"> <li>- Programs that involve a large amount of government resources or that have important potential benefits or possible negative consequences to the public should be given higher priority. Thus, the likely cost of the evaluation should be compared to the possible decreased cost or improved effectiveness that may result.</li> <li>- Is the program suspected of being marginal in its performance? If so, there may be opportunities for making major improvements or cost reductions. Relatively old programs that have not received an in-depth evaluation in a long time may fit this criterion.</li> <li>- Is the program a new one whose potential benefits and costs are particularly uncertain? The program should be reviewed after operating long enough to demonstrate its effectiveness. This probably means a minimum of six months to one year of operation for most programs, though even these time periods are often too short for evaluating long-term effects. New programs are often more open to alteration because they have not yet gained a strong constituency.</li> <li>- Programs that are candidates for expansion are particularly suitable candidates for an evaluation.</li> </ul>
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Source: Hatry, Winnie, and Fisk (1981).

## 5. Implementing a performance management system

This section discusses several issues that emerge and are relevant while implementing a performance management system.

### 5.1. Capacity building – training and technical assistance needs

As noted above, despite the common-sense focus of outcome management, managers and professional staff throughout the government are likely to need a meaningful amount of training. This includes both training in how to undertake performance measurement (the technical side) and how to use the information obtained (“managerial” training).

#### 5.1.1. Technical training

Managers and professional staffs within both national and line agencies (including those in administrative offices such as finance, procurement, and personnel offices) will need some degree of technical training. This includes exposure to such subjects as:

- The distinctions between indicators of inputs, outputs, efficiency, intermediate outcomes, and end outcomes – including use of such tools as outcome sequence charts (logic models) and the use of focus groups to obtain information on how to identify appropriate performance indicators.
- Background in the concepts of analysis, with at least a basic understanding of basic measurement approaches and the use of data comparisons to help the programs assess how well the program is doing and the progress being made.
- Exposure to the basics of surveying program clients (likely to be a major source of data for many public programs) to maximize the likelihood that surveys will be valid and unbiased. (This training includes some exposure to sampling concepts to enable agencies to avoid the need and added costs for surveying large numbers of clients.)
- The elements, and applications, of “trained observer” approaches in which personnel are trained to make systematic ratings of physical conditions as a way to measure various aspects of service quality

#### 5.1.2. Training in using the performance data

Often badly overlooked in many, if not most, governments throughout the world is the lack of attention to training managers, especially on how they can use the performance information, especially to help them make program improvements – and not only using the performance measurement process to satisfy higher level requirements. This badly neglected topic has meant that agency managers and ministry officials tend to look on performance measurement as primarily something to get done in order to satisfy some higher-level authority. The important need is to transition managers from performance measurement to performance management. This means training in such elements as the following, each of which can considerably increase the value of the data to managers and their staffs:

- The need to obtain and report performance data in sufficient detail to enable managers to identify and compare performance achieved for the various key client groups the program serves, such as client demographic characteristics (such as for various age, gender, income, and ethnicity groups).
- The need to obtain and report performance data in sufficient detail to enable managers to identify and compare performance achieved for key service

characteristics (such as individual organizational units or regions and for different service delivery characteristics where different amounts and/or types of a service are delivered to client's).

- The need to obtain and report performance data on many specific service characteristics, which while they may not be of interest to higher-level officials, are important to citizens (such as obtaining information on the timeliness, helpfulness, courteousness, and accessibility of the services).
- The need for regular and reasonably frequent collection and reporting of the performance data. Typically higher-level officials examine performance data on an annual basis, typically during the budget/appropriation process. However, annual reporting is not likely to be adequate for managerial purposes. Reporting performance data at least quarterly is likely to be desirable for managers and their staff to track what is happening. This added frequency will make it more feasible for managers to make mid-course corrections and then have the opportunity to determine in later quarters whether or not changes that were introduced have led to desired improvements in performance.
- The utility of regular managerial performance reviews with staff after each performance report has been discussed. Such reviews can be used to identify where performance is on target and where not, to identify possible explanations for unusually good or unusually disappointing per levels; and to suggest ways to improve future performance (such as by identifying practices that have been particularly successful for some organization units or for some client groups that might be transferred to other units or other client groups).
- The need to undertake thorough searches for explanations for performance that is unexpectedly for or good. A search for explanations should be an explicit part of the performance management process. This topic is discussed in more detail in a later section.
- The need to have data that becomes available and is processed in a reasonably and timely way, such as within no more than one month after the end of a reporting period. Data that takes years, or even months, to obtain will lessen the ability of managers to react to that data and to make improvements.

The training, such as that described above, preferably will encompass all levels of management and supervision. Professionals who are involved in some way in program and policy issues also are likely to need at least some training in performance measurement and its use. Provision also needs to be made, not only for initial training in the initial years of the introduction of the performance management process, but also for training for new managers and new professional staff, whether they come from inside or outside the government.

Such wide coverage, while highly desirable, will likely put a strain on the resources of a government and its ministries. Of course, not all the training needs to be done at once but rather over a period of years. Much training will come internally, through the on-the-job training of staff by persons who have had obtained some previous experience and knowledge in performance measurement and performance management issues. Some agencies in many countries will have staff that have experience in performance data collection, analysis, and reporting, such as staff in health education, and transportation agencies. These persons and their experience might be drawn upon for training and technical assistance.

One strategy, that has been used, is to use persons that have completed the training to help train others. Those persons might come from outside the agency or

even outside the ministry. In the long run, providing adequate training is the responsibility of the agency itself. An agency can choose to use outside consultants or inside the government personnel, or some combination. As far as the cost of such training (and technical assistance), a good argument can be made that such training is just a basic part of management, and the costs should be borne by the agency itself.

## 5.2. Performance information in the budget/appropriation process: performance budgeting

In most countries the desire for information on performance by a legislative body or by a national office, such as the Ministry of Planning and Budget, has been the cause of the performance measurement activity. The usual reason for the high level interest is to use the performance information in the government's budgeting and appropriation process. Ultimately, it is assumed that budget decisions will be improved if they can be made at least partly on the basis of data on recent accomplishments of programs and program estimates of future performance if a budget of a particular size is approved. The key question for public officials in the budgeting/appropriation process is: What are we getting for the money that the government is spending?

Budgeting will become much more effective if the agencies and their programs provide performance data of reasonable quality.

What is not widely recognized is that budgeting requires estimating the future. Performance measurement (and program evaluation) is about measuring what has happened in the past. Measuring results is difficult. Projecting into the future, even one year into the future, with all the uncertainties and potential contributing factors is even more difficult. Thus, budgeting will always likely be as much of an art as a science. Estimates of how much particular physical output a particular amount of funds will produce in the way of outputs often can be estimated reasonably accurately. However, estimating the relationship between funding and outcomes is much more of a problem. Many external and internal factors can affect the outcomes, such as changes in the national economic situation, unusual weather conditions, international issues that arise, loss of key personnel, unexpected behavior of citizens relating to a particular service, etc.

The first need is for the government and its agencies to provide quality timely data on performance to provide a basis for forecast performance for the budget year and beyond.

A second need in performance budgeting is for agencies and their programs to be asked to provide targets as to the likely outcomes that will occur with the amount of funds requested. When funding levels are changed from those proposed, whether the changes are made by a national office or by the legislature, the agency needs to be given the opportunity to revise its targets accordingly. Target setting is even more of an art than other parts of the budget process. In the initial year, or two, in which an agency collects performance data for new indicators, targets should be considered as particularly questionable – until the agency has gained experience with the data for those particular outcome indicators. Agencies should not be criticized for substantial differences from targets for such new performance indicators.

Another complication for national governments, one not often discussed, is that the funds for a particular budget year often produce outcomes in future years beyond the budget year. It takes time for funds to be expended and then for outcomes to be achieved. The outcomes from budgets from a particular budget year may not occur for one, two, or say three years after the funds have been appropriated. Preferably, this

means that agencies are asked, as part of the formal budget process, to provide out-year estimates of out-year outcomes for those programs for which significant outcomes are expected to occur in later years. The authors of this report have seldom seen this done, at least not in a systematic way.

There is a timing issues that are should consider. Full scale performance budgeting cannot be done until agencies have a performance measurement process that provides performance data. However, governments just beginning to develop performance measurement systems can at least qualitatively address the question of what they are getting for the money. Programs and agencies preparing budgets but lacking performance data need to consider at least qualitatively the outcomes achievable from requested amounts. Similarly, those examining budget requests will need to seek qualitative information from requestors as to what outcomes they expect – even if no data are available. This at least will begin to encourage agencies and their programs to begin thinking about, and giving consideration to, outcomes.

In the initial year, before any historical performance data are available, so that the agency has had little experience with the data, relating budget amounts to the performance indicators and target setting are not likely to be meaningful. The initially available past data might be reported, but any targets set for those performance indicators for the budget period probably should be considered to be questionable. After experience is gained with the data, the performance indicator targets estimated for the budget period, based on the budget amounts requested, will have a better basis.

Performance budgeting fully occurs when budget amounts are linked to outputs and outcomes. This may mean simply displaying the amount of output or outcomes expected for each budget program line. This is currently what is most often initially done by governments that are introducing some form of performance budgeting. However, real performance budgeting does not occur until agencies and their program use the performance information to help make and justify their budget choices.

A special problem arises for performance budgeting for governments that only use some form of line – item budgeting. To be meaningful, linking performance to the budget requires that the government have program/service categories to which performance information can be related. Thus, this is a prerequisite for performance budgeting.

A word of caution is in order at this point. Governments and other stakeholders need to recognize that linking future outcomes to budget amounts will probably seldom, if ever, be precise. Too many outside factors can affect outcomes to enable agencies and their programs to have precise formulas that link funds to outcomes.

### **5.3. Long-range/strategic planning**

Here we discuss issues involved with program and policy planning that contains a major focus on results (and not only fiscal planning) beyond the budget year. These plans represent an opportunity for a government, agency, and/or program to review thoroughly what it is doing, how it went about it, and to identify what it should do in the future, including possible major changes. To do this properly can take considerable time and effort, including: making projections as to the nature and amount of the future demand for the government's service; predicting the environment in which the service will find itself; and analyzing various options as to what the government/agency/program should do.

A first issue is whether strategic plans need to precede the development of a performance measurement system. Performance monitoring does not appear to require a strategic plan. Agency and program mission statements and general statements of the

agency's, and program's, objectives do need to be developed as a starting point for both purposes. It can be argued that strategic planning will be better done if it is based at least in part on the information coming from the performance measurement process. Sweden initially required agencies to critically review what they were doing, but for a variety of reasons has dropped this requirement.<sup>106</sup> The United States requires five-year strategic plans with interim updates. However, the development of these strategic plans came after development of the initial performance measurement systems in the agencies.

Nevertheless, long-range, strategic plans that consider both costs and outcomes are conceptually quite desirable. The World Bank is encouraging developing "medium-term expenditure frameworks (MTEF)" with a time horizon of about three years into the future. (MTEFs have been prepared by many OECD countries. However, the primary focus of MTEF has been on fiscal and financial policy, without much attention to the role of information on policy and program outcomes for citizens.) The United States government requires each federal agency to develop strategic plans, covering five years into the future, and to periodically update them. Some planning can go out much further into the future, ten or twenty years. The World Bank and other funders have also encouraged multi-year Poverty Reduction Strategy Papers.

Any such long-term plan, regardless of whether it covers three, five, ten, or more years into the future should focus not only on funding needs but also on what results are expected and desired. (This vital element of long-range planning has often been neglected.) Long-range plans should identify the key outcomes, provide key outcome indicators for assessing progress, the latest data on those indicators, and provide targets as to what the plan expects to achieve if the plan is successfully executed. This provides the major basis for tracking progress against the plan.

Such plans can become obsolete quickly so governments, such as Sweden and the United States call for their reviews periodically, perhaps every other year, if not annually, to consider the latest developments. Strategic plans, if properly done, require considerable time and effort by public officials to develop the plan. Thus, it is not likely to be feasible to redo completely each year the plan. However, important changes and unexpected events can occur that might significantly alter either the expenditure flow or results expected. Thus, a government should probably at least review its plan on a regular basis, such as annually or every other year, and modify it as appropriate.

Long-range, strategic planning is an opportunity for an agency to re-think what it is doing. Full strategic planning would include such elements as those shown in Table 13-6.

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<sup>106</sup> See the paper by Gustafsson in this volume.



Table 13-6. Suggested elements in a state's strategic planning process

<ul style="list-style-type: none"> <li>● Identification of the population served and outcomes sought by the agency</li> <li>● Identification of specific outcome indicators by which progress will be measured</li> <li>● Examination of the future environment within which the agency and its programs operate (such as demographic, economic, and social factors and trends)</li> <li>● Identification of the latest available baseline values for each outcome indicator</li> <li>● Examination of alternatives and practical options for achieving outcomes, including the current service delivery approach</li> <li>● Analysis of each option's likely cost, feasibility, and effect on the outcomes, including estimates of the out-year values for each outcome indicator included in the plan</li> <li>● A process for obtaining input from the legislature, agency customers, agency employees, and interest groups</li> <li>● Selection of the strategic option to include in the plan.</li> </ul>
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Source: Adapted from Liner et. al., (2001).

Typically, most such long-range, strategic, plans have neglected many of the elements listed in Table 13-6. They often provide little indication that the planners have examined thoroughly future "environmental" characteristics (such as likely population and technology changes). Seldom do they appear to have examined in a systematic way alternative service delivery approaches to what they are currently doing. (Rather, the plans merely present what agencies have been doing in the past and extend the current process into the future.)

At which level or levels should long-range plans be prepared? Should each Ministry, each agency, each program, have its own long-range plan? And should the government as a whole have a go-wide strategic plan? Probably each ministry and each agency within ministries should have its own plans. Probably major agency programs should each have their own plans. Conceptually, a government-wide strategic plan is also an excellent idea. A problem is that such plans can become quite political and be revised every time there is a change in presidents and prime ministers. These plans, thus, can become "wish lists," and "get-elected" statements than thoughtful reviews of what the government is about and what it should be aiming for in the future.

A key question is what are the purposes of long-range plans? Are they worth the time and effort? One purpose often claimed for plans is that they provide a vision for the future. As noted earlier, the planning process provides an opportunity for a government, ministry, agency, or major program to examine from a fresh perspective what it is supposed to be doing and how to do it. Such a plan, if it contains outcome targets for the future, also provides a basis for assessing the government's progress over time in achieving those objectives. And the plan should provide key input into decision that need to be made in the next budget period.

To be of practical use, these plans should be linked to the organization's annual plans, such as its budget and business plan. Thus, the first year of the plan should provide a basis for the next budget plan.

#### 5.4. Controlling data quality

Once performance data become available on a regular basis and become used for “high stakes” purposes, public officials and key outsiders will become very concerned about the quality and accuracy of the performance data. Government organizations need to plan early how to maintain reasonable control and thus confidence in the data.

Inevitably, the primary responsibility for performance data quality will be that of the organizations responsible for collecting the data – and as a practical matter, this responsibility will usually need to reside with the ministries and their agencies. Even in those situations when an independent, outside organization is conducting an in-depth program evaluation, the evaluation will likely require some data obtained by the agency itself rather than new data obtained by the evaluating organization.

Some outside quality checks will need to be established, with outside-the-agency review of at least a sample of performance indicators and performance data. The sources might include periodic reviews by:

- A ministerial office, such as its office responsible for management, performance, or budget oversight.
- A ministerial or agency inspector general office, if these exist.
- A national audit or inspector general’s office – perhaps located under the legislature or a completely independent office.

The State Auditor’s Office of the State of Texas in the United States is required by state legislation to review annually a sample of performance indicators in each major agency to assess the quality of the data collection procedure for the performance indicators. It has established a regular process for these reviews. The United States federal government has a somewhat looser approach. Agency inspector general’s offices may undertake such reviews, but these are not formally required, nor does the U.S. General Accounting Office undertake such reviews as an on-going activity. The federal budget examiners who try to become familiar with the programs whose budgets they review conceptually are in a position to make some appraisals of the quality of the data that are provided to them. However, again this is not an officially-required activity.

Performance data quality control appears throughout the world to be an underdeveloped area. This is partly because the collection, reporting, and use of performance data, particularly data on program outcomes, is still a new activity form most governments and most agencies. A major problem is that agencies will be generating large amounts of performance data, making it infeasible to review more than a small portion of the data each year. A key ingredient for maintaining data quality may be data transparency. When agencies report and disseminated performance data widely, such as to the public, this is likely to place pressure on the reporting agencies to provide data that can pass open review.

## 5.5. Costs of implementing and maintaining performance management

The additional financial cost of performance management is likely to be surprisingly small. Most governments that have implemented a performance measurement process consider the process to be a basic part of operations and have expected agencies and their programs to absorb any cost without an added budget. To our knowledge no one has provided cost estimates, either in monetary units or even as to the amount of time, probably because of this. As discussed below, many factors will affect how much additional financial costs and staff time will be needed.

However, a small amount of added cost appears to be a wise investment – for such activities as startup training in performance measurement and performance management for managers and professional staff. Some legislatures have approved hiring of small numbers of executive branch agency analysis staff. The legislature of the state of Louisiana (in the United States) offered such funding support, but very few agencies asked for the added staff.

Probably, the major “cost” for implementing, and subsequently maintaining, performance management is the time of existing personnel. Some actual financial cost will be required, such as for outside training and technical assistance.

Most costs, financial and staff time, will likely occur during the start-up year or two. An important consideration is the likely need for individual ministries, agencies, and programs, to establish new, or modified data collection procedures (including data processing) for obtaining outcome data not previously available. Another need for at least some ministries and agencies will be the cost of a small number of added staff to oversee the performance measurement process, analyze the data, and provide reports of the findings. This role, however, might be filled by existing staff, where appropriate staff are available, and other roles, such as detailed oversight of line-item information is diminished. For example, performance measurement has a citizen/customer focus. Many programs will likely need to survey their clients on a periodic basis to obtain outcome information. Many governments already undertake occasional national surveys; however, for performance measurement, considerably more survey work is likely to be needed – and on a regular, at least annual, basis. For some surveys, agency personnel probably will be able to use their own current resources or those of the government office that does national survey work. However, if an outside contractor or university is needed to administer the survey, this can entail added financial cost.

As noted above, the key “cost” is most likely to be staff time. Substantial staff time is likely to be needed in the start-up phase of performance measurement and performance management – for such activities as training, selection of performance indicators, and data analysis. As noted above, most governments introducing performance measurement and performance management (such as Australia, Canada, New Zealand, United Kingdom, and United States) have required the cost of these activities to be absorbed by the agencies and their programs, as merely being part of basic operations. A key issue for less industrialized countries is whether they are willing to reduce other activities such as their attention to line-item budgeting and instead ask staff to focus more on service outcomes.

Other cost issues relate to the current capacity of the government and its various agencies. To the extent that agencies already have analytical staff and technology, such as computers and copiers, effective and efficient implementation will be easier. Governments, and agencies, with more limited resources will need more assistance and have to settle for less, more selective, measurement and reporting.

Some ministry start-up costs should preferably be covered by the Ministry of Planning and Budget, as an incentive for ministry participation. Bilateral or multi-

lateral funding organizations are also a source of funding for the start-up costs and initial training associated with developing and implementing performance management. Subsequent costs for the training of staff and on-going implementation can be considered the responsibility of individual ministries and their agencies and be funded from their own resources – as has been done by all the governments that we have examined.

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CHAPTER 14

**Results Based Budgeting in Australia**

*by*

*Richard Murray, Australia*

**1. Outline**

- Overview of the fiscal framework
  - Charter of budget honesty
  - Medium term fiscal strategy
  - Accrual budgeting
- The outcomes and outputs framework
  - Outcomes, outputs and administered programs
  - Case study: education
- What have we learned?
  - Programs versus outcomes
  - Measuring performance against outcomes
  - The need for central oversight
  - Evaluation

**2. The fiscal framework**

**2.1. Charter of budget honesty**

- Guides rather than mandates the conduct of fiscal policy. Requires the Government to:
  - outline its medium term fiscal strategy
  - publish financial statements consistent with Australian and international accounting standards
  - specify fiscal policy actions that are temporary in nature, and the process for their reversal
  - publish an Intergenerational Report every 5 years

## 2.2. Medium-term fiscal strategy

- Strategy since 1996/97 is for budget balance on average over the cycle
- Supplementary objectives are:
  - maintain surpluses while economic growth prospects remain sound
  - no increase in the tax burden from 1996/97 levels
  - halve net debt – achieved in 2000-01
  - improve the Commonwealth's net worth position over the medium to longer term

Figure 14-1. Improvement in net debt

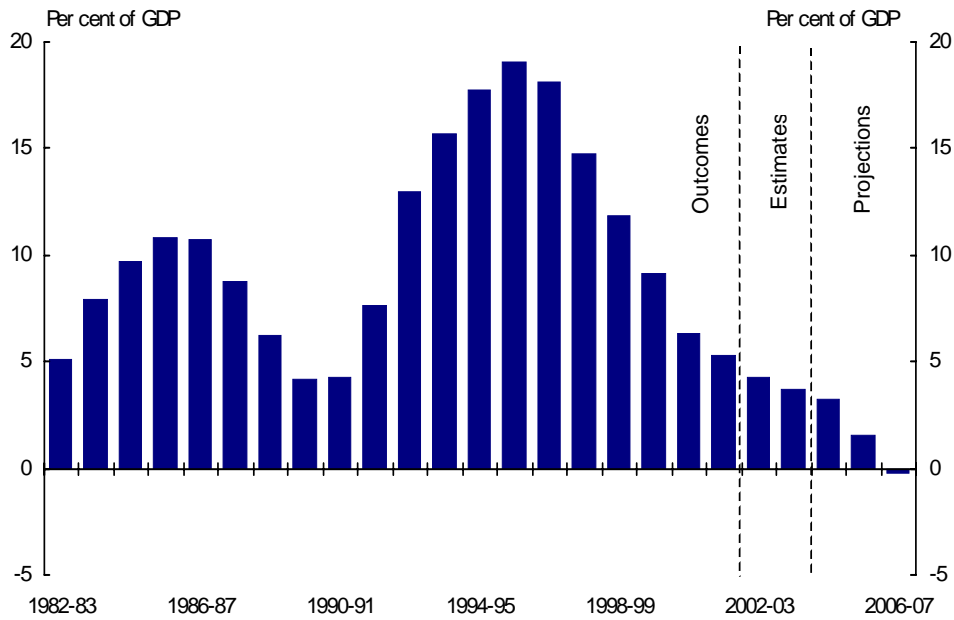
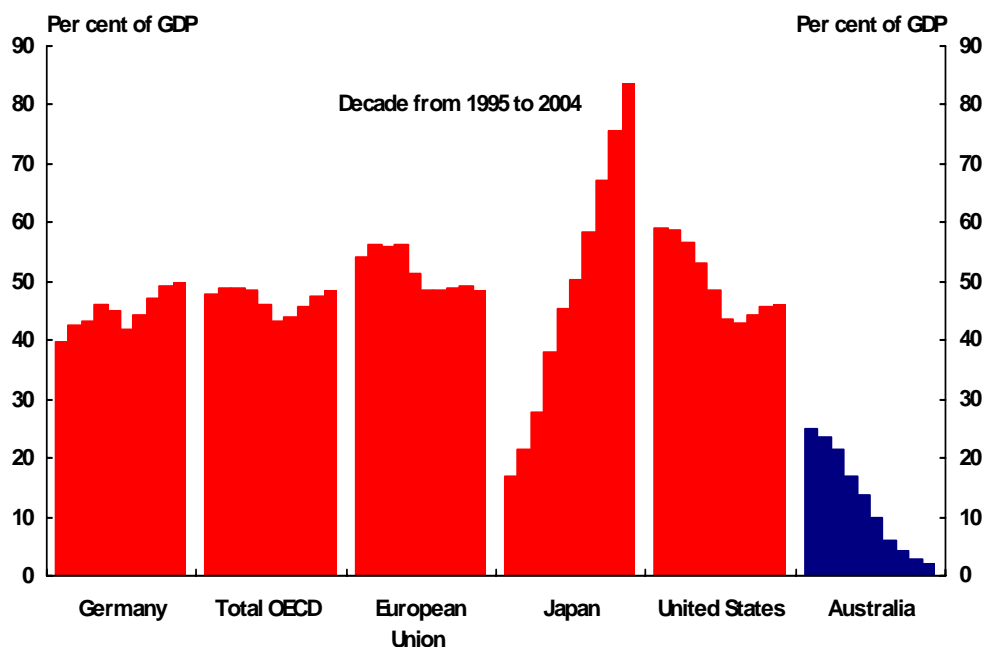




Figure 14-2. OECD comparison of net debt



### 2.3. Accrual budgets

- Provides a more comprehensive picture of government operations
  - Improves focus on fiscal sustainability (the balance sheet) and intergenerational equity
    - compares assets and liabilities (rather than just inflows and outflows of cash)
      - for the Budget and forward estimates
      - for individual agencies as well as whole of government
  - Imposes more business-like discipline on agencies
  - Ensures more focus on net worth

## 3. The outcomes and outputs framework

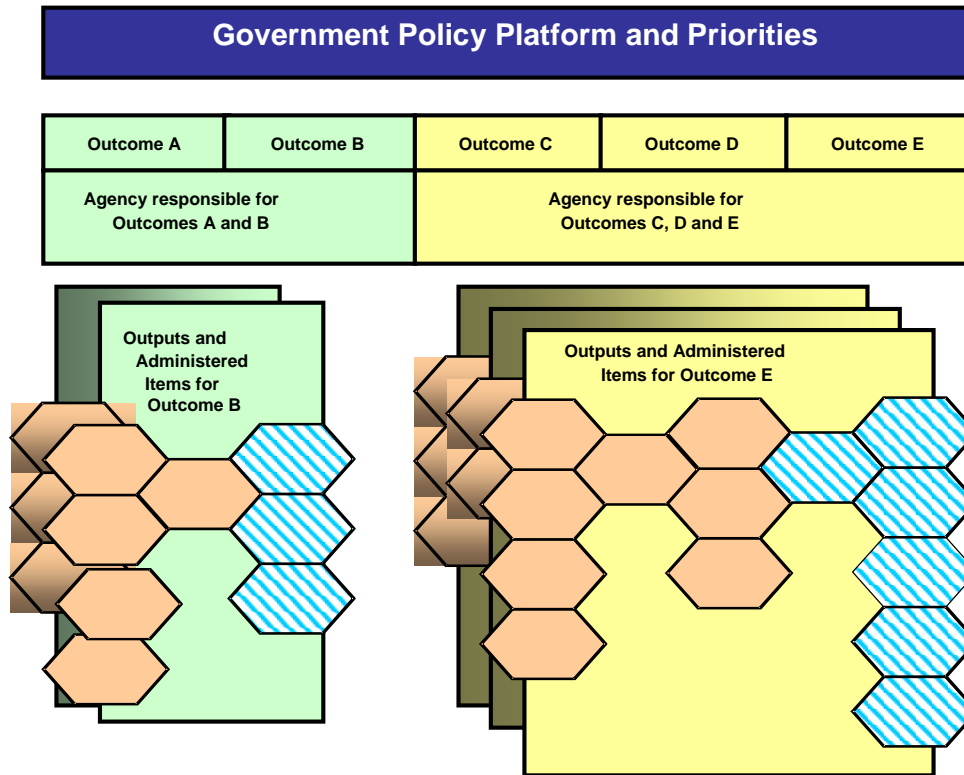
### 3.1. Outcomes, outputs and administered programs

- Outcomes are defined by Finance as:

*'The impact sought or expected by government in a given policy arena.'*

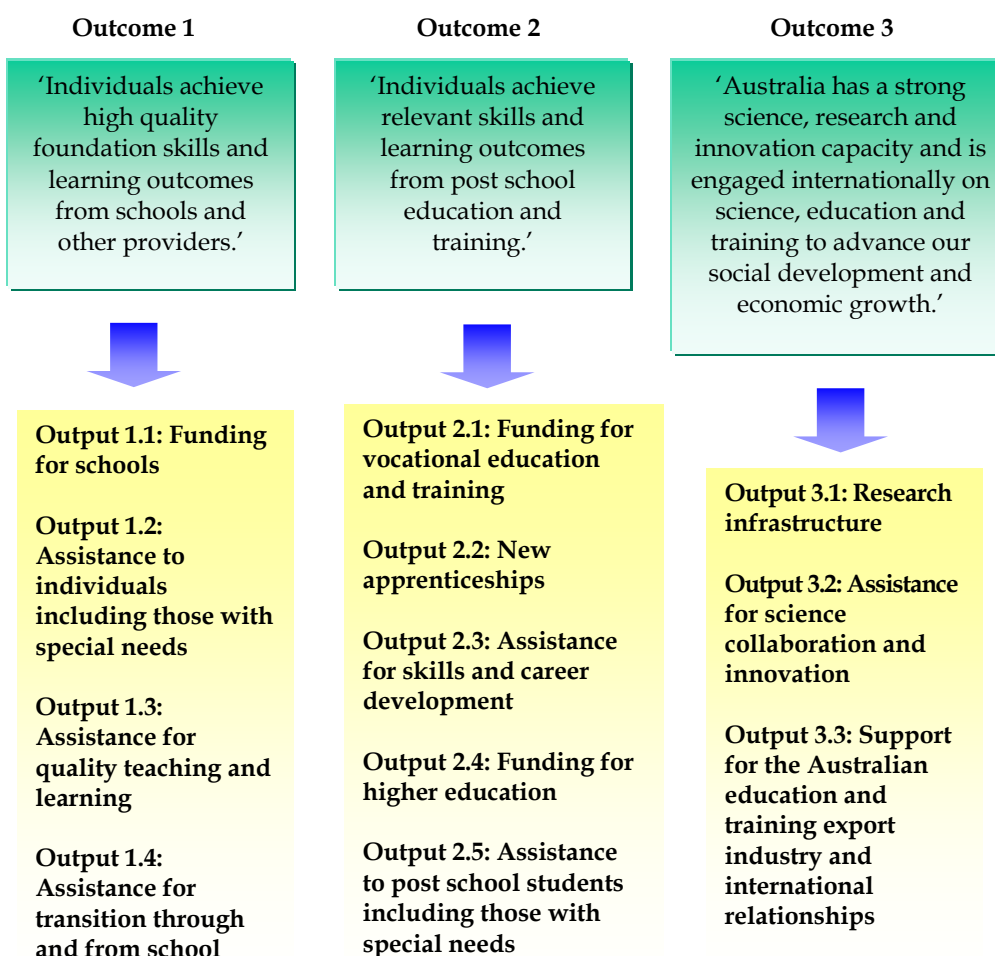
- *The focus is on change and consequences: what effect can government have on the community, economy and/or national interest?*
- Outputs have been defined by Finance as:  
*'The actual deliverables – goods and services – agencies produce to generate the desired outcomes specified by government.'*
- *Customers include members of the public, industries or sectors, ministers, members of Parliament, other agencies or even in some instances, interests (eg the national interest).*
- Administered Programs are defined by Finance as:  
*'Those resources administered by the agency on behalf of the government (such as transfer payments to the States, grants and benefits) to contribute to a specified outcome.'*
- They are identified separately from outputs because they involve different accountability requirements.

Figure 14-3. A model of the framework

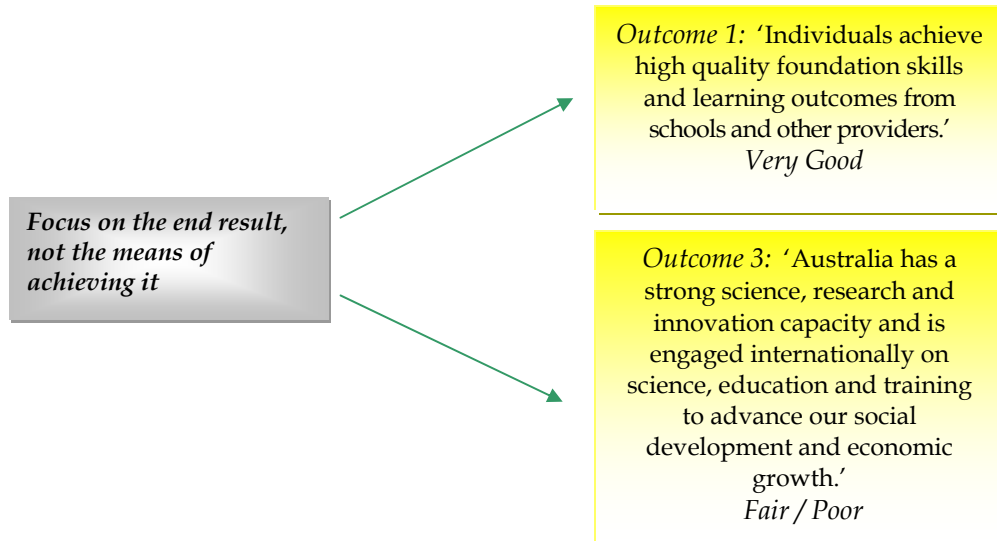


## 3.2. Case study: education

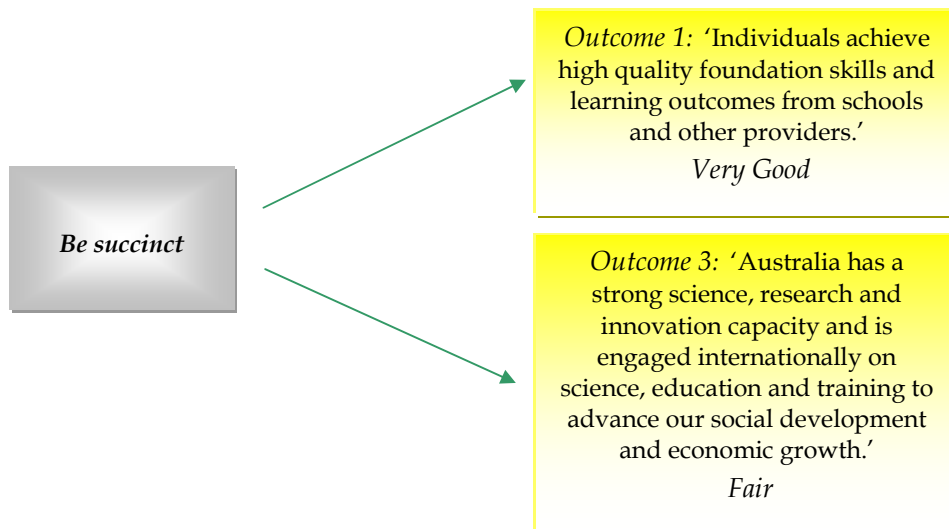
### 3.2.1. Outcomes



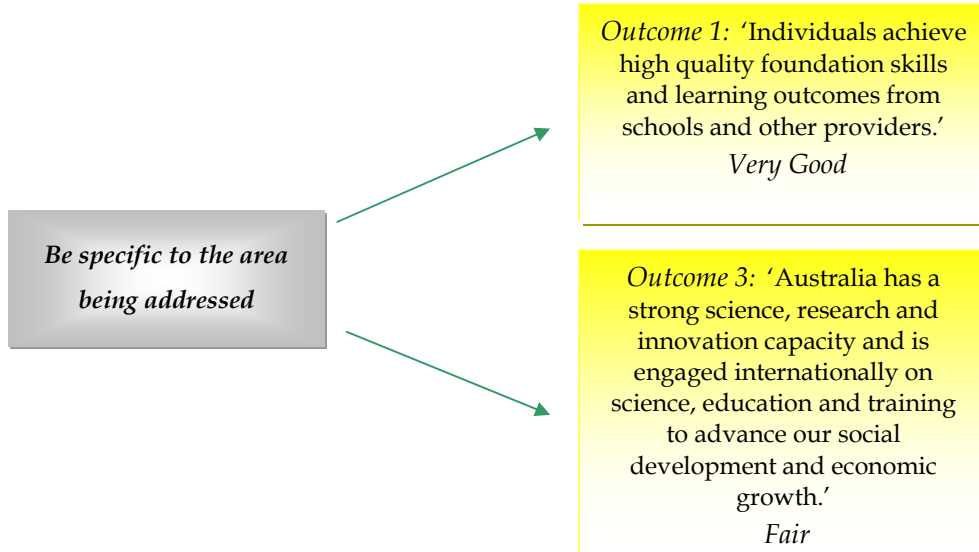
Outcomes should:



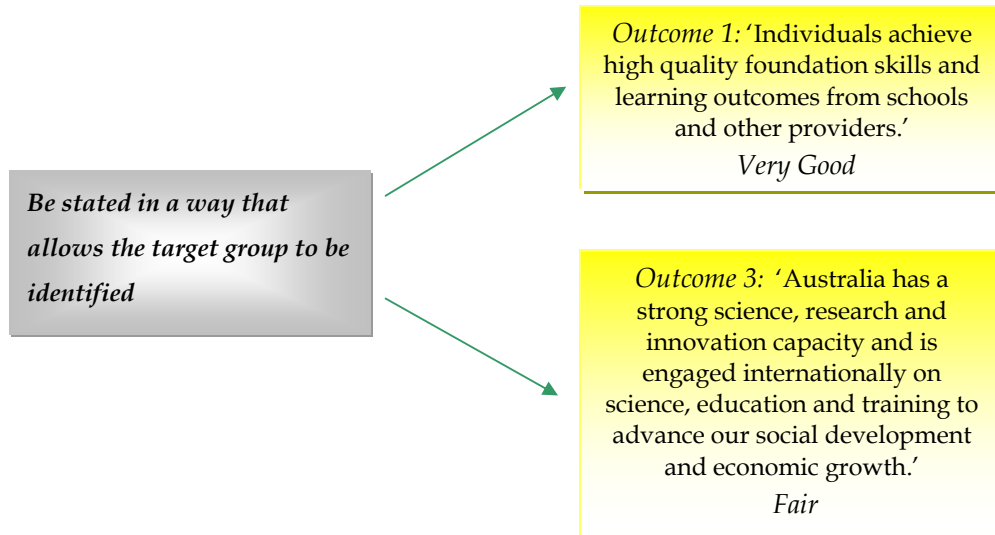
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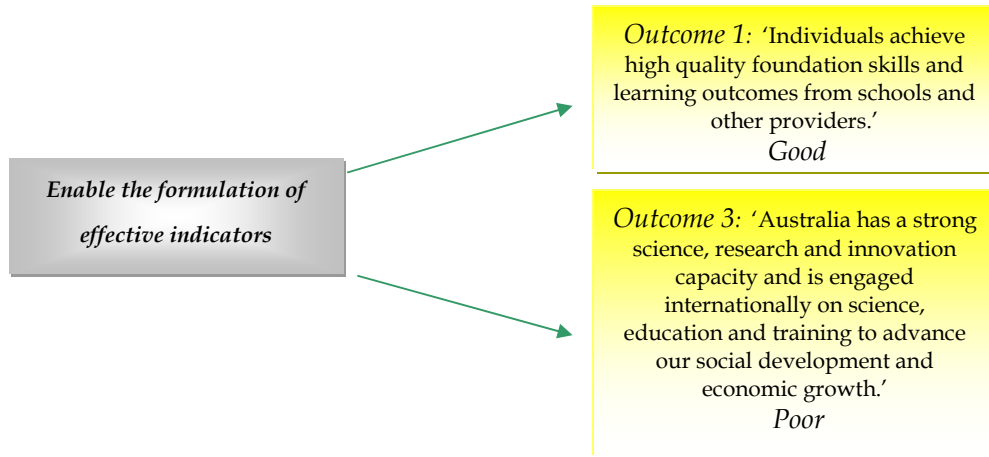
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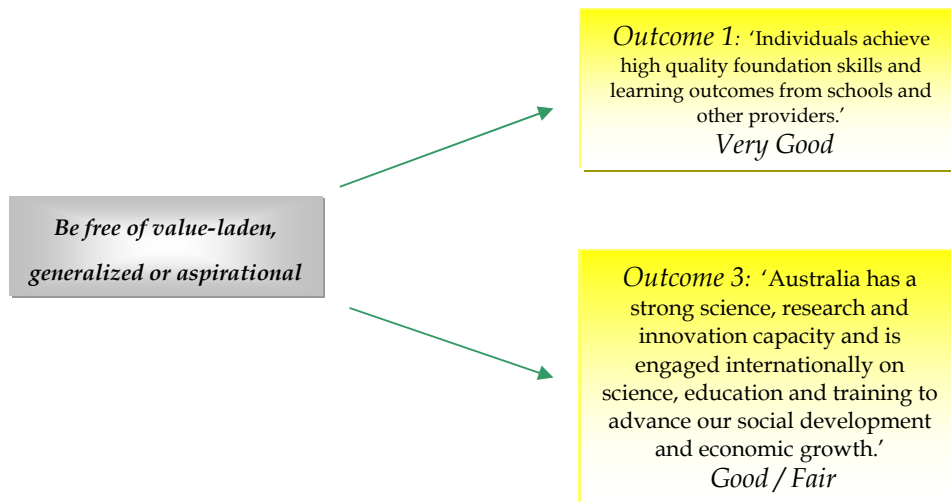
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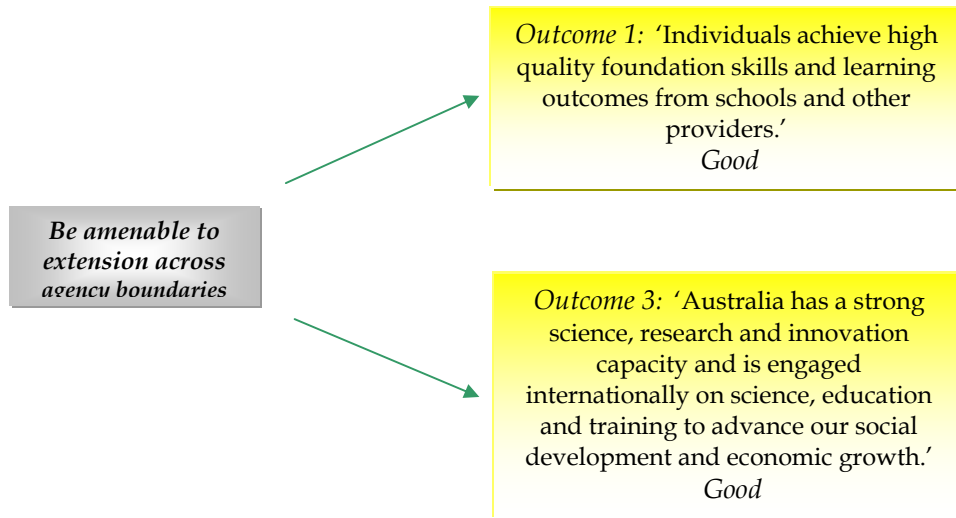
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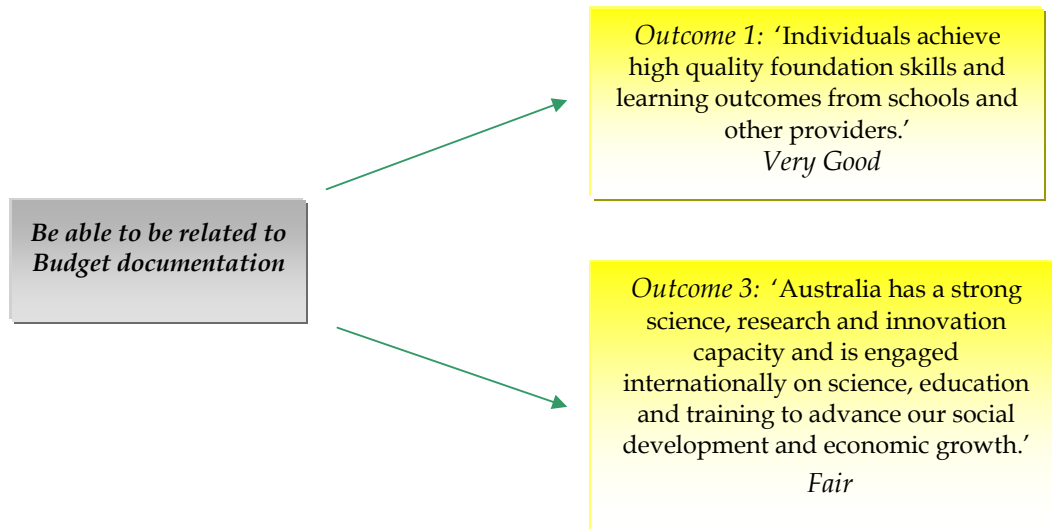
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Outcomes should:



Outcomes should:

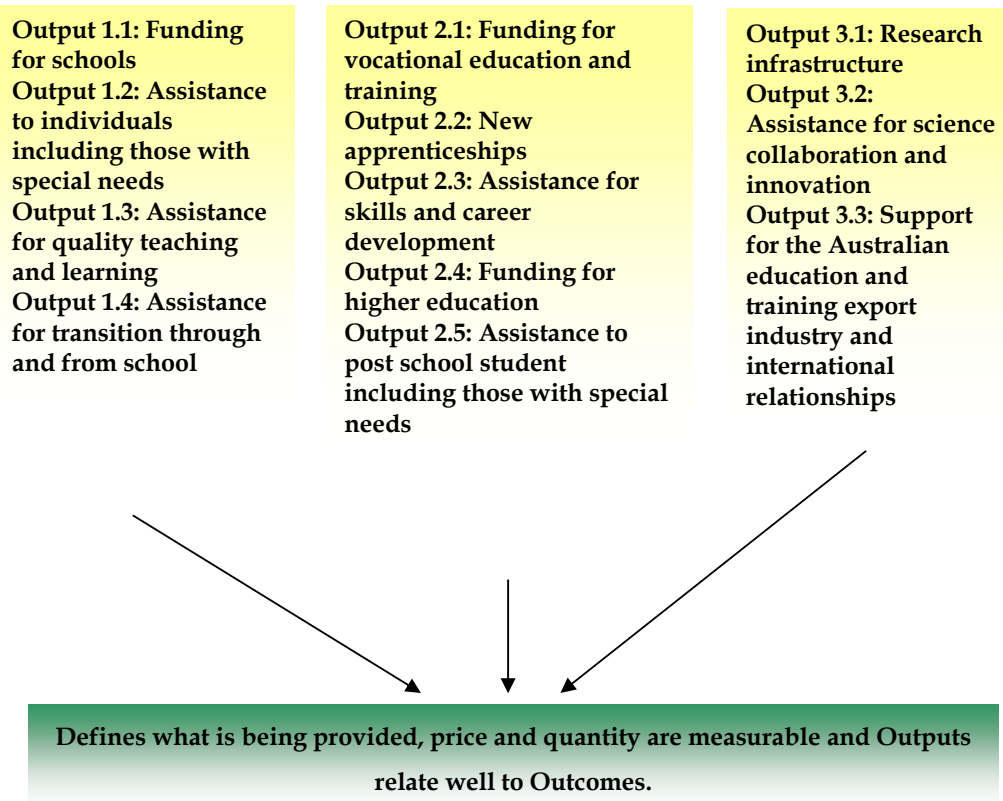


### 3.2.2. Outputs

*For Outputs it should be possible to:*

- define outputs in terms of what is produced;
- measure both departmental outputs and administered programs in terms of price, quantity and quality (PQQ); and
- relate outputs to an outcome
  - if this cannot be done the agency should cease to produce the output or identify an additional outcome that the agency should achieve.

#### Output Groups





3.2.3. Targets and performance indicators

Figure 14-4. Mean scores of Australian students in reading, mathematical and scientific literacy compared with OECD average for 2000 (set to 500)

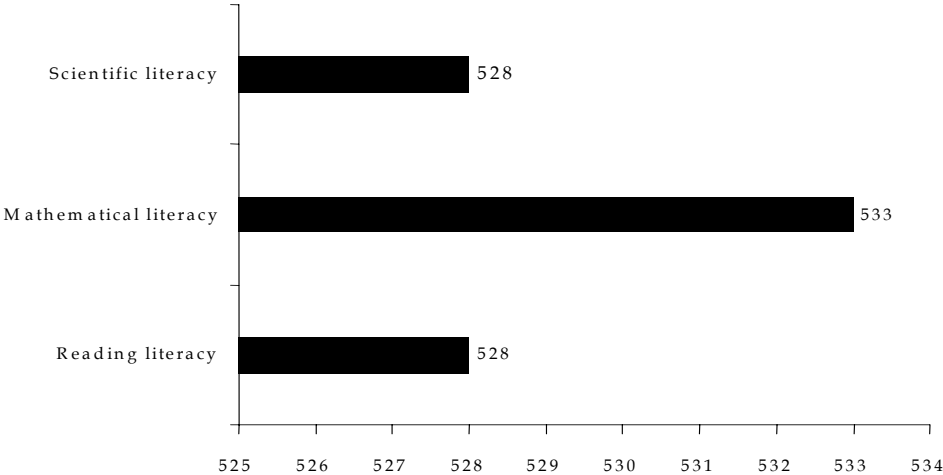


Figure 14-5. Graduate starting salaries as a proportion of Average Weekly Earnings

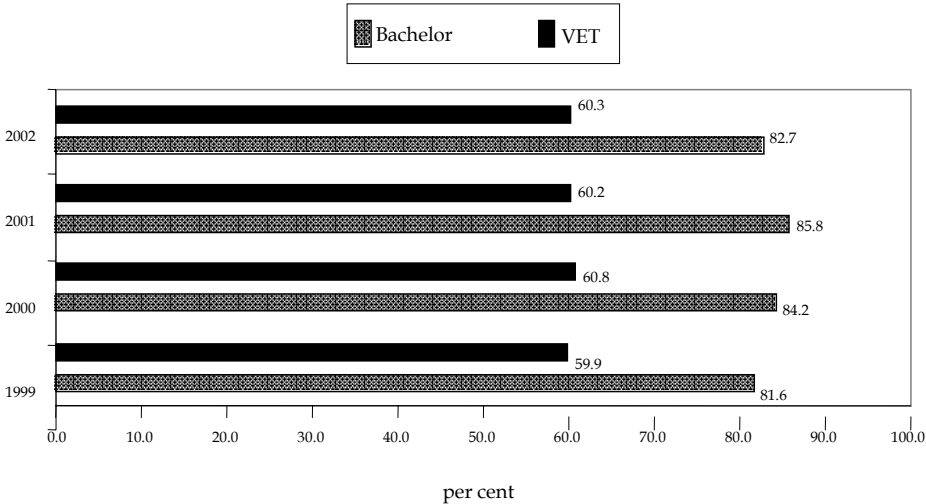
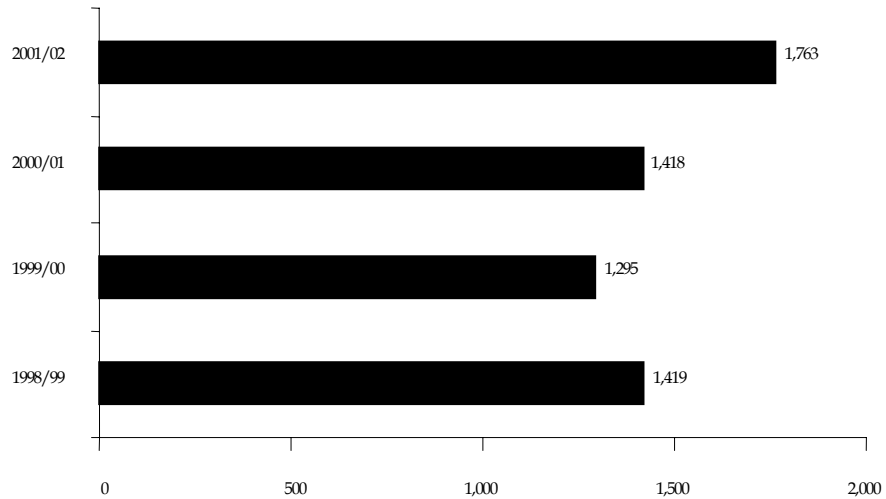


Figure 14-6. Number of patents issued to Australian residents in Australia



## 4. What have we learned?

### 4.1. Programs versus Outcomes

- Ministers often make policy decisions based on programs
- Budget documentation tends to provide information on Outcomes
- There has been a move towards providing more administered program information to Government

### 4.2. Measuring performance against Outcomes

- Many outcomes are too broad. For example 'The Defense of Australia'
  - In this case the Government has moved to define 7 sub outcomes for reporting purposes
- Outcome 1: Command of Operations in Defense of Australia and its interests
- Outcome 2: Navy Capability
- Outcome 3: Army Capability
- Outcome 4: Air force Capability
- Outcome 5: Strategic Policy
- Outcome 6: Intelligence
- Outcome 7: Superannuation and Housing Support Services for Current and Retired Personnel

### **4.3. The need for central oversight**

- A devolved management model and relative financial autonomy has led to a lack of central knowledge on financial information
  - Leads to a lack of scrutiny of agency performance by central agencies
  - Directly affects the ability of central agencies to advise on Budget Strategy
- The Government has acted to provide the Department of Finance with additional resources and mandated 'program' and 'cash' reporting

### **4.4. Evaluation and Audit**

- Evaluation of performance information is essential to measuring the achievement of Outcomes
  - Senate Estimates Committees scrutinize performance information ex-ante
  - The Audit Office scrutinize performance information ex-post
- Are Chief Executives held accountable for Outcomes?



## Performance Management and Budgeting: a Case Study of Sweden

by

Allan Gustafsson, *Mapsec*

### 1. Country Context

Sweden is a constitutional monarchy and the King is the formal Head of State. The Constitution is based on the principles of popular sovereignty, representative democracy, and parliamentarism. Sweden has a unicameral parliament, the Riksdag, with 349 seats. All elections are by proportional representation. A party must gain at least 4 percent of the national vote to qualify for representation. There are presently seven parties represented in the Riksdag.

Swedish politics has, since the 1930s, been dominated by the Social Democratic Party. The party has since then, except for two short periods, been in power as the dominant party in a formal coalition, or as a minority government with the explicit backing of one or more minor parties in the Riksdag. Presently the Social Democratic Party is backed by the Greens and the Leftist Party but their collaboration is limited to economic matters.

The ideological pillars of the Social Democrats can be said to be three: private production, public redistribution, and public provision of welfare services. The economic policy of the Social Democrats has generally been pragmatic, but the 1960s and 1970s saw a rapid growth in the size of the share of national income that passed through the government. Most of that growth was in the directly redistributive part of government spending, i.e. in entitlement programs. Another basic tenet of the "Swedish model" has been and continues to be that social benefits shall be general in nature. That is they shall not focus uniquely on the most disadvantaged of society but rather every tax payer should feel that he gets something in return for his tax contribution. The trend towards an ever-growing public sector stopped abruptly in the early 1990s when a fiscal crisis, in the form of a ballooning deficit, forced the Government to dramatically curtail spending. As a result the share of General Government in GNP was rapidly brought down from 70 percent during the height of the crises to approximately 55 percent where it has now leveled off.

In the context of the topic of this paper it is noteworthy that the dominant share of government spending - more than 50 percent - refers to individually consumed social services. A little less than one third can be classified as individually consumed private-type services while only one tenth refer to classic collective goods.<sup>107</sup> In other words:

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<sup>107</sup> A service is classified as individual if it is associated with positive marginal costs for each person consuming it. It is conventionally classified as being of a social type because they are traditionally provided by the public sector and/or the public sector determines its price and availability - for example health care, education, child care, care for the elderly, culture, etc. The category individually consumed private-type services refer, for example, to support to agriculture and housing allowances. Collective goods refer to defense, central administration, etc.

there is an individual, identifiable consumer at the receiving end of the vast majority of the activities of the Swedish public sector!

## 2. Origins of the reform and the historical context

The present system of public management is not the result of a one-time comprehensive reform but rather of a drawn-out series of partial reforms – the aggregate result of which could be termed performance management. Whether or not it can be claimed that performance budgeting has been introduced depends on how you define it.

This long reform process dates back to the 1960s when in an Official Government Report it was suggested that what was called “program budgeting” be introduced. The inspiration came from the US military under McNamara. The fundamental idea was that the budget should be divided into programs. It should be possible to identify the outputs of programs as well as the quality of these outputs. It should also be possible to calculate the full cost the outputs, including indirect costs. The proposal, however, drew a line for what indirect costs should be apportioned to final output. Central administration, for example, was to be treated as a separate auxiliary activity. Somewhat contradictorily, it was suggested that separate programs should be set up for investments. To complement the one-year perspective of the budget, it was also suggested that every agency should elaborate multi-year plans showing planned output and costs. In regard to appropriations, the Official Government Report suggested two alternatives: either that they be expressed in terms of cost with a separate set of accounts in expenditure terms (modified cash) or that they be expressed in expenditure terms with a separate follow-up in cost terms.

The ideas put forth in the Official Government Report on Program Budgeting were tested in a number of agencies over several years. The pilot tests were eventually abandoned and the attempts have often been maligned as unrealistic and mechanistic. It is nonetheless clear that the Official Government Report and the pilots had a profound impact on the reforms implemented during the decades to come.

The Official Government Report on Program Budgeting was followed by a number of new studies, proposals, and initiatives. In the early 1970s a new Official Government Report termed the Budget Review presented a first proposal for a division of the budget into a number of broad areas. The study proposed 23 sectors under which some 3-8 program groups would be defined. Every program group could contain 2-8 programs. Appropriations would apply to programs. A lot of emphasis was put on the need for long-term planning and a number of instruments to bring in the long-term into the management process were proposed. The Official Government Report had no immediate practical impact on processes and procedures but some of its ideas have later been picked up, for example the division of the budget into a number of broad areas. The latter reform was introduced as part of the introduction of top-down budgeting in the late 1990ies. (See Chapter 5)

Results-based management as we see it today was further shaped by a 1985 Official Government Report which resulted in concrete government proposals tagged on to the supplementary estimates in 1986 and in 1988. A starting point for the proposals was that they should permit a continuous review of government activities with a view to reallocating resources from low-priority to high-priority areas.

Thus, the budget process should be changed so that:

- the Riksdag (Parliament) and the Government would focus less on the details but rather provide general guidance and define the objectives of government activities;
- decision that customarily had been taken outside the budget process, but which had an impact on the budget, should be handled within the budget process;
- a longer-term perspective was introduced in the budget process;
- productivity and efficiency would be enhanced allowing the provision of more relevant services;
- agencies were given greater responsibility for the use of the appropriations provided for the running of the agencies and for the organization of its activities; and
- the analysis and the reporting on results achieved would be improved.

One important and concrete change of the budget process was the introduction of three-year cycles for the presentation of the agencies' budget proposals. Every third year, the agency was to produce a more ambitious and "soul-searching" document in which it was expected to critically review what it was doing and how it went about it. The proposals for year 2 and 3 needed not go to the same depth but were rather to serve as bridges between the more thorough reviews. The cycles of the agencies were staggered so as not to overburden the Government Offices. On the basis of the more thorough review carried out every three years, the agency would receive a firm three-year budget frame.

The system was maintained for a few years but was dropped in the middle of the nineties when the urgency to reduce spending left no room for elaborate and thoughtful prioritization processes. The whole idea that the agencies would voluntarily question their own activities – at least beyond the margin – was probably unrealistic anyway and it is doubtful that the system would have survived even in calmer seas.

A reform ushered in by the 1988 bill – a reform that has survived – is the requirement that each agency shall produce a yearly report on results. After the introduction of accrual accounting in 1992, the report on results is normally combined with a statement of accounts.

The 1988 bill furthermore announced a number of changes in the legal framework for the management of the agencies as regarded:

- the management of the agency direct income;
- the setting of fees;
- the use of framework appropriations;
- the financing of agency investment;
- the accounting framework; and
- cash management.

These intentions were gradually translated into government ordinances and instructions during the first part of the nineties.

Not specifically presaged by the bill of 1988, but of particular importance was the introduction of accrual accounting in 1992/93.

The Generic Budget Law of 1996 gave a results-based budgeting a legal basis. The Performance Budgeting Project, generally known by its Swedish acronym VESTA, initiated in 1997 picked up a number of loose ends left by close to three decades of piecemeal reforms with the objective of creating a more consistent and systematic performance orientation to the entire management framework. Its work focused on the

coverage, basis, and structure of the budget, the definition of appropriations, the control and management of investments in infrastructure and in the defense area, and on the structure and flow of performance information. A first Ministry of Finance White Paper was prepared in 2001. The work of the project has now been integrated into the normal development work of the Budget Department of the Ministry of Finance and continues. Some of the original ideas of the project are shelved for the moment, while others are pursued. A new white paper resulting from the continued work is expected during the first part of 2004. The most recent reform initiatives are discussed below in the section on outstanding issues.

### 3. Elements of performance management and budgeting in Sweden

Rather than an outcome of a single comprehensive and consistent reform, performance management in Sweden is thus, as shown above, the result of a long series of piecemeal reforms strung out over a thirty-year period. Despite the mixed record of the early experiments, the course was really set in the 1960s with the introduction of the notion that the public sector should be managed rather than simply administered. Many of the basic ideas of the early proposals have also survived, albeit often in a different format, while others have been added. The initial years were, however, largely experimental and the concrete Swedish performance management model as we see it today is the outcome of reforms implemented during the last fifteen years.

What follows is an overview of the elements that in some way or another constitute performance management *à la Suède* as we see it today. Problems, shortcomings and future areas of development are discussed in the final section.

#### 3.1. The objective of performance management

The fundamental objective of performance management is to increase the effectiveness and the efficiency of public action in general and of the application of the resources managed by the public sector in particular.

The concrete content of performance management is set of rules, mechanisms, processes and technical support systems that will enhance effectiveness and efficiency. In principle the arena for performance management ought to span all actors involved in shaping and executing public action – from the legislative bodies to the civil servants delivering services to the public. In other words it ought to involve: a) the parliamentary process, b) the relationship between the legislature and the government, c) the internal processes in the Government Offices, d) the role of and relationship with audit institutions, committees, independent think-tanks, etc., e) the relationship between the Government Offices and the agencies, f) the internal process within the agencies, and g) the interaction between the agencies and the public.

In practice performance management has come to be associated very much with the relationship between the Government and the agencies, with the internal operations of the agencies, and their relationship with the public. Most of the elements listed below fall into those three categories. The shortcomings and the areas for further development relate mostly to categories a) – d).

As the content of public activity and public spending (“doing the right thing”) is determined primarily – at least at the more aggregate level – in the first four processes, while efficiency (“doing things right”) is determined more in the latter three, the focus of reforms have thus been on enhancing efficiency.



The driving force of the reforms has been the conviction that efficiency is a function of authority and accountability. If institutions and individuals are given authority to decide on how best execute a task they will behave responsibly and efficiently, provided they are held accountable for the result.

The listing of the elements of the Swedish performance management model is thus divided into elements that give authority to institutions and individuals, and those that are put in place to achieve accountability.

## **3.2. Authority**

### ***3.2.1. Decentralization to local level***

This paper will focus on central government. However, it must not be forgotten that the perhaps most important delegation of authority within the Swedish public sector is that to local government. Of the total 28 percent of GDP that is public consumption, 20 percent is the responsibility of local government. There are 289 municipalities and 18 county councils. The division of responsibility between county councils and municipalities has it that tasks requiring a larger population base, secondary health care and local transport for example, are handled by the county councils, while the municipalities take care of the rest.<sup>108</sup>

The elements of performance management at the central level that will be discussed below have all been part of the local government landscape for a long time, longer than at central level. Most services are executed by institutions with a great deal of managerial independence. Many local governments have implemented purchaser-seller arrangements for much of its service provision – even between public institutions. Health clinics and hospitals, for example, are often reimbursed on a piece-basis for services provided. Many local governments have introduced a system of school vouchers allowing an individual student to attend any school with the local government area, including privately run schools. Most community services like street cleaning and local transport are outsourced. When they are not, their operations are normally organized in community-owned companies. Standard private sector management tools, like accrual accounting, have been used in local government for decades.

The independence of local government is guaranteed by the constitution and fiercely defended. There are, as a consequence, also considerable variations between municipalities on how they are run. The independence of the local authorities has been somewhat constrained in recent years with central government temporarily imposing tax freezes and balanced-budget requirements while at the same time saddling them with an increasing number of unfunded mandates. The Swedish Association of Local Authorities, among other things, represents the local authorities vis-à-vis the Central Government, for example on financing issues.

### ***3.2.2. Decentralization to independent central government agencies***

Sweden has a long history of strong independent agencies that are responsible for the execution of the bulk of the budget. A sign of the importance of agencies in the Swedish system is that 98 percent of all central government staff work in agencies and

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<sup>108</sup> There is a long-standing debate whether or not the county councils should be eliminated and its responsibilities assumed by the municipalities singly or, where needed, in collaboration. Such a reform may come in the next few years.

only 2 percent (excluding the Foreign Office) in the Government Offices, i.e. the equivalent of traditional ministries. In the UK the proportion is 75 to 25 percent.

The responsibilities of an agency are specified in an "Agency Ordinance". A minister is not allowed to intervene directly in the operations of an agency or in any decision - within its area of authority - made by it. To a degree, but in a subtle way and behind the scenes, the independence of agencies has, however, become compromised by an increasing politicization of the appointment of the director generals of the agencies.

#### Block appropriations

In order to achieve the objectives set forth in the letter of appropriation an agency is given one or several block appropriations, i.e. a total expenditure ceiling for the area(s) that are its responsibility. If the agency is responsible for only one global task, like for example the Prosecution Services, it receives only one single appropriation. This allocation it is free to allocate to whatever inputs it deems necessary to carry out its work. Agencies with a range of responsibilities may receive a number of appropriations. The County Administrations, an extreme case, may finance their operations from over twenty different appropriations. Agencies, like the National Insurance Board which handle a number of entitlement programs, receive one appropriation for their administrative expenditure and are responsible for execution of the different entitlement appropriations.

#### Carry-overs and credit facilities

There are two types of block appropriations: framework appropriations (ramanslag) and reservation appropriations (reservationsanslag). A framework appropriation gives the agency the right to carry over unused funds to the following year - up to a limit. The agency has also the right to borrow against next year's appropriation - up to a limit. A reservation appropriation only allows carry-overs.

#### Authority over payments

All payments are executed by the agencies. There is no central treasury or payments office intervening in the process. In order to minimize the total cost of liquidity to the government, all payments are, however, made to and from accounts that are part of the government group held in one of the commercial banks.

#### Personnel

The agencies are free to hire whomever and however they desire and to set the salary at the necessary competitive level. The latter right is, however, to some extent tempered by the formal process of wage negotiations between the unions concerned and the representative of the Government, the Swedish Agency for Government Employers. There is of course also the restriction set by total available resources. An agency will not, in principle, be compensated for cost increases resulting from wages increases beyond index. Should it, however, choose to reallocate resources from other types of expenses it is free to do so.

#### Facilities

Agencies rent their premises and pay market price even if and when the property is owned by the Government. Government commercial type property is managed by a public company which is expected to behave like a normal commercial operator.

### Right of disposal of own revenue

Some 33 percent of central government consumption, i.e. services production, is financed through fees, external grants and other types of direct revenue. The right to levy fees is regulated in a government "Fee Ordinance" and regulations attached thereto issued by the Swedish National Financial Management Authority. A general principle is that fees should cover the full costs associated with the production of services concerned. Once authorized to levy fees, the agency has full disposal of that revenue.

## **3.3. Responsibility and accountability**

To balance the large degree of freedom that the agencies have to shape their operations and decide on the input mix, a number of instruments and processes have evolved to foster responsible behavior and to uphold accountability. It is worth pointing out that responsible behavior and accountability in Sweden does not depend on one single mechanism but is rather the (hoped for) outcome of a number of factors that together are expected to create responsible behavior.<sup>109</sup> In the end, every public institution is accountable to the public that it is to serve. That accountability can be ensured by direct or indirect mechanisms. Here they are grouped into mechanisms that involve the Government, mechanisms that involve the public directly or indirectly, and mechanisms that involve the elected bodies directly.

### **3.3.1. ... vis-à-vis the Government**

#### Agency ordinance

The "Agency Ordinance" (Verksförrordningen) establishes the general rights and responsibilities of agencies.

#### Agency specific instructions

For every agency there is a specific instruction which establishes the concrete responsibilities of the agency, its general reporting requirements, its organizational structure in broad terms, its authority to levy fees and other matters of specific relevance to the agency.

#### Letters of appropriation

Yearly letters of appropriation are prepared for single appropriation and/or for a set of appropriations under the jurisdiction of a specific agency. The letters of appropriation vary a bit in character depending on the nature of the appropriation, but when it concerns the operations of an agency they contain sections on:

- objectives;
- results indicators;
- special reporting requirements;
- assignments (tasks) for the coming year; and
- financing of the activities of the agency.

The latter includes:

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<sup>109</sup> In the discussion of the reforms in New Zealand an important distinction has been made between responsibility and accountability, the former being the broader concept relating to the spirit and not merely the letter of the objectives set for an agency.

1. the value of the appropriation(s) for the year;
2. an indication of any planned use of carried-over appropriations;
3. a ceiling on the appropriation credit, i.e. the right to borrow against next year's appropriation;
4. an estimate of fee revenue that will be under the control of the agency;
5. a ceiling on borrowing for investment in fixed assets, a ceiling on credit to meet short-term cash-flow needs; and
6. any explicitly authorized, special, longer-term or multi-year commitments.

The letters of appropriation establish or confirm the objectives that are set out for the activities that the agencies carry out and spell out the results indicators that the agencies are supposed to report on. The objectives defined for the activities have tended to be rather vague in nature and the results indicators more or less *ad hoc*. What has been missing in terms of preciseness has often been made up for by increasing the number. The problems with objectives and results indicators are discussed further on.

In addition to the more or less formalized results indicators, the agencies may be requested in the letters of appropriation to report on specific issues that are of interest to the Government.

#### Statement of accounts and yearly performance report

Every year an agency is required to produce a yearly performance report including a statement of accounts. The statement of accounts follows normal private sector standards. Thus it contains, at a minimum, a profit and loss statement, a balance sheet and a cash flow statement. The reports otherwise vary a great deal in size and ambition but generally contain a rather extensive descriptive part. As can be expected – after all institutional self-preservation is a very pervasive force – there is often tendency to depict the situation in rather rosy colors.

#### Follow-up meeting with the responsible minister

Every year, each head of agency is to have at least one formal meeting with the responsible minister in order to discuss the development of his or her agency. As there exists no formal contract between the Minister and the Head of the agency – cf. the situation in some other countries like New Zealand and Denmark – it is difficult to assess the importance of these meetings.

#### External audits

Agency financial accounts are audited every year by external auditors. Performance audits are carried at the initiative of the National Audit Office when deemed important by the latter.<sup>110</sup>

#### Evaluations of financial management

Of a slightly different nature but nonetheless important when it comes to upholding high standards in the financial management of the agencies, have been the yearly evaluations of the agencies carried out by the Swedish National Financial

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<sup>110</sup> The National Audit Office was moved in 2003 from being under Ministry of Finance to being under Parliament. Its modus operandi have, however, remained largely the same with the one exception that they are now empowered to audit the Government including the consolidated accounts.

Management Authority. The agencies have been rated in a number of areas and then ranked. The top-ranking agency receives a prestigious award.

### **3.3.2. ... vis-à-vis the public**

#### Consumer choice

As pointed out above, much of the services produced by the public sector have an identifiable consumer-citizen at the receiving end. Perhaps the most efficient way of enforcing accountability in these circumstances is to give the consumer a choice as to from whom he chooses to receive the service.

This latter philosophy has shaped much of the development at the local government level. At the central level this tendency has not been quite as strong but there are areas where it applies, for example higher education. At local educational levels freedom of choice is ensured through the voucher system. This system is partially introduced at university level when it comes to students wishing to study abroad. Swedish universities are instead financed on a piece basis, i.e. per student year, differentiated by type of education.

#### Application processes

Some services, in particular research, are financed by grants for which the institutions have to apply and on the use and the results of which they have to report. The same procedures apply to EU-grants made available to individual public institutions.

#### The Parliamentary Ombudsman

Residents in Sweden have recourse to the office of the Parliamentary Ombudsman in case of malfeasance by a public authority or an individual official. Other ombudsmen exist but they do not focus primarily on the public sector.

#### Media

Media serves as a very powerful, albeit often a bit erratic, watch-dog keeping public institutions and officials on their toes. A very potent instrument in the hand of the media is the very far-reaching Swedish Freedom of Information Act.

### **3.3.3. ... vis-à-vis elected bodies**

#### Agency annual accounts and performance reports

The agencies' annual accounts and performance reports are public documents which are relatively widely used by the members of the Riksdag. Parliamentarians tend to specialize on the issues of concern to the committees of which they are members.

#### Consolidated Government annual accounts

Consolidated Government Annual Accounts have been produced since 1995. The document is gradually evolving from a mere financial document to a more analytically oriented one. It was originally produced by the National Financial Management Authority (ESV) and, before the latter was created, by the National Audit Office. Now ESV only produces the background material, in particular the financial part, and the overall responsibility for the document has been taken over by the Government Offices, concretely the Budget Department within Ministry of Finance. In order to increase the political relevance of the document, its tabling in the Riksdag has been moved up to the

spring. Earlier it was tabled too late to have any impact on the deliberations on the Budget Bill.

### 3.4. Reassessment and prioritization

One of the core arguments for moving away from traditional input focused management to performance management was the felt need to reassess and prioritize government spending. There was a hope that, with the new approach and the new tools, continuous reassessment and prioritization would become an integral part of the normal budget process. That has not really happened. The faith put in the three-year in-depth reviews *cum* budget proposals to be prepared by the agencies quickly proved unfounded. It has happened that agencies have proposed their own elimination, but those are rare exceptions. Normally institutional self-preservation or expansionist ambitions tended to take over. The three-year in-depth reviews/budget proposals have now been abandoned.

The traditional way of initiating structural changes has been and continues to be the appointment of a committee giving it, sometimes, very clear terms-of-reference – to the point of more or less prescribing its conclusions. When the Government is less sure what it wants to do, the terms-of-reference are more open-ended. Committees may or may not have parliamentary representation and draw more or less on external academic and other expertise. Over 100 Swedish Government Official Reports produced by the committees are published every year. Committees may deal with just about any issue of public concern, and it does not necessarily have to be budget-related.

Changes – budget-related or not – may also be initiated by appointing internal working groups within the Government Offices. Their deliberations and proposals are, when they are expected to translate into legislative proposals, normally presented in the different ministries' publication series.

Committee reports and the reports published in the publication series of the different ministries' are all formally referred to a large number of selected bodies for consideration and comment. These bodies may be public authorities, local government authorities, NGOs, advocacy groups or voluntary associations.

Impetus to change may also come from the semi-autonomous research institutes that have been set up for a number of areas; for example the Swedish Institute for Transport and Communications Analysis and the Institute for Labour Market Policy Evaluation. An Expert Group for the Study of Public Economics, attached to the Ministry of Finance but fiercely defending its independence, financed a large number of critical studies on a wide range of topics.

### 3.5. Tools

#### Accrual accounting

The reforms carried out during the last thirty years have moved Swedish public management in the direction of that of the private sector. The legal and regulatory framework is still important, but agencies and their managers have been given greater authority to manage their operations and their finances. In regard to the latter it is no longer merely a question of executing the budget. Agencies are financed from a number of sources and manage a wide range of programs and projects.

As complexity increased it became obvious that traditional budgetary accounting was inadequate and the whole central government, without much ado, moved to standard accruals in 1992/93.

Agencies are free to choose their own accounting system and their own chart of accounts provided that they can report in the format of the central chart of accounts used for the consolidated government accounts.

#### Central FIMS

A web-based central Financial Information Management System is now being developed. The system, when its complete parts are up and running, will contain budget, accounting, and results information.

#### Balanced scorecard, benchmarking, et. al.

The move to performance management has as much been a change of how agencies manage their own operations as a question of the relationship between the Government and the agencies. The responsibility for the execution of agency budget is decentralized to the different departments, and agencies often develop results indicators that are only used for internal management purposes. Some agencies have chosen the balanced scorecard approach to packaging management information.

Benchmarking has spread, particularly in local governments where there are plenty of nearby experiences to benchmark against. A central database to facilitate and stimulate benchmarking, as well as independent research, is being developed. In central government there are fewer opportunities for this.

## **4. Implementation**

As already pointed out, the move towards performance management has been a very drawn out process involving a number of successive initiatives. It is therefore difficult to provide a simple and single answer to what has been driving it and where the resistance has come from.

However, one can say what it has not been. It has not been a reform process driven by politicians. There has been no Tony Blair seeing the political benefits to be drawn from public sector reform. It does not mean that the politicians have always been on the sideline. They have been supportive but the original initiatives have not come from the political sphere but rather from within the administration. And politicians have generally not, perhaps with the exception of the move to top-down budgeting, invested much political capital in the reforms. Nor have the reforms, again with the exception of the move to top-down budgeting, been the result of a crisis. The Swedish reform process is thus very different from that of New Zealand's.

When attempts at writing the history of the reforms are being made - the definitive one is still to be written - it is customary to refer to the different committee reports and to other initiatives like VESTA. International influences - like program budgeting in the US in the sixties and new public management in general and the reforms in New Zealand in particular - are also highlighted. Surprisingly little influence is deemed to have come from developments in local Swedish local governments despite their geographic and cultural proximity.<sup>111</sup>

The conceptual champions of change and external influence are important. But the question is if it is not the thirst for authority by the institutions that actually "do the job" and their acutely felt management needs that have been the most important *force*

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<sup>111</sup> For some reason, central governments seem to turn to each other for inspiration rather than to their brethren in lower levels of government. Perhaps it is precisely because of this institutional pecking order.

*motrice*. It is worth noting that local governments have been many years ahead of central government in their reforms and it probably has to do with the fact that they are primarily service providers and as such in close contact with their clients.

At the central government level, the reforms have also started from below. The move to accruals, for example, was driven by agencies most acutely suffering from the inadequacies of traditional public sector accounting. Agencies within the central government have a long history of constitutionally protected independence and they enjoy having the authority. Perhaps as a reaction to this, the more recent reforms in this field have actually been presented as a way of bringing the politician back in the driver's seat rather than as a means to "letting the managers manage." Agencies do not need to be empowered; politicians do.

The one vociferous opposition to the notion of performance management has also come from a group of more or less leftist-leaning academics who see performance management as a technocratic exercise, depriving the politicians of their right to govern. The fact that some of the management techniques and tools come from the private sector and from abroad is also seen as suspicious and has made some politicians wonder whether it is all a Trojan horse. The enthusiasm expressed by some of the opposition parties has not helped allay the fears of Social Democrat parliamentarians either. Given their rather lukewarm interest it is actually surprising how far the reforms have got.

On the other hand no one, particularly not the academics who staunchly defend that it is not their role, has been able to present an alternative to performance management. It is like with post-soviet Russia, people gripe about it but very few would want to return to the old ways.

Thus, while there has not been any strong political leadership there has not been any active resistance either. The biggest brake on reform has rather been inertia – political and bureaucratic. Reforms have thus had to be introduced one step at a time. The boon: easier acceptance. The drawback: a lack of consistency. When accrual accounting was introduced, for example, its architects initially also wanted to introduce accrual budgeting but decided against it because they feared that it would be too big a bite for the Government Offices.

Another reason for why the reforms have tended to be piecemeal and gradual is that the agents and managers of change have been outside the Government Offices – at least during most of the 1990s. Of particular importance during that period were the National Audit Office and eventually the National Financial Management Authority (ESV). The Swedish Agency for Public Management also played a role. Being at arms length from the Government Offices and with a direct mandate to foster the development of financial management at agency level, they were very well placed to initiate and implement reforms that were largely limited to the agency sphere. Their authority to drive reform processes that had a direct impact on the work of the Government Offices was, however, much more limited; *vide* accrual budgeting. The weakest link in the performance management chain has thus become the Government Office which in turn has left the Riksdag in limbo. Despite the latter's oft-expressed desire to receive and factor in performance information in its decisions, it has been given little chance to do so because of the Government Offices' failure to deliver it in an intelligible format.

In the Government Office the institutional responsibility for public management reforms has shifted around. During the 1980s the Ministry for Public Administration (now defunct) was the driving force. A remnant part of that ministry, responsible for public reform in general, has had an itinerant life. For a while it was located in the Ministry of Finance; then it was moved to Ministry of Justice. At the end of the 1990s,



the VESTA project based in the Budget Department took the lead and, in close collaboration with ESV, drove the process – for a while but not without opposition.

The ambition of VESTA's was to extend the performance management chain all the way to the Riksdag and to tie up a number of loose ends left by the piecemeal reform process. Some of the proposed reforms are moving ahead – true to the piecemeal tradition – while others are deferred, mostly for fear<sup>112</sup> of losing control of cash.

Changes in the management framework have always been backed up by training. ESV offers courses directed at the agencies and the Government Offices have internal training units responsible for offering the needed training. When accrual accounting was introduced, agencies sometimes had to recruit new blood from the private sector but that demand was easily met.

## 5. Incentives

The attractiveness of performance management to agencies is the greater authority accorded them. No special, direct financial incentives have been linked to the reforms as such, but the greater freedom to set wage levels has had the effect of narrowing/eliminating the wage gap between the public and the private sector.

The incentives to the staff of the Government Offices are less clear-cut. One possible benefit could be work satisfaction. Rather than simply applying norms and rules defined by others, all officials need to get involved in the substance which is more intellectually stimulating. In the short term, a common, very human and difficult-to-avoid reaction to any change – one certainly seen in during the long course of reforms in Sweden – is that it will increase the workload. The consequences of that type of resistance very much has depended on the leadership exercised by the ministers and by the other high officials of the Government Offices. When taking a clear stance, the political leadership of the organization has been able to count on the solidarity of the organization; when not, things can quickly get bogged down.

## 6. Results

Most observers would probably agree that the Swedish version of public performance management has led to greater efficiency and to greater responsiveness to its citizen-clients.<sup>113</sup> To statistically prove it is, however, next to impossible for want of any counterfactual information. The fact that the reforms have been carried out over such a long period also makes it very difficult to attribute efficiency improvements to particular components of the reform. Attempts at calculating cost effectiveness at a disaggregate level have, unfortunately, been abandoned. The global estimate in the national accounts is that productivity in the public sector is growing by, on an average, 1 percent a year.

It is less clear whether the reforms have led to greater effectiveness. It has proven difficult to develop mechanisms for systematically reassessing what the government is

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<sup>112</sup> Unfounded in this author's opinion.

<sup>113</sup> This does not mean that all agencies are efficient. Greater authority does not automatically lead to good leadership and other factors, such as shortsighted unions more concerned with the immediate well-being of its members than with the services they are to provide to the public, may constrain the choices open to management.

doing and for reprioritizing when society changes. The latter failure is, however, not, in this author's opinion, the result of a failure of the basic conceptual framework. It is not a design flaw.

It is rather a political failure; a failure to recognize that a more systematic use of information on outputs and outcome on costs and effects, an unbiased search for alternatives, and readiness to accept failures can be turned into good and vote-winning politics.

## 7. Outstanding issues

The Swedish public sector has come a long way on its way from public administration to public management. Nobody would, however, claim that the present model is the final, definite one. There are a number obvious outstanding issues and history will not stop even if and when the latter are resolved.

### Performance budgeting

Most of the reforms, so far, have concerned the internal operation of agencies and the relationship between the Government and the agencies. The relationship between parliament and the Government in many ways is a vestige of pre-performance management days.

### The Budget

The Central Government budget is still based on different principles and is presented in a format and with a coverage which is different from that of the accounts. A process is, however, on its way to change that. A shadow budget compatible with the accounts will be presented in next year's budget bill and eventually the old type budget will be phased out.

### The budget constraints

The budget constraints are also presently based on other principles than those of the accounts and can thus not be followed directly in the normal accounts. A partial reform is underway but will not fully solve the problem.

### Programmatic structure

A three-tier programmatic structure has been elaborated and will be used for performance follow-up. The budget is, however, still organized in expenditure areas and appropriations. This duality forecloses one of the fundamental objectives of performance management; the possibility of contrasting costs and results. Besides it is untenable for practical reasons and single structure will have to be agreed upon.

### Improved objectives and indicators

Arriving at clear objectives and good results indicators has proven one of the Achilles heels of the Swedish performance management model; and the difficulties experienced have been used as arguments against the approach in general.

Of course it should be acknowledged that in many areas, particularly for broad policy areas, it is genuinely difficult to define good and clear objectives. Furthermore there may very well be more than one objective for an area. It should also be recognized that indicators can be dangerous if not handled with care. There is always a risk of agencies focusing on what is measurable rather than on the broader result.

Many of the difficulties and much of the confusion surrounding objectives and indicators, however, stem from a lack of coherent and commonly agreed conceptual

framework. The lack of a design yardstick has led to a proliferation of indicators without much logical consistency and even less permanence. A deepening of performance management and budgeting in Sweden will require much more time and effort to be spent in this area without losing sight of the fact that objectives and indicators are only the starting point for the important part – the analysis.

#### Analytical capacity in the Government Offices

Like tango, performance management requires two partners – equal, but one leads and one follows. In the performance management dance, the Government Offices have proven to be the weak partner, to the point that the agencies complain about it.<sup>114</sup> They enjoy the authority they have been given, but at the same time want guidance and a strong partner to dialogue with. This they often feel they have not. They produce a lot of information on their activities and on their results but often feel that they do not get any response.

The reason is often a lack of analytical capacity at the Government Offices, in quantitative as well as in qualitative terms. One study suggested that if the Government Offices are to be able to serve as a strong owner vis-à-vis the agencies, it probably would need to grow by one third, much of it in the form a staff with a research profile.

#### Coordination

Performance management in Sweden has been based on a successively more definite programmatic structure with programs sometimes spanning ministries and agencies. At the same time agencies are the executive agents and need to be given guidance as such. The internal processes within the Government Offices have not really fully adapted to and developed the preparation and decision-making processes that are necessary to handle this matrix.

Agency coordination also leaves a lot to be desired.

#### Global priorities

The lack of analytical capacity within the Government Offices and the still limited capacity in semi-attached think-tanks has hampered the much-emphasized need for reassessment and reprioritization. It could, possibly, be argued that a part of the problem is that politicians are not always too terribly keen on independent evaluations. In specific situations that may be true, but generally speaking it is not a tenable argument.

## 8. Lessons

- Delegation of authority is easy. It is more difficult to put in place the routines and mechanism that will ensure accountability and responsibility.
- Performance management is more challenging than rule definition and rule adherence. Officials must be willing and capable of taking on those challenges.
- Willingness to take on responsibility is as important as the willingness to relinquish immediate control.

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<sup>114</sup> ESV at the end of the nineties carried out an extensive survey to find out how the agencies looked upon performance management and this was one of the conclusions.

- Other types of skills and other types of managers are needed; entrepreneurs vs. administrators.
- A programmatic approach increases the need for coordination between ministries and agencies.
- Performance management presumes professionalism. There is no room for cronyism and patronage. Promotion should be made on the basis of ability rather than seniority.
- Performance management implies a change of management culture - from hierarchical to participatory.
- Mobility within the public sector and between the private and the public sector can facilitate change.
- Strong owners are needed to balance empowered agencies.
- Good analytical capacity in the ministries is essential.
- Tools important are important: modern accounting, customer relations measures, etc..
- Clear objectives and results indicators are important but surprisingly difficult to arrive at and easily become a stumbling block.
- Mechanisms for reassessing and reprioritizing are essential but do not necessarily have to be part of the normal budget process.
- Other instruments have a complementary role to play: performance audit, independent evaluations, academic research etc..
- It is desirable that reforms are carried out within a consistent framework but it is not always possible.
- Strong political leadership makes the implementation of the reforms much easier but it is not impossible without it; it just takes longer.

## CHAPTER 16

# Performance Budgeting in the United States

by

*Bill Dorotinsky, The World Bank*

### 1. Outline

- Context
- GPRA Strategic Planning Requirements
- GPRA Performance Planning Requirements
- Key Implementing Guidance
- Lessons and Observations
- Future Directions
- Performance Budgeting in a Federal system: Collaboration

### 2. Context

- U.S. has a long history of trying to improve performance and assess what public monies buy
  - Planning-Programming-Budgeting System (1960's)
  - Zero-Based Budgeting (1970's)
  - Management by Objectives (1980's)
  - National Performance Review (1990's)
  - Government Performance and Results Act (1990's)
  - Program Assessment and Rating Tool (PART) (2000's)
- Attempts have varied between using the budget process and directly through management of programs

### 3. GPRA

- GPRA represents another step in the historical search to grasp whether agencies are fulfilling their mission, and whether programs are effective
  - a natural extension of legislative oversight
- Over-all objective: "Linking resources to results."
- The GPRA statute defines two complementary performance activities, defined by the short and long term
  - Strategic plans, covering five year horizons
  - Performance plans, covering annual goals to reach the strategic targets

#### 4. GPRA Strategic Plan Requirements

GPRA [5 USC 306] requires each agency to produce a strategic plan by 9/30/97 which includes:

- a comprehensive mission statement;
- general goals and objectives, including outcome-related goals and objectives, for major agency functions/operations;
- a description of how goals and objectives are to be achieved (operational processes, skills, technology, human, capital, information and other resources required);
- description of how performance goals of performance plan relate to strategic plan;
- identification of key factors external to the agency and beyond its control that could significantly affect goal achievement;
- a description of program evaluations used in establishing/revising general goals and objectives, and a schedule for future program evaluations; and,
- covers five years forward, to be revised at least every 3 years.

Additionally, agencies must consult with Congress and entities potentially affected by or interested in the plan, and the plan must be drafted by Federal employees.

#### 5. GPRA Performance Plans Requirements

GPRA [31 USC 1115(a)-(e)] requires the Director of OMB to require agencies to prepare annual performance plans covering every budget activity for each agency. Plans must:

- establish performance goals and performance levels to be achieved for each activity;
- express goals in objective, quantifiable, measurable form (unless OMB authorizes otherwise);
- briefly describes operational processes, skills, technology, human, capital, information, and other resources necessary to attain goals;
- establish performance indicators to be used to measure and assess outputs, service levels, and outcomes for each program activity;
- describe the means to be used to verify and validate measured values.

Agencies are allowed to aggregate, disaggregate or consolidate program activities in the plan, so long as it does not minimize major agency programs. Again, Federal employees must draft these plans.

#### 6. Key Implementing Guidance

- Goals should be quantifiable
- Outcomes over outputs
- Outcomes over process
- Input goals not acceptable
- Measures should be ones program managers use regularly, find useful, and are part of normal management information systems
- GPRA should incorporate previous performance-based reforms

## 7. Lessons and Observations

- Clear model of program important
- Choosing the right goal and outcome measures
- Outcomes don't supplant other measures
- GPRA creates "demand-pull" for better data; will change data systems
- GPRA as culture change, rather than merely a paper exercise: effects will vary.
- If central budget institutions lead performance budgeting efforts, which is natural, then a prerequisite of success is redefining the role of the central budget institution from command-and control to collaboration.
- Shorter the time horizon, more process oriented the measure
- Performance budgeting is iterative

## 8. Future Directions

- Program evaluation must be integrated into GPRA performance planning: deep look at why programs are or are not working.
- Auditing of data systems
- Auditing of performance reports
- Inclusion of performance data in annual financial statements
- Integration of performance and financial systems

## 9. Program Assessment Rating Tool

- Key assumption of GPRA was that agencies would themselves use performance information to improve program management, decisions
  - Currently little evidence this has happened
  - PART developed in 2002 with advice from President's Management Council
- Intended to integrate performance and management
  - Bridge gap between performance data and what to do with data
  - Undertaken by the budget office, though with close collaboration with agencies

## 10. Coverage of the PART

Each PART has four sections with questions designed to elicit specific information

- Program Purpose & Design to assess whether the program's purpose and design are clear and sound.
- Strategic Planning to assess validity of long-term and annual measures and targets for the program
- Program Management to rate agency management of the program, including financial oversight and program improvement efforts
- Program Results/Accountability to rate program performance on measures and targets reviewed in the strategic planning section and through other evaluations





## **Part III**

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### **Fiscal Transparency**



## CHAPTER 17

# Coverage of Public Finance in Korea

by

*Dong suk Oak, Incheon University*

## 1. Introduction

The objectives of public expenditure management are generally viewed as maintaining aggregate fiscal discipline, allocating resources in accordance with government priorities, and promoting the efficient delivery of services. The fiscal targets and indicators used most commonly in maintaining aggregate fiscal discipline are the fiscal deficit and fiscal debt, regarding which many countries have laws and rules to restrict fiscal policy.<sup>115</sup> The establishment of explicit fiscal targets allows the government to state clearly its fiscal policy and enable the legislature and the public to monitor the implementation of government policy, and ultimately make the government politically as well as financially accountable.

Fiscal deficit is defined as the difference between fiscal revenue and fiscal expenditure. In order to measure the fiscal deficit, the government needs, among other things, to determine the coverage of public finance in a sufficient and appropriate manner. Determining the coverage of public finance implies that the government should decide which public institutions, funds, and accounts are to be included in measuring the fiscal deficit. The coverage of public finance is also instrumental in measuring fiscal debt. Which public institutions, funds and accounts are to be included in measuring the public debt?

Since every country has its own historical tradition and institutional system for public finance, countries differ greatly in their governmental and fiscal coverage. While the statistics on the coverage must reflect the institutions and practices of each country, a common system of definitions and classifications is helpful to users because it allows comparisons with other countries. It is desirable for the fiscal statistics to follow the conventions and classifications in constructing the national accounts for the entire economy, as laid out in the United Nations *A System of National Accounts 1993* (SNA). Following the fiscal coverage of the SNA, the European Union publishes more specified criteria, in the *Manual on Government Deficit and Debt* in order to obtain reliable and comparable statistics for evaluating fiscal convergence concerning both the fiscal deficit-to-GDP and the debt-to-GDP ratios.

In the SNA five mutually exclusive institutional sectors are identified. They are the nonfinancial corporations sector, the financial corporations sector, the general government sector, the nonprofit institutions serving households sector, and the household sector. The IMF's *Manual on Government Finance Statistics* (GFS) harmonized with sectorization of the SNA, defines the coverage of the statistics to be a country's

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<sup>115</sup> Fiscal targets and indicators should cover three areas: current fiscal position (e.g., fiscal deficit), fiscal sustainability (e.g., debt-, tax-, or expenditure-to-GDP ratios), and vulnerability (e.g., analysis of the composition of the foreign debt).

general government sector, which is defined on the basis of institutional units. The coverage can also be extended to the public sector by including the fiscal activities of public corporations. The public sector is defined as consisting of the general government sector plus government-controlled market entities, known as public corporations.

In spite of the SNA's definition of the general government sector, the coverage of government expenditure, being the baseline of government deficit and government debt, varies in a number of countries. Especially many developing countries, having a relatively short history in operating the modern public management system and rare opportunities to share the experiences of other countries, have problems in transparency, responsibility, and efficiency because their coverage of government and public finance is not defined comprehensively and systematically.<sup>116</sup>

In the developed countries the coverage of government expenditure is not all consistently the same through the stages of budget preparation, parliamentary votes, funds release, accounts and statistics. A significant share of public expenditure is usually managed through special procedures. The objectives of the special arrangements include: avoiding excessive negotiation during the budget preparation process, resolving difficulties in the legislative debates and scrutiny, and providing greater flexibility in the use of funds by the executive.

This study draws lessons for the Korean government from the comparative study of Korea, Japan, and the UK. The paper is structured as follows. Section 2 discusses some key factors in determining the general government sector in the SNA and EU Manual, and summarizes several concepts on the coverage of the public finance according to the management process of public expenditures. Section 3 explains the Korean government's coverage of the public finance, while Sections 4 and 5 provide a broad overview on the UK and the Japanese governments' coverage of the public finance. Section 6 concludes with policy implications for reforming public expenditure management in Korea.

## 2. Several concepts on the coverage of public finance

### 2.1. Determining general government sector

The SNA, a cornerstone for the other international manuals on statistics, divides the economy into five sectors in addition to the rest of the world: (1) non-financial corporations sector; (2) financial corporations sector; (3) general government sector; (4) non-profit institutions serving households sector; and (5) households sector. The public sector includes the general government sector plus all public non-financial and financial corporations. The total resident economy except the public sector is the private sector, so there should not be no gray area between the public and private sectors.

The general government sector and the public sector are the basis for the government finance and public finance statistics. In deciding if an entity is to be included in the general government sector, the steps to be followed could be summarized as three-staged. These are provided by the *EU Manual*, describing more

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<sup>116</sup> The two terms, public finance and government finance are generally used in the literature without distinction. Fiscal deficit of the general government sector and the public sector, however, are defined as government deficit and public deficit, respectively.

specifically the concepts and criteria of the SNA for the Excessive Deficit Procedure required in the Article 104 of the Maastricht Treaty.

The first step to be taken is to ask whether the entity is an institutional unit. Sectorization decisions in the SNA must be taken at the level of institutional units, defined in the SNA as units having the autonomy of decision and a complete set of accounts. Autonomy of decision means that it must be able to own goods or assets in its own right; be entitled to make economic decisions and carry out economic activities for which it is held directly responsible and accountable by law; and be able to incur liabilities on its own behalf, to take on other obligations or further commitments and to enter into contracts. In order to keep a complete set of accounts, a unit must keep accounting records covering all its economic and financial transactions carried out during the accounting period, as well as a balance sheet of assets and liabilities.

The second step is to ask whether the institutional unit is private or public. A public unit is one controlled by the general government, whereas a private unit is one not controlled by the general government. Control, defined as the ability to determine general policy, is an essential criteria for sectorization between the public and private sectors. The general government of a country consists of the public authorities, their agencies and instrumentalities, which are established through political processes and exercise a monopoly of compulsory power. The form that administration or accounting for a entity takes – whether budgetary, extra-budgetary, special account, etc. – should not affect its inclusion for the general government sector. When a public unit, by virtue of special legislation, is recognized as an independent legal entity, it can be considered as an institutional unit, to be classified in the general government sector, and if it is not a public corporation.

The third step is to ask whether the public institutional unit is market or non-market. When the principal function of the public institutional unit is to supply certain public goods and services and fulfill certain public purposes not for commercial or financial reasons, or, if of a commercial or financial nature, not on a major basis or not primarily for profit, this unit is to be classified in the general government sector. In the SNA, the distinction between market (i.e., for commercial reasons or for profit) and non-market producers depends on whether or not prices charged are economically significant. A price is said to be not economically significant when it has little or no influence on how much the producer is prepared to supply and is expected to have only a marginal influence on the quantities demanded. In practice, the public institution whose production costs are not covered by more than 50 percent through sales is classified as a non-market producer and general government.

The general government sector, which is determined by the three steps, normally includes the ministries, departmental agencies, other decentralized public bodies, and local authorities. The principal function of the general government sector is to carry out public policy through the production of non-market services primarily for collective consumption and the transfer of income, financed mainly by compulsory levies on units in other sectors. The public institutions in the general government sector are being called in different terminology in different countries, making international comparative research difficult. Institutions other than the ministerial agencies are sometimes named as authorities, autonomous bodies or organisms, quangos, non-departmental public bodies, extra-governmental organizations, subsidiary organizations, etc.

Public policy may be also carried out by public corporations outside the general government sector, and these are sometimes called as quasi-fiscal activities. To the extent that the quasi-fiscal activities are funded by grants from the general government sector, those can be included in the coverage of the public finance. The total receipts

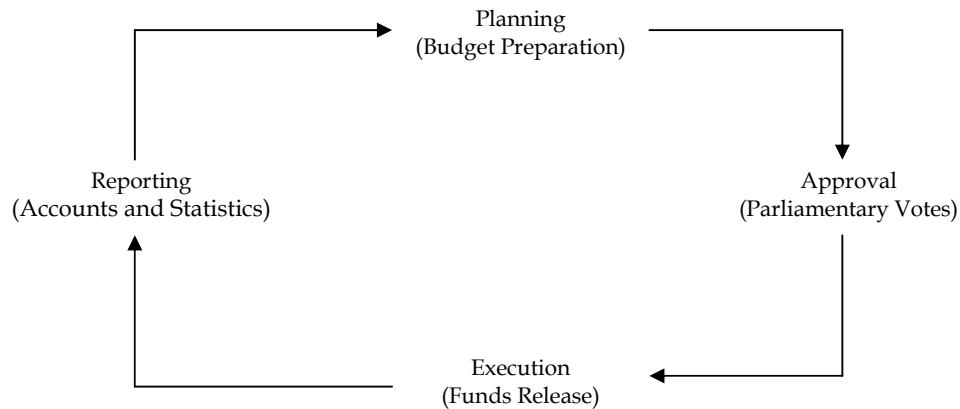
and expenditures of public corporations should not be treated equally to those of the governmental institutions, because they collect sales proceeds only by incurring corresponding production costs.

For the purposes of control and accountability, the general government sector is an appropriate coverage for the public resources and finance. The general government sector includes all the ministerial departments, departmental agencies, the public and private law non-market bodies which are directly and indirectly controlled by the ministers. The finances of those are ultimately the responsibility of the government, so those are to be answerable and accountable to the legislature and managed and controlled by the ministers. Public corporations, not included in the general government but in the public sector, are usually private law bodies whose owners have limited liabilities and can control them only with voting shares. However, some considerations should be given to public corporation established by public law, since the law provides implicit guarantee and financing for it seems to be the responsibility of the government.

## 2.2. Coverage of public finance at management stages

The expenditure management process of various institutions included in the general government sector has four major stages: planning, approval, execution, and reporting. The coverage of the institutions in each stage of the process may be greatly different because it is necessary to allow special management arrangements to some special institutions, funds, or accounts on historical, legal, political, and administrative grounds. Owing to the special arrangements, the coverage of government expenditure is not all consistently the same through the stages of budget preparation, parliamentary votes, funds release, accounts, and statistics.

Figure 17-1. Stages of expenditure management



In order to use the resources of the general government sector in a responsible, efficient and effective way, the government needs to define the budget as a comprehensive plan for the operations of the sector. Different countries have different budgeting coverage, each with its own specific features consistent with the overall administrative culture. Not many countries seem to require budgets to cover all the public institutions of the general government sector defined in the SNA.<sup>117</sup> For the coverage of the budget to be comprehensive, the budget should include all revenues and expenditures of the general government regardless of the arrangements for separately managing some particular programs, the legal provisions for authorizing expenditures, and the financing source. If the budget excludes major expenditures of the general government sector, there can be no assurance that scarce resources are allocated to priority programs and that legal control and public accountability are properly enforced.

Different actors are involved in budget preparation: the Central Budgeting Bureau (CBB) of the Administration, budget departments of line ministries, and, within line ministries, budget departments of subordinate spending agencies and decentralized public bodies. The CBB reviews budget requests from line ministries, departmental agencies, and decentralized public bodies, and is responsible and accountable for drafting budget bill submitted to the parliament. Depending on the country, the coverage of budget bill, which the CBB is involved in preparing, may not fit the general government sector. Special arrangements on the budget process may allow line ministries to have all the power and responsibilities on some budgetary resources without reviews by the CBB, which weakens accountability. Some decentralized public bodies may not be under the budgetary control of the CBB and be just under that of the line ministries. In this study, the budget that is controlled and prepared by the CBB is denoted as *Budget<sup>ctr</sup>*, and the *Budget*, controlled by the government in general, includes the *Budget<sup>ctr</sup>* plus the other budgets controlled only by the line ministries.

The *Budget<sup>ctr</sup>* is submitted to the legislature for approval some months before the start of the fiscal year, to allow budgetary debates to be completed before the start of the fiscal year. Many countries have adopted procedural rules to regulate and limit legislative debates on the *Budget<sup>ctr</sup>*. These usually pertain to (i) the coverage of voting on the *Budget<sup>ctr</sup>*; and (ii) the legislature's powers to amend the budget.

The *Budget<sup>ctr</sup>*, submitted to the legislature by the CBB, has two parts; Votes and Non-Votes. Votes are the budgetary resources which should be approved by legislature for its execution, and Non-Votes are the ones just for scrutiny by the legislature. The de-facto differences between Votes and Non-Votes lie in the legal powers of the legislature to propose amendments to budgetary items.

In addition to the annual voting process, the legislature may also have access to administrative information through regular departmental briefings and expenditure reports from the Comptroller and the Auditor General. The resource included in the *Budget* other than the *Budget<sup>ctr</sup>* will be scrutinized by the legislature through briefings and reports. For example, some decentralized public bodies do not require approval by the legislature for their budget, instead report budget executions to the legislature on a regular or *ad-hoc* basis.

Budget execution needs the release of budgetary resources from funds and accounts. Spending institutions must be provided with the funds necessary to implement the budget in a timely manner, and the cost of government borrowing must

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<sup>117</sup> Since public corporations in general do not use tax or other compulsory levies, they are not included in the budget. Only grants to them will be included in the budget.

be minimized. In most countries, the government has a number of funds and accounts to administer public money irrespective of the institutional unit. Every country has a consolidated fund or account, the main fund into which all receipts are deposited and from which all payments are made, and some earmarked special funds. The central bank is, in most countries, the main cashier of the government, so the consolidated fund or account is held at the central bank. Special or earmarked funds and accounts may be held in commercial banks, whether the funds and accounts are automatically swept at the end of each day or not.

To minimize borrowing costs or maximize interest-bearing deposits, operating cash balances should be kept to a minimum. Idle balances of special earmarked funds or accounts increase the borrowing needs of the government, which must borrow to finance the payments of some funds, even if other funds have excess cash. Whatever the institutional arrangements, the centralization of funds and accounts is required and should cover as many of the government funds and accounts used for payment transactions. In this paper, funds and accounts held at the central bank will be denoted as F&A<sup>1</sup>, and funds and accounts held at commercial banks, as F&A<sup>2</sup>. The coverage of F&A<sup>1</sup> and F&A<sup>2</sup> will vary greatly according to the country.

The last stage of the expenditure management will be government accounting and financial reporting. Government finance statistics can be distinguished from two other data systems. The CBB or other ministerial departments will publish the government finance statistics from the government budgets and accounts, maintained by operating units for purposes of control and accountability. In the national accounts, data for the government are recast in a form common to all sectors so as to measure and aggregate their production, income, consumption, capital accumulation, and finance, and delineate inter-sectoral transactions. Even if the office responsible for preparing the national accounts will vary according to the country, the statistical guidelines and concepts of the SNA should be observed. In this paper the de-facto coverage of government finance statistics published by the CBB or other ministerial department will be denoted as FS (Financial Statistics), and the coverage of national accounts NAS (National Accounts Statistics).

### 3. The coverage of public finance in Korea

The coverage of the consolidated government finance in Korea is traditionally recognized according to the criteria of accounting and fund units such as the General Account, Special Accounts, and Funds. The General Account is the main consolidated account with the Bank of Korea. Most of the central government's expenditure is financed from this account, and most taxes and other receipts deposited there. Special Accounts, whose total number is 22, and Funds, whose total number is 55, are all created for earmarking to some special programs and bypassing traditional appropriation management rules, such as rules for transfers between line items ("virements") and the cancellation of appropriations at the end of the fiscal year.

The coverage of the government accounting and fund units, however, do not correspond with that of the general government sector in the SNA, being defined on the basis of institutional units not of the administrative, legal or accounting types. According to the SNA, the central government of the general government sector in the Korean resident economy should include all the decentralized public bodies as well as ministerial departments and departmental agencies. Decentralized public bodies, most of which are public law administrations, are controlled by the ministerial departments and departmental agencies. They have their own legal personality, while ministerial

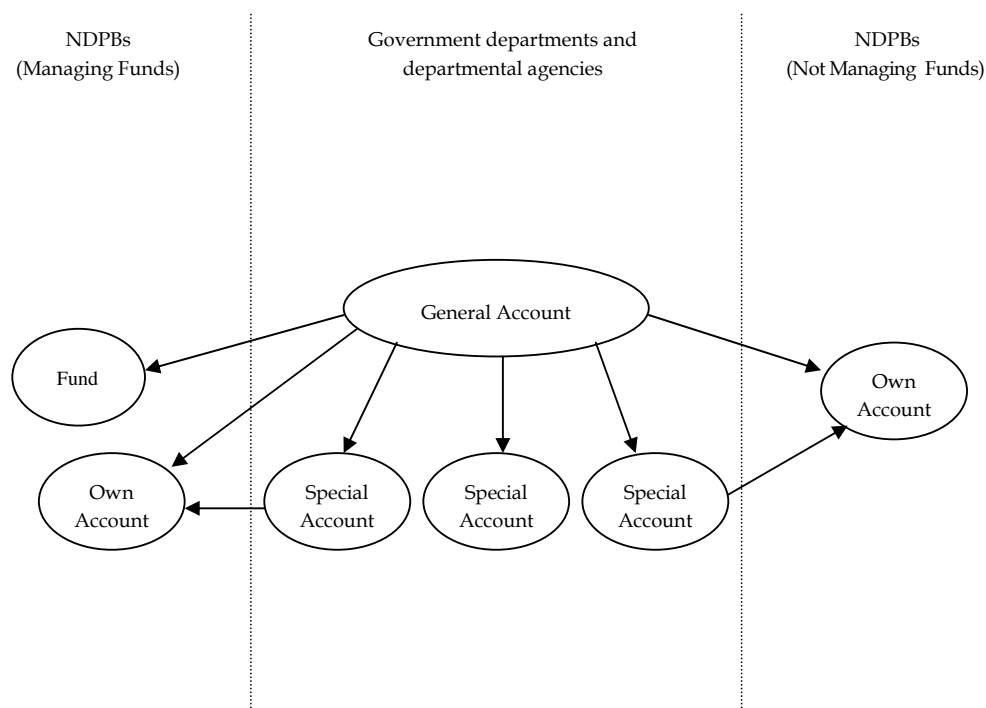


departments and departmental agencies have no separate legal identities from the state and their staff are comprised of civil servants. They are equivalent to NDPBs of the UK.

The resources of which the decentralized public bodies have control are not reflected in the government accounts except government's grants to them. The coverage of the General Account, Special Accounts and Funds do not reach all the expenditures of the decentralized public bodies. The coverage of the General Account and Special Accounts is approximately equal to the coverage of ministerial departments and departmental agencies. However, the 55 Funds do not cover all the decentralized public bodies.

Some NDPBs are managing government Funds, and some are not. In the case of NDPBs managing Funds, their expenditures funded from the Funds can be reflected in the government accounts. Since the expenditures of NDPBs have never been published in Korea, it is impossible to identify the share of the resources of the decentralized public bodies (NDPBs in the Figure 17-2) covered in the resources of Funds. All the resources of the NDPBs' own accounts, whose amount is usually alleged as equivalent to that of the General Account, are excluded in the coverage of government accounts.

Figure 17-2. Public expenditures in Korea



While the budgetary resources in the coverage of the General Account, Special Accounts and some Funds are under the control of the CBB (the Ministry of Planning and Budget), the resources of the NDPBs' own accounts are outside the control of the CBB and approved just by line ministries. In other words, the budgetary resources of the general government sector are all controlled by the government, but some are not controlled by CBB. That means the *Budget* does not equal to the *Budget<sup>ctr</sup>*. Additionally, some funds are not controlled by the CBB, so are not included in the *Budget<sup>ctr</sup>*. Those 10 Funds are related to financial intermediation activities, and are managed by the Ministry of Finance and Economy. They are not legally included in the Votes. Their operational plans are submitted and scrutinized by the National Assembly, but their approval is not legally required for execution.

Most of the Funds are held at the Bank of Korea, like the General Account and Special Accounts. While it is legally binding that the Bank of Korea holds General and Special Accounts, Funds' account can be held either at the Bank of Korea or at commercial banks. Some Funds and NDPBs' own accounts are all held in the commercial bank owing to banking services.

Since the coverage of public finance has long been recognized as the General Account, Special Accounts and Funds, both the Government Finance Statistics published by the CBB and the National Account Statistics published by the Bank of Korea reports only the *Budget<sup>ctr</sup>*. The coverage of the public finance according to the management stages can be shown as follows.

Table 17-1. The coverage of public finance in Korea

	General Account	Special Accounts	Funds	NDPBs	Local Authorities
Budget	○	○	○	○	○
Budget <sup>ctr</sup>	○	○	△	×	×
Votes	○	○	△	×	×
non-Votes	-	-	△	×	×
F & A <sup>1</sup>	○	○	△	-	-
F & A <sup>2</sup>	-	-	△	○	○
NAS <sup>1)</sup>	○	○	△	×	△
PFS	○	○	△	×	×

Note: 1) Only a few NDPBs are included in the National Accounts, but those can be neglected.

#### 4. The coverage of public finance in the UK

In the UK, decisions on which sector an actual or proposed body should be classified in are made by the Public Sector Classification Committee (PSCC), which is a small committee consisting of about 10 staff members and external experts within the Office for National Statistics (ONS). The PSCC's purpose is to help formulate decisions

about the sector classification of bodies/institutions. Straightforward classification decisions may be taken by the HM Treasury on the basis of agreed classification rules between the Treasury and the ONS. Decisions must be consistent with the principles of the international statistical manuals, i.e. ESA (European System of Accounts) and SNA, and supporting manuals and case laws. *Sector Classification for the National Accounts* was published in 1998, listing all the institutional units allocated to each sector including the general government sector and public non-financial corporations.

The UK government sets targets for themselves based on a concept of national accounts. Fiscal policy targets are based on two strict rules, namely the Golden Rule and the Sustainable Investment Rule.<sup>118</sup> The government has chosen to present the government accounts using principles from the national accounts and to control public expenditure according to the rules based on national accounts. The political debate on fiscal policy focuses on the statistics based on the national accounts principle.

Table 17-2. Key fiscal indicators in the UK

	(unit: £ million)				
	1997	1998	1999	2000	2001
A. Surplus on Current Budget (B-E)	-11,777	8,260	15,108	20,252	17,365
B. Gross Saving plus Capital Taxes (C-D)	615	20,846	27,714	33,183	30,754
C. Current Receipts	305,959	333,968	349,872	375,797	391,558
D. Current Expenditure	305,344	313,122	322,158	342,614	360,804
E. Depreciation	12,392	12,586	12,606	12,931	13,389
F. Net Investment	4,664	5,876	5,136	4,836	8,481
G. Total Managed Expenditure (D+E+F)	322,400	331,584	339,900	360,381	382,674
H. Public Sector Net Borrowing (F-A)	16,441	-2,384	-9,972	-15,416	-8,884
I. Net Debt (£ billion)	357.6	353.8	352.7	317.0	318.2

Source: ONS, *United Kingdom National Accounts: The Blue Book 2002*, p.291,

The Blue Book, *United Kingdom National Accounts*, shows the surplus on current budget (net saving plus capital taxes), net debt, net borrowing, and the public expenditure measures. The surplus on current budget measures achievement against the Golden Rule, and the public sector net debt is related to the Sustainable Investment Rule. General government net borrowing is closely related to government deficit in the context of the Maastricht Treaty, which requires governments to keep their deficits below 3 per cent of GDP. The public expenditure measures in the UK is denoted as total managed expenditure (TME). TME is the present government's main measure of

<sup>118</sup> The Golden rule is that over the economic cycle, the government will borrow only to invest and not to fund current spending. In other words current spending must be matched by current receipts such as taxation and social security contributions. The Sustainable Investment Rule is that net public debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level. The current government's intention is to hold this ratio below 40 percent.

public expenditure. It represents the consolidated current and capital expenditure of the general government sector and excludes capital grants to public corporations and adds in certain expenditures (mostly capital) by public corporations.

On Budget day, the Treasury publishes the *Economic and Fiscal Strategy Report* (EFSR) and the *Financial Statement and Budget Report* (FSBR) in order to describe the government's fiscal policy. Those two now appear together within a single budget document, sometimes called the Red Book. The Treasury also publishes *Main Supply Estimates*, *Supplementary Budgetary Information*, and *Public Expenditure Statistical Analyses* (PESA), which are command papers to be submitted to the Parliament. PESA is a compendium that brings together recent outturn data, estimated outturns for the latest year and budgetary plans covering a whole range of UK public expenditure. Further information on each governmental department's spending is made available in the individual Departmental Reports. The Red Book and PESA present TME as a government measure of public expenditure, similar to the Blue Book.

Table 17-3. TME by spending sectors

	(unit: £ million)		
	2001-02 outturn	2002-03 estimated outturn	2003-04 plans
<b>Central Government Own Expenditure</b>	<b>285,811</b>	<b>309,620</b>	<b>330,600</b>
<b>Local Authority Expenditure</b>	<b>98,424</b>	<b>105,736</b>	<b>117,900</b>
Central Government Support	74,416	81,081	88,955
Local Authority Self-financed Expenditure	18,125	18,923	21,168
Others <sup>1)</sup>	5,882	5,732	7,746
<b>Public Corporation Expenditure</b>	<b>5,344</b>	<b>5,669</b>	<b>7,200</b>
Central Government Support	2,883	3,182	4,544
Public Corporation's Own-financed Capital Expenditure	1,540	2,161	2,579
Accounting and Other Adjustments	921	327	100
<b>Total Managed Expenditure</b>	<b>389,579</b>	<b>421,025</b>	<b>455,700</b>

Note: 1) Includes Locally Financed Support in Scotland, accounting and other adjustments.  
Source: HM Treasury, *Public Expenditure Statistical Analyses 2003*, May 2003.

Some discrepancies in the numbers can exist between the Treasury statistics and National Accounts. Needless to say it reflects the differences of the fiscal year and the calendar year on the statistical period and the fact that the Treasury's accounting and budgeting concepts are based on the UK's generally accepted accounting practice while the National Accounts follows the international guidelines of the SNA. Those discrepancies are very minor.

The UK's budget covers all the public institutions of the general government sector and the capital expenditures of public corporations. Vote, approved by the Parliament, covers the resources drawn from the Consolidated Fund, which is the main Treasury

fund. Therefore, total expenditures of NDPBs, public corporations and local authorities are not included in the Vote, but grants to them are included in the Vote.

The main funds in the UK are the Consolidated Fund and the National Loans Fund, but there are other important funds such as the National Insurance Fund and Exchange Equalization Account and the Paymaster General's Accounts, National Debt Commissioners' Accounts (the National Lottery Distribution Fund Investment Account, the Court Funds Investment Account, the National Savings Bank Fund, Crown Estate Account, Donations and Bequests Account, Insolvency Services Investment Account, National Endowment for Science, Technology and the Arts, National Heritage Memorial Fund, Northern Ireland Court Service Investment Account, Northern Ireland National Insurance Fund Investment Account), the Northern Ireland Funds and Accounts, and a host of smaller accounts (Customs and Excise Account, Inland Revenue Account, etc.).

Table 17-4. Voted and non-voted expenditure in TME

(unit: resources, £ million)

	2001-02 outturn	2002-03 estimated outturn	2003-04 plans
<b>Total Voted Expenditure in TME(A)</b>	<b>261,757</b>	<b>283,452</b>	<b>275,672</b>
Central Government Spending	189,909	199,178	191,976
Central Government Support for Local Authorities	62,081	65,770	72,151
Central Government Support for Public Corporations	1,014	1,257	2,239
Accounting Adjustments	8,753	17,247	9,306
<b>Total Non-Voted Expenditure in TME(B)</b>	<b>127,822</b>	<b>137,573</b>	<b>180,000</b>
Central Government Spending(including spending by NDPBs and Devolved Executives)	108,525	114,882	132,237
Central Government Support for Local Authorities	12,335	15,312	16,804
Public Corporations	1,869	1,924	2,305
Others <sup>1)</sup>	5,094	5,455	28,650
Total Managed Expenditure(A+B)	389,579	421,025	455,700
Voted Expenditure not in TME(included within "Non-Budget" in Estimate)(C)	52,245	62,627	96,955
Grants to NDPBs to finance their expenditure	19,688	24,115	28,205
Grants to Devolved Executives to finance their expenditure	31,134	35,954	36,643
Other non-public expenditure	1,423	2,558	32,107
<b>Total Voted Expenditure(A+C)</b>	<b>314,002</b>	<b>346,079</b>	<b>372,627</b>

Note: 1) Include DEL not allocated by spending sector, Central Government Debt Interest, AME Margin, Locally Financed Expenditure, Non-Voted Net Payments to EU, and accounting and other adjustments.

Source: HM Treasury, *Public Expenditure Statistical Analyses 2003*, May 2003.

The Consolidated Fund was inaugurated in 1787, which collects every stream of public revenue and issues the supply of funds for every service. The legislation governing both the Consolidated Fund and the NLF ensures that government finances are centrally accountable to Parliament. Generally speaking, all money collected by the government must, unless Parliament specifies otherwise, be paid into one of these two main funds. And in general no money can be paid out of the Consolidated Fund or the National Loans Fund without the specific legal authority of Parliament, and the prior

approval of the Comptroller and Auditor General. Expenditures voted by Parliament are mostly financed by the Consolidated Fund.

The Consolidated Fund, NLF, EEA and Paymaster General's accounts are all held at the Bank of England, while NDPBs' accounts are held at commercial banks. This concentration of funds at the Bank enables the government to minimize both its holdings of non-interest bearing bank deposits and its gross level of borrowing. It also facilitates the measurement of the CGBR (Central Government Borrowing Requirements), which is based on the transactions undertaken by central government funds and accounts.

The coverage of the public finance according to the stages can be shown as follows.

Table 17-5. The Coverage of Public Finance in the UK

	Department	Agency	NDPBs	Local Authorities
Budget	○	○	○	○
Budget <sup>ctr</sup>	○	○	○	○
Votes	○	○	×	×
Non- Votes	-	-	○	○
F& A <sup>1</sup>	○	○	×	×
F& A <sup>2</sup>	-	-	○	○
NAS	○	○	○	○
PFS	○	○	○	○

## 5. The coverage of public finance in Japan

In the National Accounts published by the Japanese Government, the central government of the general government sector is composed of the General Account, Special Accounts and Special Entities (SEs, *tokusuhouzin*). The coverage of the General and Special Accounts are assumed to coincide with the ministerial departments and departmental agencies, whose employees are all civil servants. SEs are defined as 'institutions established directly by the government departments or established according to special public laws.' Those are public law administrations equivalent to the NDPBs in the UK. The Japanese central government has approximately 40 Special Accounts and 92 SEs, which are classified between the general government and the public corporations sector according to their principal function. The local governments of the general government sector are also composed of their general account, and special accounts including some entities established by themselves.

It seems likely that there exist a number of public institutions in Japan which are not classified into the general government sector. Japanese government is controlling many non-profit institutions, and those can be classified into the general government sector according to the SNA. Sectorization decisions in the Japanese national accounts are not taken systematically at the level of institutional units. That could be the reason to underestimate the size of the Japanese public sector.

There are three types of public institutions which may be classified into the public sector; Related Enterprises of SEs (RESs, *kankeikaisha*), Joint Enterprises between SEs and private corporations (JESs, *shusshikaisha*), Appointed Entities (AEs, *siteihouzin*). RESs are the enterprises on which SEs exercise a power in determining their general policies. The number of RESs of which SEs' ownership is more than 50 percent is 923 in 1997, while that of RESs below 50 percent is 91. All RESs should be classified into the general government sector or public corporations, since they are controlled by the central government. JESs are normally used as a policy tool for channelling funds into public-private partnership programs. The number of JESs of which the proportion of SEs' ownership is above 20 percent is 240 in 1997. Some of them can be classified into the public sector according to the nature of SEs' ownership and control.

AEs are nonprofit institutions which perform activities related to administrative procedure for public policies. They may charge administrative fees or be funded by the government. Nonprofit institutions which are established by private law are called Public Interest Entities (PIEs, *kouekihouzin*). PIEs which perform executive, advisory, tribunal, inspection and authorization role by the law, order or other administrative actions will be regarded as AEs. Those, numbering 720 in 1997, can also be classified into the general government sector.

The total number of RESs, JESs, AEs, which are currently classified into private sector but controlled and mainly financed by government are approximately 2,000. If a systematic classification would be performed observing the SNA manual, most of RESs, JESs, AEs would be classified into the public sector. Therefore, there is no government publication in Japan which can show the consolidated statistics of the general government and the public sector.

The coverage of public finance statistics published by the Japanese government is only the General Account and Special Accounts. The budget, which is submitted to Parliament for its approval, includes 11 Government Related Institutions (GRIs, *seibukankeikikan*) in addition to the General Account and Special Accounts. Eleven GRIs are all SEs which principally engage in financial intermediation for the purpose of public policy. Budget and public finance statistics do not include any other SEs than GRIs to say nothing of RESs, JESs, AEs. Government deficit and government debt, reported annually by the Japanese government, are not observing the international standard of the SNA and GFS.

## 6. Conclusions: lessons from the two countries

To be an effective instrument of policy, the coverage of the public finance should be comprehensive. In many countries, a significant share of government expenditure is excluded from the coverage of the public finance. These issues concerning the comprehensiveness of the public finance are discussed in this paper.

European countries are observing the SNA and GFS manual in determining the coverage of public finance, which require it to be the general government sector. The European Union has published *Manual on Government Deficit and Debt* in order to obtain reliable and comparable statistics for evaluating fiscal deficit and government debt. In the UK, especially, there exists an institutionalized independent decision-making process for the sectorization of the general government sector and the public sector.

In the far eastern economies, Korea and Japan, there has been a long tradition that the coverage of the public finance is recognized not in institutional context but in accounts and fund units. The government has long exercised its power to establish a number of the decentralized authorities, as a measure to accomplish policy goals. This

tradition has made the coverage of public finance be underestimated to a considerable extent.

The most important task by which the government is confronted in strengthening the management of public expenditure is to rearrange the coverage of the public finance. In making arrangements for the scope and system of the consolidated public finance, what is important is that international standards of the SNA and GFS should be applied on every government and national accounts statistics. As budgetary, parliamentary, fund, and accounting practices serve many different legal, political, and administrative purposes, they cannot be taken as a guide to the inclusion of particular institutions in the general government sector or some other sector.

All the coverage at each expenditure stage, i.e, budget preparation, parliamentary votes, funds and accounts release, reporting, and statistics need not be equal to the coverage of the general government. In both budgeting and reporting, the coverage of the public finance should be the general government sector. The CBB should manage and control all the budgetary resources included in the general government sector. Every decisions taken on public finance should be based on the reports and statistics of the general government sector.

The scope and contents of the budget submitted by the government to the National Assembly, undoubtedly, should correspond with those of the general government and the public sector. However, the coverage of the parliamentary approval may be determined by the allocation of budgetary power between the Administration and the parliament. The coverage of funds and accounts may be also determined by the accounting practices in each country.



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## Information Flow for Successful MTEF Operation and its Implication for the Korea Government

by

*Junghun Cho, The World Bank<sup>119</sup>*

### 1. Introduction

The Korean government is now preparing to introduce a medium-term expenditure framework (MTEF) and other public expenditure reforms. These reforms are intended to increase efficacy and transparency of the way public resource are allocated and spent in Korea. Among the many challenges for the Korean government to succeed with these reforms and generate anticipated benefits is to have its financial management information system (FMIS) updated to meet the new, additional information needed to operate MTEF.

Usually, MTEF requires significant, wide-ranging changes in the way a county allocates public resources. As a fundamental component to a country's decision-making process, the FMIS must provide the necessary financial and performance information if MTEF reform is to succeed. A successful MTEF will clearly define multi years' total spending and sectoral ceilings, delegate more budgetary discretion to line ministries and, in return, hold them accountable for their performance. For this to occur, the government's financial information system must supply necessary and timely information throughout the budgetary process on macro-forecasting, sectoral expenditure analysis, and costing and performance management of programs/projects.

The existing Korean FMIS is inadequate to meet the new challenges of MTEF due to the fragmented networks between ministries and low level of utilization for high-level decision-making. Also, the underlying Korean regulatory framework, including budget classification, coverage, and chart of accounts is not suitable for MTEF operation, and needs substantial changes as well. Finally, to minimize reform fatigue, the Korea government should pay careful attention to sequencing and pacing of its efforts to introduce MTEF and the updated FMIS, and carefully consider the institutional, organizational, and cultural elements impacted by the reform.

This paper consists of five sections. Following the Introduction in Section One, Section Two explains how successful reform of MTEF and FMIS also depends closely on other public sector reforms, and introduces the Korean MTEF framework that is the basis for subsequent FMIS analysis. Section Three introduces a stylized chart that illustrates the preferred information flow between the central budget office and line ministries for MTEF operation. Section Four evaluates the adequacy of the existing Korean FMIS to meet the information needs identified above in Section Three. Finally, Section Five proposes an

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<sup>119</sup> This paper incorporates substantial contributions from Dong Yeon Kim, Bill Dorotinsky, Mike Stevens, and Il-Whan An of the World Bank, and Sang Dae Choi, Ho-Joong Shin, Seok-Kyun Lee, Su-Min Park of Korean Ministry of Planning and Budget, Kwang-Ho Kwon of the Korean Ministry of Finance and Economy, and Allan Gusfasson, a former Director of Budget Department of Swedish Ministry of Finance.

implementation strategy to improve FMIS and MTEF that will minimize internal resistance and avoid reform fatigue.

## 2. MTEF, FMIS, and other public expenditure reforms

### 2.1. Medium-term expenditure framework

During the 1990s, many countries, both developed and developing, have introduced medium-term expenditure framework (MTEF). Most OECD countries have adopted the full plethora of features of MTEF: 73 percent have multi-year expenditure estimates incorporated into their budgets and 67 percent have a medium-term fiscal framework with ceilings for expenditures, deficits, and revenues over multiple years as part of their budget.<sup>120</sup> MTEF is also widely spread out to many middle- and low-income countries including 19 African countries.<sup>121</sup>

However, specific framework of MTEF significantly differs among countries and it reflects different purposes of MTEF and country's unique environment. While MTEF is meant to improve all three goals of public expenditure management<sup>122</sup> – a) maintaining fiscal sustainability by controlling aggregate, b) linking budget allocation with national policy priorities, c) improving efficiency of public service delivery – specific framework of each country differs according to its focus among three objectives. For example, Sweden adopted MTEF to contain and reduce fiscal deficit; since the introduction of MTEF, fiscal balance has improved from the deficit of 10.8 percent of GDP in 1994 to the surplus of 4.8 percent in 2001.<sup>123</sup> On the other hand, the U.K. intended to increase public investment that continued to decrease; through MTEF, public investment has increased from 20 UK billion pound in 1997 to 31 UK billion pound in 2003.<sup>124</sup>

Strengthening the linkage between budgetary allocation with national policy priorities is the main purpose for the Korean government to introduce MTEF. According to the 'National Resource Allocation Improvement Plan,' the Korean government's main purpose of MTEF is to change a rigid expenditure allocation structure, meeting social demands that have changed significantly since the 1970s. It is self-diagnosed by the MPB that current budgeting process is in effect unable to change swiftly sectoral allocation according to changing environment.

### 2.2. Financial management information system.

Financial management information system (FMIS) is a basic foundation for country's public expenditure management. Information system provides public sector managers a modern set of tools to assist them in performing a variety of tasks including a) designing fiscal and monetary policies in responding to changing macroeconomic

<sup>120</sup> World Bank/OECD Survey on Budget Practices and Procedures, 2003. Available at: <http://ecde.dyndns.org>. As of December 2003, 27 (of 30 total) OECD and 17 developing countries are included in the database

<sup>121</sup> Benin, Burkina Faso, Chad, Ethiopia, Gabon, Gambia, Ghana, Guinea, Kenya, Lesotho, Malawi, Mali, Mozambique, Namibia, Rwanda, South Africa, Tanzania, Uganda and Zambia.

<sup>122</sup> Schick (1997).

<sup>123</sup> Swedish Ministry of Finance (2003), p. 7.

<sup>124</sup> The number is expressed in nominal term (Passman, 2003, p.4).

conditions, b) conducting policy analysis to effectively allocate resource among sectors, and c) delivering service with efficiency and accountability.

Integrating central budget offices' FMIS with those of line ministries can more effectively provide the types of information that MTEF requires. Integration of public financial management means that the core functions of a financial management system like budgeting, accounting, cash/debt management, and auditing/reporting need to work as one entity even though it consists of multiple organizations with geographical distribution.<sup>125</sup> Under an integrated system, the information outflow from one component is inflow to all other related components so all components share a common financial evaluation and measurement basis. This consistent information flows and linkage among various components in financial management increase public administrations' overall efficiency.

### **2.3. MTEF and other public sector reforms; performance management and fiscal decentralization**

Line ministries' performance on projects/programs must be regularly fed into the central budget office; it allows the central budget office to monitor the progress and serves as an accountability mechanism as MTEF delegates more budgetary discretion to line ministries. In order for performance management to work successfully, ministries and agencies need to monitor their performance indicators very closely and the central budget office must have access to the performance information. The types of information and frequency of reporting, however, vary by country, depending on a country's regulatory framework.

As a country becomes more fiscally decentralized, FMIS's coverage under MTEF must be expanded to include expenditure spent by sub-national governments. Fiscal decentralization indicates that more expenditure is channeled through subnational governments. Managing only central government's expenditure shows only fraction of nation's overall expenditure and MTEF's function of maintaining nation's fiscal sustainability is seriously impeded. Thus, a country's FMIS should encompass sub-national level expenditure by linking local governments' and municipalities' information system with the central budget office's FMIS.

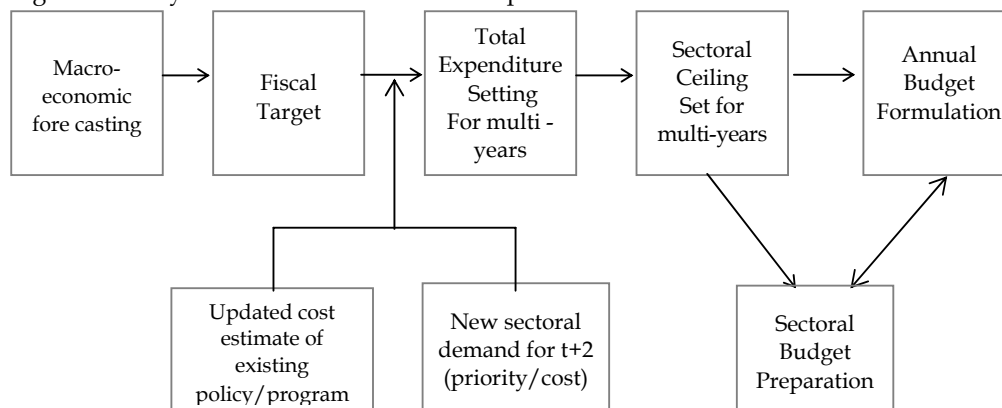
### **2.4. MTEF in Korea**

To draw the list of information requirements and implementation strategy, this paper is based on the MTEF framework designed by the MPB. While the final plan of the Korean MTEF framework is yet to be finalized by the MPB, this paper bases its analysis upon the document, "National Resource Allocation Improvement Plan" prepared by National Resource Allocation Improvement Team of the MPB. The stylized chart below shows overall process that the MPB is preparing. For more detail, please see the Annex 18-1.

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<sup>125</sup> Hashim and Allan (2002).

Figure 18-1. Stylized chart for Korean MTEF process



### 3. New information needs for MTEF operation

#### 3.1. MTEF, a new paradigm for budgeting process

As the medium-term expenditure framework expands horizontal budgetary coverage and strengthens top-down approach, decision-makers' information needs change at all stages of budgetary process. Providing necessary information to decision-makers is the essential prerequisite for successful MTEF operation in a timely manner. Integration of financial information systems operated by each ministry is essential for MTEF to link nation-wide policy with budgetary allocation and to ensure timely feedback of performance for accountability. Also, for information provided by FMIS to be useful and relevant for MTEF, underlying framework of budgetary classification, coverage, and chart of accounts must be aligned with MTEF framework. The following provides types and flow of information needed for each stage of budgetary process.

#### 3.2. Information needs for budget formulation

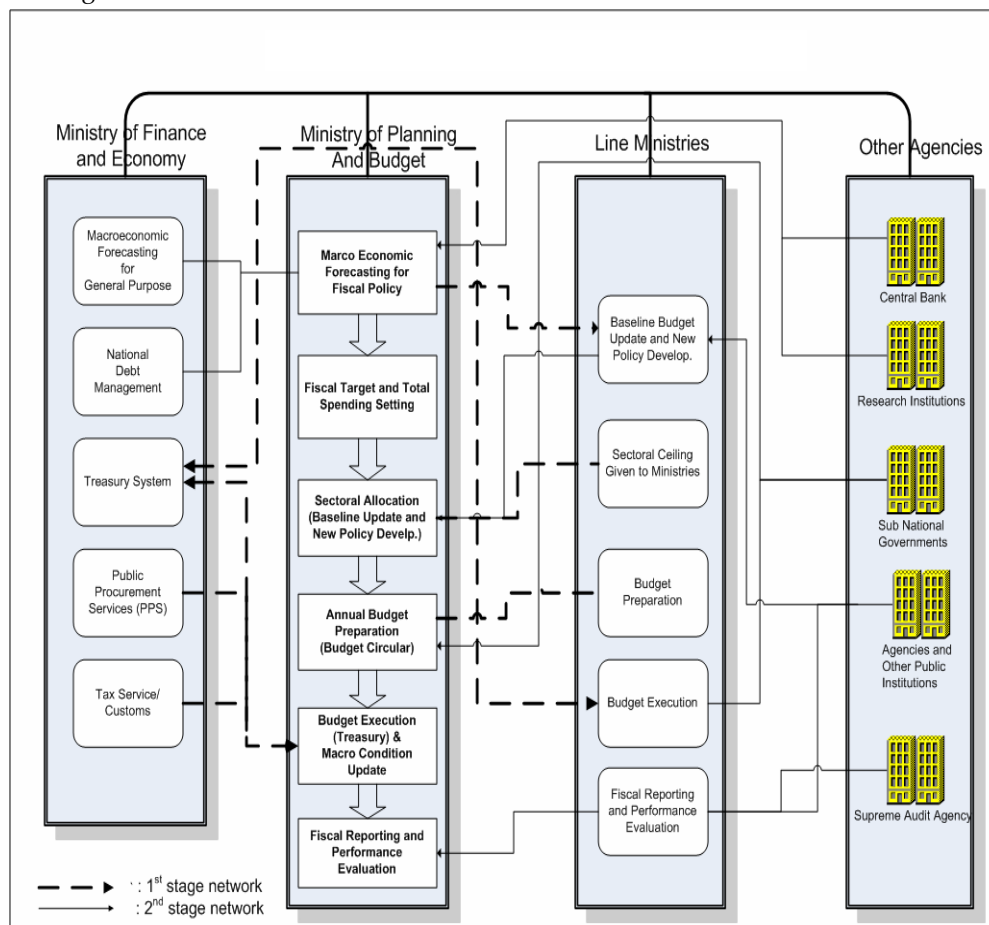
##### 3.2.1. Macroeconomic forecasting

The development of macroeconomic framework needs to be seen as a continuous process with the framework updated frequently. According to the MPB's plan, the MPB will prepare a 'Long-Term National Fiscal Management Plan' to draw a long-term sectoral allocation strategy and this Plan will be updated every year, which will necessitate updating macroeconomic framework every year. However, more frequent update will be necessary for preparing supplementary budget and cash management.

Macroeconomic framework needs to be linked with other systems, including debt management system, treasury system and national accounts data for frequent update. As a country's macro economy is intricately affected by numerous variables - national debt level, cash balance, foreign reserve, interest, and exchange rate among others - and these variables are managed by different agencies and ministries, predicting macroeconomic condition involves linking relevant information systems so that data from each system flows in and out of the rest of systems on a timely basis.

The central budget office needs to formulate a separate, conservative macroeconomic forecast by a) combining multiple sources of forecasts and b) creating pre-determined mechanism to lower economic growth rate to ensure fiscal sustainability. Countries often conservatively modify general-purpose macroeconomic forecasting for budgeting-purpose forecasting.<sup>126</sup> It seems to be a prudent exercise for the central budget office to base its revenue estimate and other budgetary decision on a conservative set of assumptions. For this purpose, the central budget office should have access to necessary macroeconomic information as well as technical capacity to analyze the results of macro forecasts presented by other institutions, such as the central bank and private and public research institutes, and then come up with its own version.

Figure 18-2. Information flow under MTEF in Korea



<sup>126</sup> For example, the Canadian Department of Finance systematically revises the private sector forecasts downwards as a further measure of prudence. This takes the form of the government adding 50-100 basis points (0.5-1.0 percentage points) to the average private sector economic forecasts for interest rates and then feeding this through its entire econometric model, thus producing lower forecast economic activity. This provides a buffer in order to maintain the government's fiscal objectives (OECD, 1999, p.9).

### 3.2.2. Fiscal target and total expenditure setting for multi-years

Setting fiscal target and total expenditure ceiling involves both economic and political consideration. Interpreting the status of current economy within economic cycle is very important, because the fact that the economy is viewed as in its downturn of economic cycle more easily justifies central budget office to create fiscal deficit to boost up consumption and investment. However, precise and accurate interpretation of economic cycle is extremely difficult and often vulnerable to non-economic factors.

To maintain fiscal sustainability, therefore, the central budget office needs to design a decision-making mechanism based on objective and quantifiable indicators and multiple scenario analysis. Reducing room for the central budget office's capricious intervention on macroeconomy can actually increase the automatic stabilizing effect of public expenditure and increase the credibility and integrity of central budget office. Also, the central budget office needs to develop several scenarios – optimistic, pessimistic, and medium – regarding economic growth and other macro indicators and then decide which scenario to take through a committee that consists of well-known scholars and policy makers.

### 3.2.3. Sectoral ceiling setting for multi-years

While countries allocate resource to sectors/ministries using various processes, this paper bases its analysis on the Korean government's proposal outlined in the 'National National Resource Allocation Improvement Plan.' According to the MPB's plan, sectoral allocation is done in three stages; Stage I is setting national strategy and sectoral priority; Stage II is reviewing line ministries' expenditure update,<sup>127</sup> and Stage III is allocating resource to sectors. The following analyzes each stage in terms of the role of FMIS and the degree of computerization of FMIS.

Stage I may not need to be computerized as it involves political and strategic process. The central budget office consults with the President's Office to incorporate the President's policy priorities. Also, the central budget office comes up with its own policy analysis to prioritize public spending for the coming three years. As the Korean MTEF covers three to five years' span, this analysis needs to have a medium-term perspective and be agreed by sector ministers and the ruling political party.

Stage II, on the other hand, requires significant level of computerization as it involves massive amount of information coming to the central budget office from all line ministries. An extensive information network between the central budget office and all ministries and agencies need to be set up so that line ministries' expenditure update is transferred through the network. The central budget office needs to provide standardized template to line ministries so that line ministries can easily aggregate and analyze all the updates submitted. The template also needs to fix all the macro indicators to be used for updating line ministries' cost estimate so that all line ministries apply the same indicators to their calculation.

In addition to data transfer capacity, the central budget office's FMIS should provide in-depth analytical tools to verify the reasonableness of line ministries' expenditure forecast. Given the massive amount of information submitted and the limited resource and time within the central budget office, a computerized analysis system is a critical prerequisite to this task. Given that, under MTEF, more autonomy

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<sup>127</sup> Expenditure update usually consist of a) cost estimate of existing programs/projects for year t and t+1, using updated indicators such as price index, unemployment rates, estimated number of students by grade, and b) new policy proposal for year t+2 and its cost estimate.



will be given to line ministries once sectoral ceiling is agreed, central budget office's critical review at this stage becomes more important.

Stage III can be done using a simple set of linked spreadsheets until sophisticated software is developed. Once national policy priority is set and the line ministries' budget update is analyzed, the central budget office begins to categorize all expenditure in terms of priority. It will calculate all statutory spending and highest priority spending and then move down to the next priority level spending until the sum of expenditure reaches pre-determined total aggregate ceiling for ensuring accountability of public spending.

For this task, codifying each expenditure account by priority, functional /programmatic classification,<sup>128</sup> and netting out all internal transfers will be a prerequisite. Especially, it will be important to clarify and simplify the flow of expenditure among the general account, special accounts and funds within a sector. In many countries, program expenditure usually consists of direct spending as well as transfer to other accounts or institutions and these transfers are often counted twice by both giving and receiving institutions. In order to make the sum of all sectoral spending equal to total aggregate ceiling, netting out all the internal transfers within a sector should be readily available from the FMIS.

#### **3.2.4. Annual budget formulating**

This section assumes that the total expenditure aggregate and the sectoral /ministerial allocation is already finalized. Detailed information on decision-making process can be found in the MPB's National Resource Allocation Improvement Plan.

The central budget office prepares an electronic Budget Circular template that prefixes sectoral allocation and major macroeconomic indicators and line ministries submit their budget request on line. Preferably, an electronic Budget Circular has an easy-to-use template with macro variables fixed so that line ministries can easily fill in. Line ministries prepare their own budget within the provided ceiling for upcoming three years. As mentioned above, the FMIS should have a function to categorize requested expenditure by function or programs and netting out internal transfers.

The FMIS should allow the central budget office to detect any request that exceeds prefixed ceiling or any uses of different assumptions by line ministries to calculate budget request. If sectoral allocation is hard constraint, the FMIS can be set in a way that prohibits line ministries from putting more than the ceiling. Alternatively, if some kinds of adjustment and negotiation on sectoral ceiling are allowed, the FMIS can be set to detect and signal all the requests that exceed the ceiling.

In addition to financial information, the FMIS under MTEF should have capacity to record and monitor cost and performance information of major, if not all, programs and projects. MTEF, in return for allowing line ministries greater budgetary decision power, needs to establish an accountability mechanism. While manual, separate follow-up on performance may be one option as MTEF starts to operate, the FMIS should eventually capture performance and cost information. In particular, cost information for major programs and projects is an essential element for performance evaluation and is in effect feasible to trace only with well-developed computerized cost accounting system.<sup>129</sup>

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<sup>128</sup> According to OECD Guidelines, functional or programmatic classification is most suitable for sectoral allocation under MTEF.

<sup>129</sup> However, costing in public sector is recognized to be more difficult due to complex overhead cost sharing and unclear valuation of government assets.

The central budget office's FMIS should be linked to treasury system and other execution system. Once the National Assembly approves the draft executive budget, the approved budget needs to be automatically registered in the treasury system. In this integrated network, if situations such as low revenue collection, cash shortage, and natural disasters arise so initial disbursement plan needs to change – in terms of both amount and timing of allocation – the central budget office can immediately effect this change by restricting line ministries' spending authority through FMIS, which is a necessary control mechanism in a fiscal emergency.

### **3.3. Information needs for budget execution and reporting**

While effective budget execution and fiscal reporting requires many types of information, what is needed under MTEF is not much different from the existing system. Thus, this paper deals with only information that needs to change or add under MTEF. For more detailed information regarding the role and working mechanism for execution process, please refer to the Hashim and Moon (2004).

Even though MTEF allows more discretion to line ministries in operating their budget within ceiling, the central budget office should have access to detailed accounts of line ministries throughout a fiscal year, not just at the end of fiscal year. The fact that the central budget office has access to what and where line ministries are spending serves as a check-and-balance system for line ministries' increased budgetary power. However, line ministries are very likely to resist sharing information with the central budget office. Therefore, legal mandate and political support is a critical element for central budget office's accessibility to these information.

As maintaining fiscal sustainability is one of the objectives of MTEF, an FMIS should cover expenditure spent not just by central ministries but also by agencies and sub-national governments. This is particularly important, for many countries now delegate spending decision into local government and central ministries' spending is often made through agencies and local governments. While integrating local government information system into a central FMIS is the most desirable setting, manual data transfer may be the initial step to feed local government spending information into a central FMIS.

More important action than the network integration is the integration of budget classification and chart of accounts between central and local governments. For central budget office to effectively monitor and control sub-national level expenditure, it is very important to ensure local governments use same classification and chart of accounts as those of central government. Otherwise, central budget office will have great difficulty aggregating and analyzing them.

## **4. Inadequacy of current FMIS to support MTEF**

The current FMIS in the MPB and other ministries is not appropriate to provide necessary information in a timely basis due to three major reasons; a) fragmented system among ministries and agencies, b) inappropriate regulatory environments, and c) low utilization for policy-level decision-making.

#### 4.1. Fragmented systems among ministries, agencies, and sub-national governments

The MPB, the central budget office, and Ministry of Finance and Economy (MoFE), the treasury, have two separate information systems and they are not sufficiently integrated. Currently, the MoFE is in charge of macroeconomic and treasury management, and the MPB is in charge of budget formulation and execution. For an effective public expenditure control, two systems need to be integrated so that the central budget office can regularly monitor budget execution progress, cash balances, and other important indicators and enact any changes on spending amount and schedule, if necessary.

An information system that ministries use to submit their budget request is different from the one that ministries use for budget execution such as allotment, commitment, and cash rationing. Within the MPB, two separate software are used for line ministries' budget submission and budget execution. There is hardly any justification to operate two systems for budget formulation and execution other than that two softwares were developed separately in different period. With two separate systems, line ministries tend to care more on formulation and less on execution and this can potentially lead to brakeage and inconsistency when transferring budget information from one to another.

The e-procurement system in the Public Procurement Service (PPS) needs to be linked with the MoFE and MPB systems to reduce opportunity cost from idle cash. The PPS has its own e-procurement system,<sup>130</sup> a very advanced feature for effective and transparent public procurement, but it is not sufficiently linked with neither the MoFE's nor the MPB's network. For example, e-payment function of the PPS's e-procurement system is not linked with the treasury system so that PPS needs to keep large amount of cash in its account to ensure sufficient fund to pay goods and services it purchases, which incurs significant opportunity costs from idle cash balance. If the PPS's network is linked with the treasury, PPS doesn't need to keep cash in its account.

The Internal Tax Office and the Customs use separate and stand-alone information systems. These systems need to be linked with the central budget office's system to give updated cash inflow information, which is critical for effective cash management and budget execution.

A financial information system for sub-national governments does not exist and is now prepared by the Ministry of Home Affairs, with little consideration of integrating with the MPB's information system. While developing an information system that overarches all local government spending is worth pursuing in the long run, it is very important to ensure the local FMIS is compatible, if not integrated, with the central government's FMIS to ease the burden of aggregation and consolidation. MTEF's function of maintaining fiscal sustainability doesn't work well if significant amount of public expenditure is spent on sub-national level and the central budget office has a very poor handle on it.

#### 4.2. Low utilization for policy-level budgetary decision making

It is usually acknowledged that senior-level officials make little use of FMIS to make policy-level decisions.<sup>131</sup> While the MPB's FMIS has strength in transferring

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<sup>130</sup> It is called 'Narajangtu' which means national market (<http://www.g2b.go.kr/index.html>).

<sup>131</sup> The author visited the Ministry of Planning and Budget in October 2003. During the visit, both senior officials and information specialists mentioned that the MPB's FMIS doesn't have enough functions for policy analysis.

information between ministries on line so that most of paper works get eliminated, its analytical features are still underdeveloped and inadequate for sectoral and other aggregate-level spending analysis even though FMIS can potentially equip the central budget office with strong analytical tools.

Both senior officials' lack of interest and understanding of FMIS and FMIS' inability to provide aggregate analysis information attribute to the low utilization of FMIS. Like a vicious circle, lack of analytical tools in FMIS disinterests senior officials from using FMIS and, in turn, lack of interest of senior officials makes it hard for information specialists to gather inputs and feedback from senior officials to strengthen FMIS' analytical features.

National debt management system is not integrated with the MPB's information system. The Korean government expects the national debt level to increase significantly in the coming decades due to the rapidly aging population and potential unification costs. Effective debt management requires accurate forecasting and prudent management on macroeconomics, cash balance, and capital market monitoring. The current MPB's debt management system is, however, far from comprehensive and integrated, thus needs much work in this area.

### **4.3. Lack of capacity to record and monitor costing and performance information**

The FMIS currently does not produce any performance information, output or outcome of each program/project, on which decision-makers need to base their judgment to make in-year and out-year budgetary adjustment. Past efforts of the Korean government to implement performance budgeting has been mixed.<sup>132</sup> A few selected ministries and agencies prepared and submitted performance reports manually only at the end of fiscal year. During the fiscal period, however, central budget office doesn't have any control over line ministries' performance. Also, central budget office hardly makes any budgetary decision based on the performance report. As a system is as strong as the weakest link, the lack of performance information feedback to budgetary process can considerably weaken the MTEF's overall trustworthiness.

Also, the FMIS doesn't have built-in functions to calculate costs of major, if not all, projects or programs so the MPB staff has to manually compute the costs. Accurate and timely cost information for major projects/program is an indispensable source for performance evaluation. The Korean government's expenditure system has an extremely complicated accounting structure and flows of fund between accounts and special funds. Manually sorting out all the internal transfers and double accounting is in effect prohibitive, and therefore, computerized FMIS is the prerequisite for cost accounting in a modern government expenditure system.

### **4.4. Inappropriate regulatory framework**

#### **4.4.1. Complex budget classification and chart of accounts**

Current Korean accounting system doesn't provide a functional (or programmatic) classification, which is the appropriate classification for MTEF's sectoral allocation. Classifying expenditures is important for policy and budget formulation and measuring the allocation of resources among sectors. According to OECD (2001),<sup>133</sup>

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<sup>132</sup> Young-Sun Koh (2003).

<sup>133</sup> OECD (2001), p.121.

functional or programmatic classification is appropriate for efficient allocation of resource, which is the primary purpose of the Korean MTEF. In this regard, the UN Classification of the Functions of Government (COFOG) can be one benchmark for Korea to introduce functional classification.<sup>134</sup>

Government accounts are too detailed and rigid and there exist complicated internal transfers between general accounts, special accounts, and extra budgetary funds. Currently, more than 6,000 accounts exist in public expenditure system, and this excessively detailed accounts make expenditure very rigid. It leaves very little room for line ministries to manage funds flexibly to meet unexpected situations. Also, extremely complicated internal transfers between accounts and funds make it difficult to categorize expenditure by sector.<sup>135</sup> For an effective MTEF operation, the central budget office's span of control needs to be moved upward to a more aggregate level of chart of accounts.

#### **4.4.2. Insufficient budget coverage**

Current Budget Law does not include in the budget, which requires parliamentary approval, some extra-budgetary funds (EBF),<sup>136</sup> and often exclude them from statistical analysis. For purpose of fiscal control and efficient allocation of resources, which are core objectives of MTEF, the coverage of the budget should be comprehensive.

Also, expenditure by certain institutions, which has defining characteristics of public sector, is not included in the budget at this moment. For example, the Korea Development Institute (KDI), whose funding comes almost 100 percent from the government, fits the GFS' description of general government.<sup>137</sup> However, KDI doesn't count in the general government in the Korean budget. While acknowledging some shadowy areas exist in defining the public sector, the Korean public sector is defined too narrowly.<sup>138</sup> In principle, all expenditure spent by all institutions that fit a general definition of public sector needs to be brought into consolidated financial account for both comprehensiveness and transparency purposes.

#### **4.4.3. Inappropriate government statistics**

Currently summing up all expenditure allocated to each sector in the budget document far exceeds the government total spending due to the practice of double accounting of program/project expenditure affecting multi-sectors. One of the reasons for this double accounting is the pressure to inflate spending on certain sectors so spending on certain program/project counts twice depending on programs' sectoral coverage. While the complicated accounting structure and classification have in effect prohibited anyone outside the MPB from detecting this flaw, introducing MTEF will require the sum of all the sectoral spending equals to total aggregate, especially to draw the table below as identified in the MPB's Plan.

Table 18-1. Analysis of budget composition

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<sup>134</sup> For more information, please refer to Annex 18-2.

<sup>135</sup> For more information, please refer to Annex 18-3.

<sup>136</sup> Korean Ministry of Finance and Economy (1999).

<sup>137</sup> According to IMF's GFS (p.15), the 'public sector' consists of the general government and public corporations. The general government includes the central, state, and local governments, and public corporations include financial public corporations, non-financial public corporation, monetary public corporations including the central bank, and non-monetary financial public corporations.

<sup>138</sup> International Monetary Fund (2001).

	2005
By Function Education Health Defense .....	Total = 100
By Policy Wage/benefit IT Investment R&D .....	Total < 100 (only major programs)
By Organization Ministry of Education Ministry of Construction .....	Total = 100

## 5. Implementation strategy for improving FMIS and MTEF

Both introducing MTEF and integrating and improving FMIS require significant amount of information flowing frequently between the central budget office and line ministries. Thus, it is critical to engage all the relevant stakeholders during the implementation process. Unless stakeholders have the sense of ownership through this process, the new FMIS will have very little use and impact and will be unable to provide necessary information to support MTEF's smooth operation.

Both introducing MTEF and integrating and improving FMIS require considerable time and resource, and should be viewed as a long-term process. As evidenced from the World Bank-supported projects, the average project duration to introduce FMIS is 6.7 years.<sup>139</sup> Also, changing budgetary process must be carefully approached in order not to impede annual budgeting process as budgeting is a continuous process and can't afford any stop or break. At the same time, integrating FMIS can be successful only after the underlying business process is reviewed and updated to fit into a newly integrated environment. Many ICT-oriented government reforms have been unsuccessful because they ignored or skipped business process reengineering and just computerized the old, and often flawed, process.<sup>140</sup>

Therefore, a modular approach would be more appropriate since some elements of information needs for MTEF are available in existing system and, more importantly, the Korean government needs to update related laws and regulation to improve budget classification and coverage, charts of accounts, and statistical methodology.

The following is a list of factors which deserve close attention in introducing MTEF and improving FMIS in Korea. While this list is not comprehensive, it may raise

<sup>139</sup> Dorotinsky and Cho (2004).

<sup>140</sup> Department for International Development (1997).

awareness to reformers that more often than not projects with good intention and design fail when the implementation strategy is not well thought out.

### 5.1. Leadership and management support

Continued commitment and support at the highest level to improve and make better use of FMIS is a primary success factor for successful change. This is arguably 'the' most important success factor for any public sector reforms. Any trial without continued commitment and support is in effect most likely to fail. While it is likely that MTEF reform gets sufficient supports from the highest level in the MPB<sup>141</sup> and the Office of the President, the importance of improving FMIS to successfully implement MTEF seems to be less appreciated within the government. The fact that current FMIS suffers from low utilization for policy-level budgetary decision-making reinforces this concern.

One way to increase the support for FMIS reform is to piggyback with national e-government initiative that the President puts high priority during his term. Good example of the effectiveness of piggybacking strategy is e-procurement reform, which was one of the eight e-government reforms that Korean government initiated since 2001.<sup>142</sup> As one of the President's high priority policy, the e-procurement reform received lots of media attention and political support during the reform. Today, it is generally agreed that the e-procurement system in Korea is one of the most successful in the world.<sup>143</sup> Likewise, the FMIS reform, framed as a national issue, not a MPB's, has a better chance to get much needed support from line ministries.

### 5.2. Inter-agency coordination

**Successfully** integrating the network of information systems between the MPB and line ministries to provide necessary information for MTEF is crucially dependent on the cooperation of diverse users in ministries and agencies. While the MPB may initiate to introduce MTEF and take lead in rolling out its plan, the MPB should engage all levels of players in implementing MTEF and FMIS. However, the idea of setting sectoral ceilings in advance can be seen as a mere return to the old control regime under the Economic Planning Board during 1961 to 1994, with an empty promise of autonomy within the ceiling. To overcome this suspicion and reluctance, various types of awareness building efforts, including training, seminar, and on-the-job training, needs to be provided to line ministries from the early stage of implementation. Also, strong support from the President and political parties can increase interest and participation from line ministries.

In particular, a careful coordination and collaboration between the MPB and MoFE is necessary. The organizational evolution between the MPB and MoFE – once one institution and now divided into two separate institutions – create the sense of both cooperation and competition.<sup>144</sup> Thus, the MPB needs to be particularly careful in designing macroeconomic forecasting function in MTEF, because the MoFE can perceive the proposal of creating macroeconomic forecasting function within the MPB

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<sup>141</sup> For MTEF, the current vice-minister of MPB is a champion of reform and he makes a strong drive to introduce MTEF into the Korean Government.

<sup>142</sup> PPS started to computerized procurement in 1998 but it became nation-wide project in 2001.

<sup>143</sup> It receives UN's Public Service Award (PSA) in 2003, "[http://www.unpan.org/dpepa\\_psaward.asp](http://www.unpan.org/dpepa_psaward.asp)"

<sup>144</sup> For historical evolution of two ministries, please refer to Annex 18-4.

as an intrusion of its territory and hold back any information generated by its treasury system and other information systems.

### **5.3. Institutional mindset**

While the Korean public sector seems to have technical capacity and infrastructure sufficient to manage complicated information system, cultural bias against technology specialists needs deliberate efforts and time to overcome. As evidenced by the lack of FMIS usage among senior officials, Korean public sector seems to have imbedded bias against technical specialist over generalist. This issue has a long historical root and is unlikely to change over night. However, efforts should be made to bring deeper understanding and appreciation for technical specialist. Getting rid of separate job grading between generalist and specialist positions and rotating all staff between the budget department and the information system department may gradually diminish the bias.

### **5.4. Avoiding reform fatigue**

Careful sequencing and phasing of reforms, using a modular approach, will reduce the risk of reform fatigue from the simultaneous implementation of MTEF and FMIS. The MPB and line ministries often complain that they lack resources, mostly staff, to exclusively commit to reform agenda while keeping up with heavy daily routines. Also, so many reforms have been tried out since late 1990s without much success or recognition, which creates somewhat cynical sentiment among public servants and poses big challenge to MTEF and FMIS reforms. Therefore, careful sequencing and phasing, using a modular approach seems the most feasible and desirable way to mitigate this challenge.

The first step should be getting the basics right; improving budget classification, coverage, charts of accounts, and statistical mythology. As Allen Schick (1998) rightly pointed out, getting the basics right should be the beginning of any advanced public expenditure reforms. This is more so to the types of reforms as comprehensive as MTEF. Classifying expenditure by program, aggregating the chart of accounts, and netting out all internal transfers within the same sector and within public sector boundary should be the first action to be taken and require significant amount of time and resource.

The second step is to review and reform the budgetary process itself (business reengineering). This step includes identifying shortcomings of the current budgetary process and draws a blueprint for a new budgetary process under MTEF, including cabinet budget meeting, sectoral ceiling setting, and performance information feedback. The MPB may initially implement only parts of complete blueprint of MTEF, but having a master plan from the onset of reforming process will keep the MPB focused and directed. This process will involve extensive consultation with other stakeholders, especially the Office of the President, which shouldn't be bypassed for the argument of time-saving.

Simultaneously, the MPB can initiate to integrate various information systems located in multiple ministries and agencies to provide information necessary for MTEF operation. As a new budgetary process is being drawn, the MPB can initiate reviewing technical aspects of FMIS and incorporate new information needs identified from the MPB's master plan. Once all the information needs and new budgetary process is finalized, the MPB can update its system by adding new functions, and integrate its network with other ministries' network.



Finally, having these prerequisites met, a new budgetary process can be introduced more smoothly by building confidence among the MPB staff and creating a learning curve effect. As pointed out before, introducing MTEF usually takes several years before fully operational. As Dong Yeon Kim (2004) points out, MPB and line ministries staff can, through this modular approach, build understanding and confidence of the new system as well as benefiting from a learning curve effect. As budgeting can't afford any halt and the MPB is currently short of its staff, a gradual approach seems to be more acceptable and desirable to the Korean government.

**ANNEX 18-1. The Korean budgetary process comparison**

Before MTEF	Month	After MTEF
Estimate of new and on-going projects spending request - no line ministry's input	12	MPB provides Guideline for long-term fiscal plan  Line ministries' submit of long-term spending plan and major project exp. plan MPB draft total/sectoral ceiling for three years
	1	
	2	
MPB provides Budget Circular for this year's formulation	3	Cabinet Budget Meeting a) total aggregate, b) sectoral ceiling for 3 years, c) major program spending plan  MPB provides Budget Circular for this year's formulation
MPB reports to N.A. and party	4	MPB reports to N.A. and major parties
Ministries submit budget	4-5	Ministries prepare budget request
Budget formulation - review of individual projects	6-8	MPB reviews proposals sectoral/ministerial overview update of March's macro conditions
Consultation with ruling party	8	Consultation with ruling party 2 <sup>nd</sup> Cabinet Budget Meeting - finalize next year's budget
MPB submits draft budget and coming three years'	10	MPB submits draft budget and coming three years' total/sectoral ceiling to N.A
	11	MPB Updates long-term fiscal management plan

## **ANNEX 18-2. COFOG: Breakdown by division and group**

### **01. GENERAL PUBLIC SERVICES**

- 01.1 Executive and legislative organs, financial and fiscal affairs, external affairs
- 01.2 Foreign economic aid
- 01.3 General services
- 01.4 Basic research
- 01.5 R&D general public services
- 01.6 Other general public services
- 01.7 Public debt transactions
- 01.8 Transfers of a general character between different levels of government

### **02. DEFENCE**

- 02.1 Military defense
- 02.2 Civil defense
- 02.3 Foreign military aid
- 02.4 R&D defense
- 02.5 Other

### **03. PUBLIC ORDER AND SAFETY**

- 03.1 Police services
- 03.2 Fire-protection services
- 03.3 Law courts
- 03.4 Prisons
- 03.5 R&D public order and safety
- 03.6 Other

### **04. ECONOMIC AFFAIRS**

- 04.1 General economic, commercial and labor affairs
- 04.2 Agriculture, forestry, fishing and hunting
- 04.3 Fuel and energy
- 04.4 Mining, manufacturing and construction
- 04.5 Transport
- 04.6 Communication
- 04.7 Other industries
- 04.8 R&D economic affairs
- 04.9 Other

### **05. ENVIRONMENTAL PROTECTION**

- 05.1 Waste management
- 05.2 Waste water management
- 05.3 Pollution abatement
- 05.4 Protection of biodiversity and landscape
- 05.5 R&D environmental protection
- 05.6 Other

### **06. HOUSING AND COMMUNITY AMENITIES**

- 06.1 Housing development
- 06.2 Community development
- 06.3 Water supply
- 06.4 Street lighting
- 06.5 R&D housing and community amenities
- 06.6 Other

### **07. HEALTH**

- 07.1 Medical products, appliances and equipment
- 07.2 Out-patient services
- 07.3 Hospital services
- 07.4 Public health services
- 07.5 R&D health
- 07.6 Other

### **08. RECREATION, CULTURE AND RELIGION**

- 08.1 Recreational and sporting services
- 08.2 Cultural services
- 08.3 Broadcasting and publishing services
- 08.4 Religious and other community services
- 08.5 R&D recreation, culture and religion
- 08.6 Other

### **09. EDUCATION**

- 09.1 Pre-primary and primary education
- 09.2 Secondary education
- 09.3 Post-secondary non-tertiary education
- 09.4 Tertiary education
- 09.5 Education not definable by level
- 09.6 Subsidiary services to education
- 09.7 R&D education
- 09.8 Other

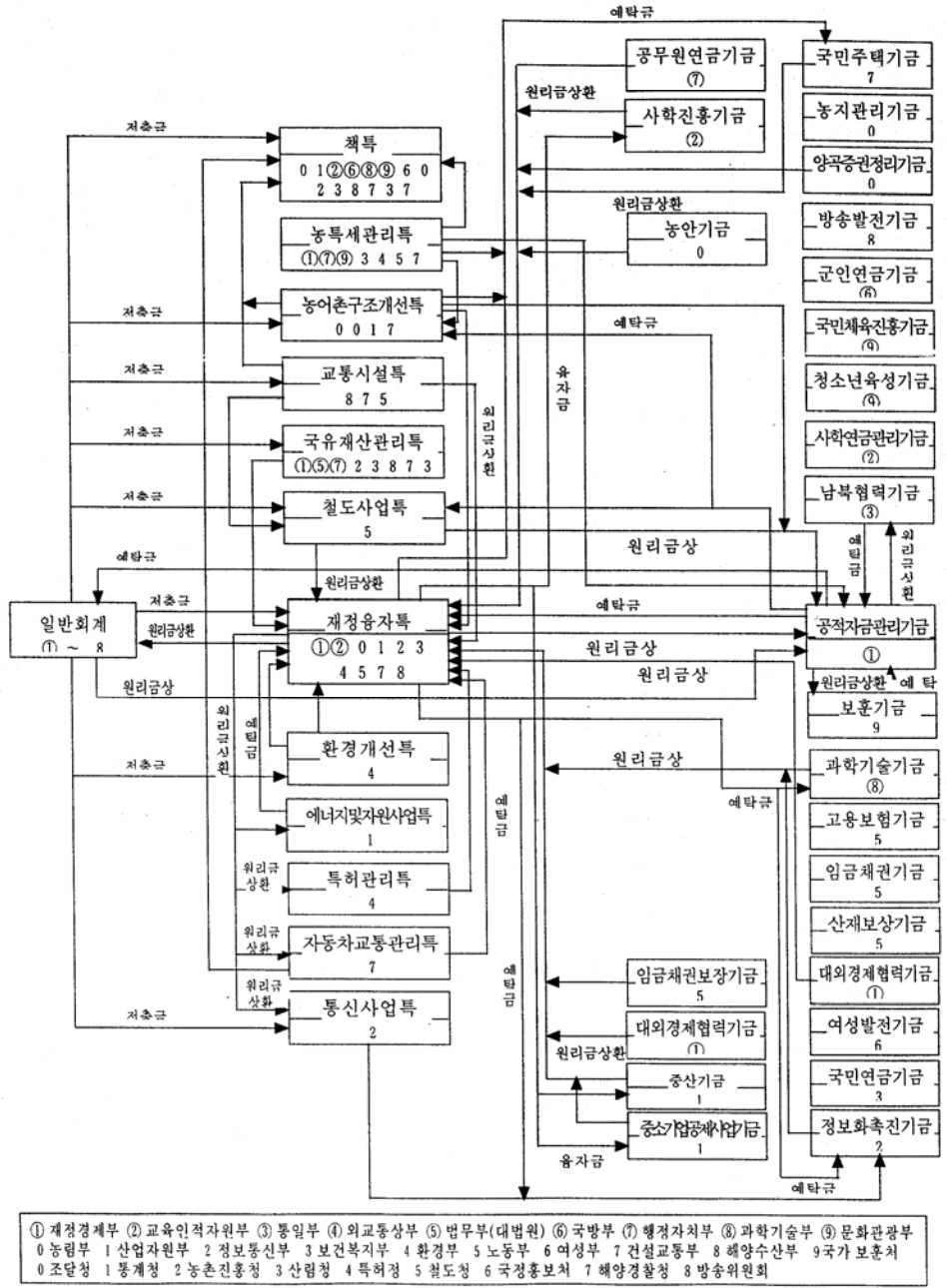
### **10. SOCIAL PROTECTION**

- 10.1 Sickness and disability
- 10.2 Old age
- 10.3 Survivors
- 10.4 Family and children
- 10.5 Unemployment
- 10.6 Housing
- 10.7 Social exclusion
- 10.8 R&D social protection
- 10.9 Other

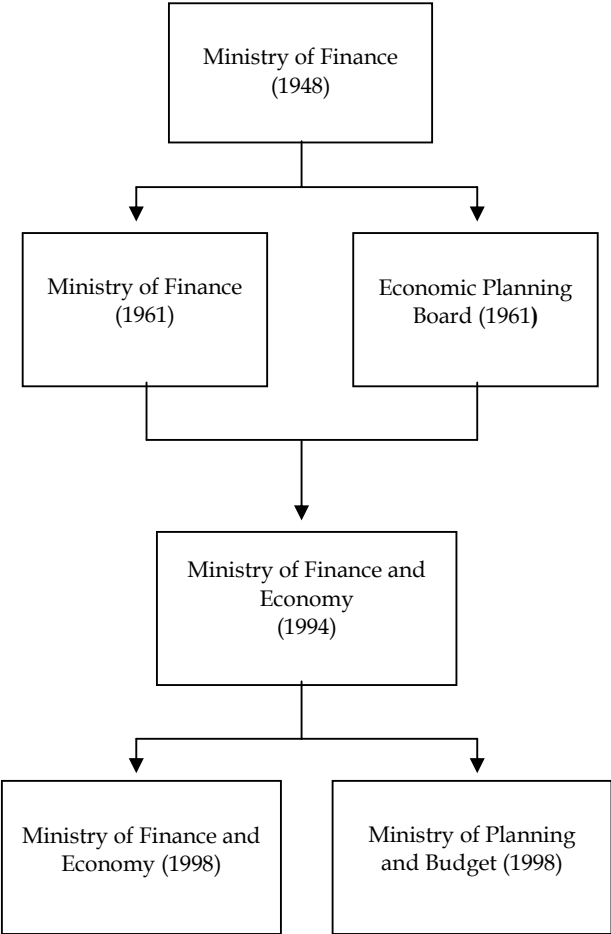
Source: United Nations. Classifications of Expenditure According to Purpose, 2000. ST/ESA/STAT/SER.M/84. New York.

ANNEX 18-3. Example of internal transfer within accounts and funds

참고 재정자금 흐름도



**ANNEX 18-4. Organizational evolution between the ministry of planning and budget and the ministry of finance and economy**



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## **Medium -Term Expenditure Frameworks, Performance, and Transparency**

*by*

*Bill Dorotinsky, The World Bank*

### **1. Introduction**

The connections between these three public sector reform areas may not be immediately obvious. Medium-Term Expenditure Frameworks (MTEFs) are about improving budget decision-making processes and incentives to lead to better outcomes. Performance budgeting and management are about getting more output or impact from any given level of public spending. And transparency, broadly, is about greater provision of information on public sector operations, finance and performance. How might these relate?

This paper briefly explores the relationship between the three areas. The paper first provides a brief overview of each of the three topics and their salient features. The remainder of the paper explores the relationships between a MTEF, performance, and transparency.

### **2. Medium-Term Expenditure Frameworks (MTEFs)**

An MTEF supports (1) macrofiscal discipline and stability (avoiding public finance crises and supporting economic growth and stability), (2) strategic allocation of resources, and better matching government policy with programs', objectives, and (3) technical or operational efficiency (getting the most from each won spent).

An MTEF is about creating an orderly public financial management process and appropriate incentives, promoting sound decisions and outcomes. Generally, an MTEF tries to integrate policy with resource allocation decisions in a multi-year context to better reflect the effects of decisions on public finances, and generally lead to improved policy decisions. It also involves structuring the decision-making process to encourage economy and efficiency, and focus spending and policy on attaining the government's objectives. So a MTEF could be said to be about strategic allocation of resources in line with government priorities and the opportunity costs of decisions.

### **3. Performance budget/management**

Many different approaches to performance budgeting and management have been tried over the years. Reforms from program budgeting, performance budgeting, program-planning-budgeting systems (PPBS), management by objectives (MBO), and zero-based budgeting (ZBB) fall within this genre of reforms. Program evaluation and impact analysis are also initiatives that properly fall within this genre as well.

These initiatives fall into three types of reforms:

- Reforms that try to assess whether programs are working or can work better, to provide incentives for resources to be used more efficiently through linkages with resource allocation, and to reallocate resources from less to more effective uses (e.g. impact analysis);
- Reforms that directly try to improve use of resources through management oversight and action (e.g. MBO); and
- Reforms that attempt both.

Many early attempts at performance budgeting fall into the first category, focusing on developing and publishing information on performance for government activities. In this respect, organization of activities within ministries into programs can assist in easing the challenge by grouping like activities with common objectives into one program, and then developing measures of impact or at least output.

With lessons of experience, it has become clear that producing the information is in itself not sufficient. The act of measuring performance can have a positive impact, but more along the lines of the Hawthorne Effect, where the novelty of measurement modifies performance of those being measured, but only for a limited period of time. The collection and production of information does not result in a sustainable cultural change or modification of incentives. Some reforms have attempted to address this by developing a process of performance measure development that is done by the line ministries and agencies themselves (e.g. U.S. prohibited use of consultants to develop the GPRA performance measures or plans).

The more enduring issues that have emerged in performance management involve the following questions: What is done with the performance information once produced? Who uses the information, for what end, and how? How can decision-makers productively use the information? How can the system be structured to produce more enduring changes in incentives for better performance? How can the information be made more user-friendly to policy officials?

Some selected lessons from international experience indicate both the challenge and promise of performance management and budgeting. For example, *implementing effective performance monitoring*<sup>145</sup> requires:

- Setting organizational incentives to support performance monitoring;
- Getting performance monitoring consistent with organizational culture;
- Need for a central unit to play active and effective leadership role in defining criteria and implementing practical performance monitoring;
- Linking ongoing performance measurement with more periodic program and policy evaluations strengthens the culture of evaluation and program improvement; and
- Attention to client/customer/citizen in developing performance monitoring can strengthen value and use;

Further, *integration of performance and financial management*<sup>146</sup> is easier where:

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<sup>145</sup> Mayne and Zapicogoni (1997), pp.22-24.

<sup>146</sup> OECD(1999a), p.9.



- Strategic/target objective setting is linked to resource allocation;
- Global or output-based budgeting is in place;
- Full-cost activity accounting is in place;
- Programs consist of tangible and measurable products or services;
- Integration is attempted at the level of program management and operational management;
- The impact of programs can be seen soon after delivery; and
- The results can be attributed to the program with high degree of confidence;

With respect to program evaluation, it is first critical to understand that it generally refers to deeper, more extensive review of the impact of a specific program using relatively more advanced techniques, such as impact analysis or randomized sampling. It can be an invaluable adjunct to performance information, but is not a replacement. From experience, *issues for maximizing the use and value of evaluations*<sup>147</sup> include:

- Gaining support from the top of Government;
- Generating effective demand for evaluations;
- Setting realistic expectations;
- Systematizing evaluation activities;
- Linking with the budget process;
- Meeting user needs;
- Ensuring relevance;
- Involving stakeholders;
- Communicating findings;
- Monitoring and follow-up; and
- Recognizing needs of staff for training and support.

From reviewing these lists, some common patterns emerge. First, groups or stakeholders that are to be served or are expected to use the information are many and varied. To enable full use of the information, it must be disseminated broadly. It must be transparent.

Further, use of the information must be clear: who is using it, for what end, and how? This applies to agencies, policy officials, finance staff, etc.

And in terms of linking with the budget process, full-costing of programs and having a program structure and an MTEF provide a vehicle for pursuing these.

#### 4. Transparency

The theme of 'transparency' has many dimensions. At a broader conceptual level, it is about having open decision-making process and easy access to information by the public. It is an enabler of accountability and performance assessments, and a prerequisite for sound decision-making (e.g. MTEFs).

More specifically, the IMF has developed an instrument for assessing many dimensions of 'transparency,' operationalizing the concept. For the IMF Fiscal ROSC, improved transparency is a necessary basis for improving the efficiency and effectiveness of fiscal management through:

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<sup>147</sup> OECD (1999b), p.22-24.

- Better and broader information, leading to better decisions;
- Broader access to information, and better decisions by actors within and outside government;
- Stronger public and parliamentary oversight, and potential for improved governance and accountability; and
- Improved business environment and attractiveness to FDI.

However, transparency is a public good and merit good – gainers don't pay and losers don't support. Taking the first steps of providing the information and improving accountability must be an exercise in leadership. Once done, market analysts and civil society organizations can demand the information, making it very difficult to turn back. More importantly, private sector and civil society organizations, as noted previously, can exert pressure on government for better decisions. The broad objective is to create a virtuous cycle, whereby better information strengthens policy and leads to demands for continuing improvement in information and policy making.

The focus of Fiscal ROSC is on data quality improvement and improved definition of public sector roles and scope of public finances.

The Code of Fiscal Transparency includes many principles and questions, but some examples will bring greater clarity. For example, IMF ROSC questions 4.1.1, 2.1.2, 3.1.3, 3.1.1, 3.1.4, 3.1.3, and 3.1.5 all address the extent of a country's medium-term budget framework. Question 2.1.3 address off-budget activity. And, questions 2.1.1, 3.2.1, 3.3.1, and 4.1.2, address issues of accounting and data quality. As is evident, the ROSC actually tracks the key components of an MTEF, and through it one can monitor country progress in implementing the MTEF.

It should also be evident that data and accounting quality are essential for effective performance management or monitoring. Bad data do not allow accountability or performance assessment.

## 5. MTEF and performance

From this brief over-view, the MTEF is directly about improving the performance of the public financial management system along the three objectives. But equally important, an MTEF involves several dimensions that seek to enable improved program performance.

First, in terms of removing barriers to program performance by providing more predictability in resource flows to programs. One of the most common barriers to public sector performance is the erratic flow of resources to programs, undermining service delivery. Managers spend time handling weak staff morale, angry vendors, and dissatisfied customers, and are not able to spend time improving service delivery.

Second, with more predictable resource flows, planning and budget take on more relevance. If the budget includes resources for the program, the program will receive them. Plans developed in advance can be executed. Better planning can improve program performance.

Third, the MTEF is also about changing incentives in the budget process, including for spending ministries and under them, service delivery programs. With hard budget constraints, spending ministries must re-examine all spending and ways of conducting business to find savings for reallocation to new or higher priority programs. Within the

total ceiling, spending ministries have greater discretion in allocating funds to programs under their jurisdiction, and during budget execution, have modest discretion to reallocate across economic categories of spending to meet program needs. Line agencies are more 'empowered,' hopefully have greater ownership over the budget and outcomes, and certainly have more authority over managing their funds and resources. This is fundamentally about shifting bureaucratic cultures from a traditional administrative approach to a managerial approach – innovative managers continually pursuing program improvements and efficiencies. Certainly, absent greater authority over resources, there can be no accountability for results --- there is always an excuse for poor performance (e.g. "I did not get the resources in the budget," or "I have no control over my resources so cannot achieve better results").

## 6. MTEF and transparency

Transparency – more open decision-making processes and accessibility of information – is integral to an MTEF. Indeed, greater transparency is a prerequisite for successful MTEFs – good budget classification, good accounting and reporting – and key to changing incentives in the budget process and also enabling performance and accountability.

First, in terms of improving the budget process, spending ministries under an MTEF have a greater role in developing sectoral policy within resource constraints, and through cabinet in engaging in and understanding the macroeconomic constraints facing the entire public sector. For this to work, spending ministries need better information on spending – past, current, and planned – as well as better information on spending during the year to enable active management of finances.

Second, greater availability of accurate public finance information is important for the general public and for markets. If citizens have a clearer picture of the economic and public finance situation, they are better positioned to modify expectations of government services, and also more receptive to any needed retrenchment in spending.<sup>148</sup>

Third, greater transparency is a key technique for changing incentives and reinforcing good practice in public financial management. For example, as noted in another conference paper in this volume,<sup>149</sup> weak macroeconomic estimates are one of the most common problems leading to weak public finance system performance. Beyond better forecasting techniques or more skilled staff, approaches for improving macroeconomic forecasts include: comparison with private or other forecasts during forecasts development (Poland, Canada, U.S.); vetting of forecasts through academic or non-government fora or blue-ribbon panels (Poland); early release of forecasts to Parliament and the public (U.K., Sweden); technical rules (publicly announced) for making the forecasts more conservative (Canada); economic updates prior to budget enactment that allow modifications to the budget proposals to fit emerging trends (Finland, U.S.); and, inclusion in the budget of a table comparing the key economic variables of the government forecast with several reputable private or public forecasts, with explanations for significant variation for median forecasts (U.S.).<sup>150</sup> The leitmotif

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<sup>148</sup> For more on the IMF Code of Fiscal Transparency and markets, see Petrie (2003).

<sup>149</sup> See Chapter 1 in this volume.

<sup>150</sup> *IBID.* Pages 2-3.

running through these is transparency: providing more information, earlier, to more people, to allow accountability to work.

The IMF Code of Fiscal Transparency allows an assessment to be made of transparency practices in countries, including among other issues whether components of an MTEF are in place, and the general availability of information, openness of processes, etc. While a more focused and applied definition of transparency, it can be a valuable vehicle for monitoring progress in improving transparency.

## **7. Weaving it all together**

There are clear synergies between the three public sector reform concepts of MTEFs, performance, and transparency. Each reform reinforces the others, and allows the strengths or improvements from each to be fully recognized. Where pieces of each are missing, less than the full benefit of the reforms is likely.

The MTEF promotes fiscal sustainability, removes barriers to program performance, and is designed to also empower line ministries and managers (within limits).

Performance budgeting and management focuses on the performance of government activities and spending, is easier to undertake where fiscal sustainability exists, and can more fully achieve its benefits if there is a good decision-making process (MTEF) for using the information and incentives for agencies to use the information more effectively in setting priorities and making funding decisions.

Transparency, as a general concept, can broaden the constituency for reform, and assure information is available for those seeking to use it. Transparency amplifies the effects of performance information, and is essential for an effective MTEF. Narrowly, in terms of the IMF Fiscal ROSC operational definition of transparency, it tracks country implementation of an MTEF and the openness of decision-making and accuracy of information.

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