

Selected budgeting issues in Chile: Performance budgeting, medium-term budgeting, budget flexibility

by

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The Chilean government is exploring several important areas of public sector reform. This article discusses performance budgeting (including spending reviews, efficiency reviews, and the Chilean performance management system), medium-term budgeting (especially the use of forward estimates and fiscal rules), and flexibility and efficiency in budget execution. Chile's situation as of May 2012 was analysed in the light of OECD country best practices at the annual meeting of the OECD network on performance and results in November 2012, and the article makes several suggestions for reform.

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1. Current performance budgeting challenges

1.1. Introduction

Chile's interest in strengthening performance budgeting and medium-term budgeting reflects the political and fiscal circumstances of the country.

On the political front, the election in 2010 of a president from the conservative parties after two decades of centre-left government represented a significant change in the landscape. There is the common phenomenon of a new government suddenly finding itself in charge of the massive ship of state, discovering that it is no easy matter to fully master the controls and move public policies and expenditure in the direction of its priorities. President Piñera has sought energetically to put his stamp on government policy, including through the articulation of a set of high-level government-wide objectives and performance targets (so-called *Objetivos Estratégicos*; see Box 1) – mainly relating to high-level outcomes – broadly based on the model of the “public service agreement” targets of the former Labour government of the United Kingdom. The Chilean President has personal meetings with each spending ministry throughout the year to discuss advances in the execution of government priorities. However, there is acknowledgement of the challenge involved in imprinting government priorities onto the budget. As in many OECD countries, existing policies represent substantial funding which leaves less room for new initiatives. There is thus a need to increase the focus on how to create fiscal space within the current baseline. The issue is that the structure of the budget should link spending to government priorities in a stronger way.

Box 1. “Strategic Objectives” set by the Piñera government in Chile

The following are representative of the 27 “strategic objectives” set by President Piñera in his first presidential address after assuming office in 2010:

- Reduce the number of households which are victims of crime by 15% by 2013.
- Improve the labour conditions in the country by means of a 4% reduction of the rate of industrial accidents by 2015.
- Build 10 new hospitals and 56 new clinics by the end of the government's term.
- Eradicate extreme poverty by 2014.
- Enhance citizen participation (in the political system).

Performance budgeting has potentially two things to offer the government under the circumstances:

- the first is a clear link between government priorities and resource allocation in the budget;
- the second is increased fiscal space through carefully targeted cuts to baseline expenditure.

Effective performance budgeting helps the government to identify and cut low-priority and ineffective programmes, and to realise efficiency savings. It achieves this by making it possible to systematically use information about the objectives, effectiveness and efficiency of spending when making decisions about resource allocation in the budget.

As discussed below, Chile's existing performance management system aims, among other things, to make budgeting performance-informed. However, the impact of the system on the allocation of resources in the budget is unclear. Hence there is considerable interest in what can be done to strengthen the impact of performance and government priorities on the budget.

Chile's more relatively difficult fiscal situation reinforces the need to strengthen performance budgeting because the exigencies of fiscal consolidation add to the difficulties of finding fiscal space for the priorities of the new government and therefore make it more important than ever that options for savings in baseline expenditure are routinely considered during budget preparation.

1.2. Overview of performance budgeting¹

Performance information – measures, targets and evaluations – enables governments to drive, monitor and assess progress towards achieving their policy and programme goals. For performance information to be useful to central government, it is important to have an appropriate system to monitor and evaluate performance. A consensus exists that any information captured should be specific, measurable, attainable, relevant and time-bound (commonly abbreviated as SMART) in order to be useful for public managers and decision makers.

Performance budgeting mostly focuses on the outputs and outcomes of government action. The precise definition of outputs and outcomes varies between governments and sometimes even within government. Outputs are generally considered as the volume, quality and value of goods and services produced by government organisations, i.e. the immediate result. Outcomes may be the aggregated impact of a variety of outputs (intermediate outcomes) or the eventual impact on society that can be significantly attributed to government outputs (final outcomes). Whereas it is usually reasonable to hold the government responsible for outputs, it is often not reasonable to hold them entirely responsible for outcomes. Many other factors beyond a government's control may intervene and influence the final impacts on society, typically referred to as antecedents or environmental indicators.

Almost all OECD countries use output and outcome information to measure programme performance. Over two-thirds (22) use a combination of outputs and outcomes. In addition, 12 countries include other forms of non-financial information. Only five countries use output measures but not outcome measures. In some countries, however, there has been a shift away from outputs towards outcomes and vice versa. In Canada, for example, experience has taught the government that focusing only on macro performance measures of outcomes or outputs alone may fail to identify the need for important modifications at a programme level.

Great variation exists in the numbers of performance targets. The United States has the most performance targets (3 700), followed by the Slovak Republic (1 641) and Korea (1 033). France, Japan and New Zealand have between 500 and 600 targets each, and Sweden has only 48. However, quantifying the number of targets used in the budget is not standard

practice within OECD countries, so a number of countries were unable to report this information.

The locus of responsibility for setting and achieving performance targets provides an idea of the government's approach to performance management. In OECD countries, responsibility for achieving targets overwhelmingly lies with the relevant government organisation. Within the government organisation, however, the responsibility may fall on different actors. In Canada, the responsibility for achieving performance targets is shared between the relevant political head of the government organisation and the highest civil servant. In France and New Zealand, the central government places responsibility for achieving targets solely on the highest civil servant of the respective government organisations. In Belgium, responsibility for achieving targets depends on the target.

One key element is the degree to which the central budget authority uses performance information. Some hold that this should only happen for selected areas and only with the purpose of cost cutting or reallocating funds between line ministries. The same view holds that the central budget authority should not be involved with overall monitoring and follow-up of policy objectives, which should be the responsibility of the line ministries. The opposite view holds that the central budget authority should monitor all government performance to the widest extent possible. Only by doing so can prudent budgetary decisions on financial inputs be taken and line ministries be held accountable.

For OECD countries, it is generally the case that performance information is used more by the relevant line ministries implementing government programmes than by the central budget authority. Ministries are more likely to use performance information to allocate resources within their area of responsibility, to justify existing expenditures, to manage programmes and to set new performance targets. Evidence from the OECD survey (OECD, 2007b) finds that the central budget authority is more likely to use performance information to cut expenditures.

1.3. The Chilean performance management system

In discussing performance budgeting in Chile, the first point to make is that performance budgeting is part of a broader performance management system known as the "system of evaluation and management control". This system aims to improve the effectiveness of policy making and management throughout the central government, to create performance incentives for civil servants, and to make the budget results-oriented. It is useful to describe the system as a whole before turning to the specific question of how well it links to the budget.

The Chilean performance management system has been developed and managed by the Budget Directorate (the *Dirección de Presupuestos*, or DIPRES) of the Ministry of Finance, and more specifically by the Division of Management Control within DIPRES. There are five key elements to the system:

- the strategic framework;
- performance indicators and performance targets;
- evaluation;
- the process for presenting and appraising new spending proposals; and
- performance incentives, which are discussed later.

1.3.1. *The strategic framework*

The strategic framework is the starting point of the system. Each institution is required by DIPRES to develop a strategy statement (*definiciones estratégicas*) which is presented in a budget information paper (*Antecedentes Complementarios Control de Gestión Pública*). DIPRES policies require that this statement:

- specifies each institution's mission, strategic objectives, “strategic products” and clients/users/beneficiaries;
- links institutional strategic objectives to “government priorities” and “government programmes”;
- be based on the “logical framework” concepts of outcomes, outputs, processes and inputs.

DIPRES guidelines state that “strategic products” must be the goods or services (i.e. outputs) which serve the institution's strategic objectives. For example, the interior ministry's main sub-secretariat has defined six strategic products, including “public security”, “public order” and “human rights”. Expressed differently, the strategic products are supposed to be groups of outputs with a common outcome. In principle, this framework is a sound one. In practice, however, there are certain difficulties associated with it.

The first difficulty is that the way in which some institutions have formulated their strategic objectives and strategic products leaves room for improvement. Rather than being statements of the key outcomes which institutions aim to achieve, the strategic objectives are in too many cases focused more on outputs and processes. Moreover, rather than being succinct and easy to understand, they are often excessive and written in highly bureaucratic language. The specification of the “strategic products” – while generally quite good – could also be revised to remove the processes, support services and inputs which some ministries have mistakenly identified as outputs.²

The second difficulty concerns the relationship between the strategy statements that ministries develop for DIPRES and their own strategic plans. It appears that in at least some cases the strategic plans which institutions have developed and use in their internal management have little to do with the strategy statement which they provide to DIPRES. When this is the case, the danger is that the strategy statement becomes little more than a paperwork exercise.

The third difficulty concerns the relationship between the strategic framework and the budget. The DIPRES conception of strategic products as groups of outputs with a common objective means that they are precisely what programmes or sub-programmes should be in a programme budgeting system. However, as discussed below, the strategic products are not part of the Chilean budget classification (i.e. they are not used to classify and approve expenditure in the budget).

1.3.2. *Performance indicators and performance targets*

Performance indicators are developed for each of the “strategic products” in the institution's strategy statement, as a result of which approximately 1 200 performance indicators have been defined as part of the strategic framework. Performance targets are set for each of these indicators, and the performance incentive system (discussed later) delivers rewards which are to a large degree based on institutional performance against these performance targets.

1.3.3. Evaluation

The most distinctive feature of the Chilean performance management system is the degree to which it makes use of systematic evaluation, which is quite exceptional by contemporary international standards – at least outside Latin America.³ Evaluations are managed by DIPRES, and the topics for evaluation are centrally determined. There are three different types of evaluation in the Chilean performance management system:

- Impact evaluations, the main focus of which is whether programmes have achieved their intended outcomes. Such an evaluation might, for example, examine a labour market programme whose stated objective is the reintegration into the labour market of the long-term unemployed, and examine the track record of participants from the target population to see whether the programme had actually succeeded in increasing their level of employment.
- Evaluations of government programmes (EGP): While EGPs measure some aspects related to efficiency dependent on available information, the main element of these evaluations is the analysis of what has sometimes been called the “intervention logic” of programmes. This means laying bare, and questioning the logic of, the causal chain by which programme outputs are supposed to generate specific programme outcomes and, through them, higher-level government outcomes. Taking the example of the labour market programme, such an evaluation will not indicate whether or not the employment level of the target population has been increased. It will, however, indicate whether or not it is reasonable to expect that the type of assistance being given to the long-term unemployed is likely to increase their employment level. An important point, discussed further below, is that the “programmes” which are evaluated are not the same as the programmes in the budget.
- Institutional evaluations, which often carry the potentially misleading name of “comprehensive expenditure evaluations” (*Evaluaciones Comprehensivas de Gasto*): These evaluations look at specific institutions or sectoral groups of institutions. They examine a range of issues including the consistency of institutional and sectoral objectives, organisational structures, production and management processes, resource use, and service-delivery performance.

The coverage of evaluation has progressively increased over time, with 33 evaluations in 2009 and 39 in 2010. The organisation and conduct of the three types of evaluation remain today essentially the same as described in the 2004 OECD budget review of Chile (Blöndal and Curristine, 2004) and elsewhere (e.g. Guzmán, 2007). The programmes and organisations to be evaluated are selected by a designated interministerial committee consisting of DIPRES, the Ministry of the General Secretary of the Presidency and the Ministry of Social Development, in consultation with the Congress. Evaluations are then carried out by external evaluators (consultants or research institutions) contracted by DIPRES who also provides the terms of reference and methodological guidelines. The unit in the budget office running the evaluations is not under the budget division (*Sub Dirección de Presupuestos*), but is located in a separate control pillar (*División de Control de Gestión*), answering to the Budget Director. All final evaluation reports are made available to the Congress and the public, and their summaries are included in the budget information papers in the form of “executive minutes”. DIPRES and the relevant ministry discuss the recommendations of the evaluations and agree on the actions which should be taken in response to evaluation recommendations. This then becomes the subject of a formal agreement, the implementation of which is monitored in subsequent years by DIPRES.

1.3.4. *New spending*

The final key element of the system relates to the presentation and appraisal of new spending proposals. Institutions are obliged to present all new spending proposals in a standard format designed, among other things, to make absolutely explicit their intervention logic. “New spending proposals” refers not only to proposed new programmes but also to significant discretionary expansions of existing programmes. Associated with this, DIPRES introduced in 2009 a new formal mechanism of “evaluation” (i.e. appraisal) of new spending proposals. More recently, DIPRES has added a technical assistance service, by which DIPRES provides advice to entities on how to develop and present good-quality new spending proposals.

1.4. *The impact of performance information on the budget*

The Chilean performance management system has quite broad performance-improvement objectives, including improving policy design and management and increasing the performance motivation of staff. However, from the outset the system was also seen as an instrument for making budgeting more performance-oriented. In particular, one of the functions of evaluations has always been considered to be the provision of advice to assist resource reallocation in the budget by identifying potential savings.

Despite this, today there is a perception that performance information is not having a sufficient impact on resource allocation. In particular, it appears that while evaluations often do generate changes in programme design and management, they relatively rarely impact on budget funding of programmes. A DIPRES study of evaluations conducted between 2000 and 2009 found that only 7% of these evaluations led to the termination or replacement of the programme. By contrast, 37% led to design or process modifications, 25% to “substantial” programme redesign, 24% to “minor” changes, and 7% to institutional reassignment of the programme⁴ (Arenas and Berner, 2010:69). This impression is reinforced by advice from DIPRES sectoral budget analysts that they do not often discuss evaluation findings with the affected institutions during the negotiations with line ministries, the so-called “technical commissions”.⁵ It is therefore hardly surprising that many within government consider that the performance management system is not functioning sufficiently as a performance budgeting system.

It is beyond dispute that the performance management system has produced a large body of valuable performance information over more than a decade. How is it, then, that this information is having less impact on budgetary resource allocation decisions than might be expected? In part, no doubt, the problem is that cutting ineffective programmes is never politically easy, because there is always someone who benefits from each programme and therefore some political cost to abolishing it. However, it is equally true that, when there is a top-down limit on sustainable aggregate expenditure – as there is under Chile’s excellent fiscal framework – the only way of making extra room for new spending is by cutting baseline spending. At the technical level, four factors particularly stand out when seeking to explain the limited use of performance information in the budget, discussed below:

- weaknesses in the budgetary programme structure;
- the lack of a sufficiently strong focus in the evaluation system on supporting budget preparation;
- the weakness of priority analysis; and
- the lack of a spending review mechanism.

1.4.1. Weaknesses in the budgetary programme structure

Internationally, a programme classification of the budget is widely seen as a key mechanism for turning the budget into a document which expresses, and facilitates, allocative choices. In a programme budgeting system, the programmes in terms of which expenditure is classified and allocated in the budget represent, in general, groups of related outputs which share a common outcome – e.g. a preventative health programme, a primary school education programme, or a nature conservation programme. Importantly, these programmes are then broken into sub-programmes to give an even finer classification of expenditure by outcome. Reallocations of expenditure are then effected by transfers of budget appropriations between programmes, or between sub-programmes within programmes. Expressed differently, the programme classification of the budget provides the language in terms of which government expenditure priorities can be linked to budgetary resource allocations.

Chile has a programme budget structure. However, the prevailing structure has key significant weaknesses which undermine its value as an instrument for expressing allocative choices. In particular:

- The programme structure does not provide a sufficiently detailed classification of expenditure by objective. The programmes themselves are generally very high level, and there are no sub-programmes. Take the example of the Ministry of Environment: under a programme budgeting system, the programme structure of such a ministry would normally contain separate programmes for nature conservation and for anti-pollution. However, in Chile there is no separate anti-pollution programme, and it is not at all clear whether the expenditure on fighting pollution is entirely in one of the other programmes or is split between several.
- The programme structure within each ministry pays more attention to organisational criteria than to the objectives of expenditure. Essentially, each agency associated with the ministry has its own programme, and the ministry itself will have one or several programmes. This means that where both an associated agency and the ministry itself are active in a major policy area, the expenditure will be split between two programmes rather than showing up in a single programme. For example, there is a superior education programme (within the Ministry of Education) plus a separate programme for the Council of Rectors. (Note that there is also, for reasons which are quite unclear, a further ministry programme called “operational expense of superior education”.)
- The transparency of the allocation of resources to policy objectives is blurred by the inclusion of large amounts of money in programmes which represent transfers that are paid by the organisational unit concerned to other organisational units, for objectives which are covered by other programmes. For example, there is a National Health Fund programme, and 80% of its expenditure involves transfers to other programmes such as the primary care programme (all of whose expenditure comes from this source). In a programme budgeting system, each programme should clearly show the full final expenditure of the government on the area concerned.
- There are too many cases of programmes that are not defined in terms of outcomes and outputs but according to some other criteria. For example, the education ministry has an educational infrastructure programme, whereas a basic principle of programme budgeting is that a single programme should cover both current and capital expenditure.

- The programme classification of expenditure in the budget is not accompanied by any statement of the objectives (intended outcomes) or key services (outputs) of the programmes. Thus readers of the budget papers must in some cases guess at precisely what the programme covers.

Partly as a result of these weaknesses in the budgetary programme classification, this classification is not integrated with the performance management system. In particular, the “strategic products” – key output types – which entities are required to define as part of their strategic frameworks (see above) bear no necessary relationship to the budgetary programmes. This is despite the fact that, as noted above, the DIPRES definition of a strategic product corresponds precisely to the way in which a programme or sub-programme is defined in a properly designed programme budgeting system – that is, as groups of output within common outcomes.

The failure to link the “strategic products” with the budgetary programmes has the serious consequence of separating the entity’s strategic planning from its budgeting. In a properly designed programme budgeting system, the strategic framework should be integrated with the budget via the budgetary programmes. Concretely, entities are required to specify the objectives (intended outcomes) of every budgetary programme, and to develop performance indicators for each programme. However, in Chile performance indicators are linked to the “strategic products” rather than to budget programmes, and the objectives of the budget programmes are not specified.

The other disconnect between the budget and the performance management system is that the “programmes” which are the subject of the evaluations carried out by DIPRES (“evaluation programmes” for short) are not the same as the programmes in the budget and not part of the budget classification. Not surprisingly – given the lack of sub-programmes in a budget classification based on very broad programmes – the evaluation programmes tend to be more narrowly defined than the budgetary programmes. However, DIPRES budget analysts are themselves not always clear about the budgetary programme to which certain evaluation programmes correspond. The consequence is that DIPRES sometimes has trouble knowing how to give budgetary effect to the evaluations when it concludes that evaluation programmes are ineffective or that their intervention logic is dubious. And to those outside DIPRES – including in the Presidency and in the Congress – the relationship between evaluation findings and the budget is opaque.

For these reasons, Chile has decided to reform its programme budget classification so as to make it more consistent with the principles of programme budgeting. This reform, which is initially being implemented in pilot ministries, will involve the careful definition of budgetary programmes on the basis of outputs and outcomes, plus the creation of sub-programmes. The reform will also involve the full integration of the programme classification and strategic framework, with objectives, key outputs and performance indicators being linked to programmes. This will also provide an opportunity to fix the problems that currently exist in the way in which “strategic objectives” and “strategic products” are formulated by some institutions (see above). The opportunity should also be taken to explicitly link programmes to the high-level presidential *Objetivos Estratégicos*.

Fortunately for Chile, the new financial management information system (SIGFE 2.0) which came on line in July 2011 is fully capable of handling properly defined programmes,

thus allowing the reform of the budgetary programme classification to be accomplished relatively quickly. SIGFE 2.0 began being implemented incrementally in 2011 and will be fully implemented by 2013.

1.4.2. *Lack of focus in the evaluation system on budget preparation*

In considering the contribution of evaluation to the budget, the key question that arises is the extent to which the DIPRES evaluation system is at present oriented to serving budgetary purposes, and what might be done to make it more so.

By way of background, it is important to note that evaluation can serve a variety of purposes, and that the type of evaluation carried out will reflect these purposes.

Evaluation serves the budget when its focus is on identifying potential expenditure savings, in the form of either:

- programmes or elements of programmes which are ineffective and cannot practically be made effective. These programmes can be phased out, and the resources which are freed can be added to the fiscal space available for effective and high-priority new spending; or
- savings which can be achieved through efficiency improvements.

Evaluation for budgetary purposes can be broadly distinguished from evaluation for policy/management improvement purposes. The latter type of evaluation aims to help institutions improve policy design – that is, to help institutions change the nature of the services they deliver to the community so as to make them more effective in achieving their intended outcomes – rather than to identify options for budget cuts. A policy/management evaluation can also aim to help institutions improve processes and management so as to make the delivery of services more efficient, but again without a focus on the budgetary implications of such efficiency improvements.

The evaluation system developed by DIPRES in Chile is not focused exclusively or even predominantly on serving the budget. It is rather a system designed to support performance management in general. The evaluations which are carried out have broad objectives, with a heavy emphasis on improvements in policy, process and management. The system evolved this way partly because, at the time it was first developed, there was relatively little evaluation being undertaken by government institutions for any purpose. As a result, the challenge was not perceived as primarily one of developing evaluation within DIPRES as a tool to support budgeting, but rather as one of developing evaluation more broadly within the Chilean government.

The broad focus of the DIPRES evaluation system is reflected in the wide scope of the issues examined by the evaluations and in the particular attention paid, in the standard terms of reference, to policy and management improvement issues. This is particularly, but not exclusively, the case for the institutional evaluations, which have a very wide performance-improvement focus.

The broad focus of the DIPRES evaluation system is also reflected in the choice of programmes and institutions for evaluation. If evaluation is going to make its maximum potential contribution to resource allocation, the programmes (or elements of programmes) and topics chosen for evaluation should be those which appear *prima facie* likely to yield budgetary savings. However, at present the DIPRES system does not choose programmes for evaluation primarily on the basis of the likelihood of realising budgetary savings. Rather, selection appears to reflect a goal of evaluating all programmes over time, together with a

desire to pay greater attention to programmes which are seen as potentially needing policy redesign or management improvement. In the evaluations, there has also been a deliberate policy of including programmes which are seen to be good performers.

There would also appear to be certain weaknesses, particularly from the budget point of view, in the way the DIPRES evaluation system handles efficiency issues. DIPRES evaluations do focus on efficiency issues to some extent. The institutional evaluations look in part at the efficiency of the institutions concerned, and the standard terms of reference of the impact evaluations also ask for some examination of the efficiency of programmes. Two points, however, stand out.

First, to be useful for the budget, it is not sufficient that efficiency reviews identify inefficient practices and recommend steps to reform them. It is essential that efficiency reviews go further and provide the Ministry of Finance with estimates of the magnitude of the savings that could be achieved through improved efficiency, of the time required for the entity concerned to achieve those savings, and of any support that the entity may need to achieve them (particularly budgetary support, such as funding for investments in cost-reducing technology that will yield major budgetary savings over time). The DIPRES evaluations do not at present provide this type of advice. Rather, their focus is on advising the management of the institution concerned on how to improve efficiency.

Second, there is at present no mechanism for reviewing transversal efficiency issues – that is, efficiency issues which affect many government agencies, such as the organisation of support services or procurement practices. This situation contrasts with the strong focus of efficiency reviews in many other countries on government-wide efficiency issues. In New Zealand, for example, there has been in recent years a very strong focus on reviewing the efficiency of support services, underpinned by the development of key process efficiency indicators for cross-agency benchmarking (see, for example, New Zealand Government, 2011). The United Kingdom is another good example: over the last decade, successive governments have carried out a series of transversal efficiency reviews, including the Gershon review of 2004 (Gershon, 2004), the operational efficiency review launched in 2008 (HM Treasury, 2009), and the Green efficiency review of procurement which reported in October 2010 (United Kingdom Cabinet Office, 2010). In other countries, such as Denmark and Sweden, a productivity dividend mechanism has been put in place, as discussed in Box 2.

In the light of all this, it appears that a primary reason for the limited effect of the DIPRES evaluation system on the budget is that the system is not specifically designed to support the budget. It is rather a more “general purpose” system designed to support policy and management improvement.

It follows that, in seeking to increase the use of DIPRES evaluations in the budget, the obvious course of action is to target and tailor these evaluations more to this purpose. However, if DIPRES evaluations become more budget-focused, the question arises of what is to happen to the broader evaluation function. How does one ensure that the use of evaluations for broader policy and management improvement purposes does not suffer?

This question may already be in the process of being answered by the government plans that are currently under way to build at least one and possibly two evaluation institutions. One of these institutions will be part of the new Ministry of Social Development (created by law in October 2011) and is intended to exercise a wide evaluation mandate with respect to “social” programmes across a range of ministries (see Box 3).

Box 2. Features of automatic productivity cut procedures in OECD countries

A number of OECD countries have automatic productivity cuts (dividends) in place, including Australia, Denmark, Finland, New Zealand and Sweden. According to these countries, the main advantage is that automatic productivity cuts change the baseline of current policy that serves as the point of departure for the annual budget process. This is seen by finance ministries as a strategic advantage in budget negotiations. Automatic productivity cuts do not mean that the budget of all line ministries is substantially reduced from year to year. First, the cuts only apply to current operational expenditures which are generally a small part of ministerial budgets. Second, most ministries annually have new spending initiatives which may be larger than the automatic cuts.

Procedures for automatic productivity cuts can differ somewhat between countries. In most countries, the base is current operational costs. For example, in Denmark the cuts are applied to the last year of the multi-annual estimates (three years after the upcoming budget year). In this way, the cuts are “gradually phased in” and inserted in the multi-annual estimates that serve as the basis for budget preparation every year. Denmark has been working with the automatic cuts since the beginning of the 1980s. In Sweden, the multi-annual estimates are in real terms and are translated from year to year in nominal terms through an aggregated wage and price index. If the tasks are not changed, the operational budgets are the same as the previous year, corrected by the index. In order to put productivity pressure on the agencies, the index used does not fully take account of the real increase of wages in the market sector: the index is decreased by a moving average of the last ten years of the productivity increase in the market sector. New Zealand uses nominal current operational costs as the baseline in the annual budget cycle. This implies that inflation has to be absorbed (around 2.3% in recent years), but adjustments may be made for wage developments in the market sector. Some countries exempt sizeable portions of current operational expenditure from the productivity cuts, such as the armed forces, but may subject them to more tailored productivity cuts instead.

In principle, there are two approaches to the cut percentage. One is to differentiate the percentage on the basis of empirical productivity studies, either for the public sector units that produce the services or for private sector organisations providing similar services. The other approach is to use a government-wide percentage based on a reasonable average. Most countries use a uniform percentage. In New Zealand and Sweden, this is dependent on inflation and/or wage development in the private sector; in Australia and Denmark, it is set by a political decision somewhere between 1% and 2%.

Countries that do not use automatic cuts emphasise that productivity gains differ between policy areas and that, if a single productivity estimate is used for the entire government sector or for central government, sectors with relatively low productivity growth suffer. Moreover, these countries claim that the productivity growth percentage cannot be determined objectively. And since public sector productivity may grow less rapidly than private sector productivity, comparisons between public and private sector productivity in comparable areas are difficult and do not provide reliable results. The first risk has to be nuanced: the fact that the productivity cut uses a uniform percentage does not mean that all ministerial divisions and agencies must realise the same productivity gains. Line ministers are generally free to distribute the targets as they see fit. In practice, spending priorities play an important role in this distribution, apart from the potential for productivity growth. The second risk can be mitigated to a certain extent by the choice of a low cut percentage (substantially below the market productivity development). The percentage of 1-2% generally in use meets this condition. In the long run, this will still lead to substantial savings.

Source: OECD (2011), *Value for Money in Government: The Netherlands 2010*, Value for Money in Government, OECD Publishing, Paris, pp. 78-81, doi: 10.1787/9789264096097-en.

However, there are also plans (though less firm) to develop an Agency of Public Policy Evaluation with a government-wide evaluation mandate. In this context, it could be possible for these institutions to take over the broader evaluation mandate and allow the DIPRES evaluations to focus exclusively on budgeting.

Box 3. Ongoing reform in Chile: The creation of the Ministry of Social Development

The reform aims to provide an institutional framework that can guarantee co-ordination and coherence and hinder duplication of social development policy in government. This effort is meant to strengthen one of the strategic objectives of the Chilean government – “eradicate extreme poverty by 2014” – by linking spending to government priorities. The law aimed to do this by creating the Ministry of Social Development and abolishing the current Ministry of Planning. Apart from strengthening social policy, the reform is also meant to increase fiscal space by eliminating low-priority and ineffective programmes and to realise efficiency savings.

A new kind of *ex ante* evaluation (i.e. appraisal) of social programmes is to be undertaken by the new ministry. The evaluation will assess the coherence, consistency and relevance of all programmes that are proposed or reformulated, and will be a precondition for any new programmes going forward. Such *ex ante* appraisal is by definition different from the three existing types of *ex post* evaluations (impact evaluation, evaluation of programmes, and institutional evaluations). The new ministry will also monitor implementation of existing social programmes by assessing programme efficiency, efficacy and focus. The evaluations will be delivered to the Social Development Committee composed of the Ministry of Social Development, the Ministry of Finance, the Ministry of the General Secretary of the Presidency, the Ministry of Education, the Ministry of Health, the Ministry of Housing and Urbanism, the Ministry of Labour and Social Prevision, and the Ministry of Women. This committee will create a list of current and proposed social programmes that can provide the basis for political prioritisation.

The main problems to be addressed by this new structure are a lack of coherence between various social programmes in different ministries and the duplication of programmes. One of the reasons for this situation is that actual policy programmes are not the same as those identified in the budget, which creates unclearness and confusion as discussed previously. In addition, few ineffective programmes have been cut, mainly due to entrenched stakeholder interests. By doing *ex ante* evaluation, it is hoped that ineffective programmes will not be set in motion.

The relationships between the new ministry, the Ministry of Finance’s evaluation effort and the Ministry of Finance’s Budget Directorate are not clear at present. In addition, the introduction of a spending review process cutting across all ministries would also need to be co-ordinated with this new effort.

The law creating the Ministry of Social Development and modifying the indicated legal bodies was approved by the Chilean Congress on 13 October 2011.

The other part of the solution may be increased efforts to promote the evaluation function within spending institutions. External evaluations are undoubtedly an essential part of the system; however, a limitation of external evaluation is that the institution being evaluated may not “own” the evaluation. Rather, it may regard the evaluation as an external imposition and, as a consequence, fail to make full use of its recommendations.

The maturation of the Chilean evaluation system should therefore in part involve a significant measure of decentralisation of evaluation.

With respect to efficiency reviews, there is an additional question whether it might be better to create an efficiency review process which is separate from the evaluation system, and which is at the same time explicitly designed to support the budget by going beyond recommendations on how to improve efficiency to the provision of concrete advice to DIPRES on the magnitude and timing of consequent reductions to the baseline budget allocations of the institutions concerned. Evaluation experts may not necessarily be the best people to carry out this type of efficiency review. Expertise in management and business processes may be more relevant, so that the expertise of former senior managers (from the private sector as well as the public sector) and business consultants may be at least in some cases more useful. It is important in this context to safeguard against any tendency of the professional evaluation community to claim all types of policy and management analysis and appraisal as their professional domain. The evaluation discipline has a great deal to offer, but so do other relevant professionals.

1.4.3. Lack of priority analysis

The discussion to this point has focused on the budgetary impact of analysis of effectiveness and efficiency. However, an important part of good resource allocation in the budget is priority analysis – in particular, the identification of programmes or elements of programmes which can be cut because they are low priority. This is a completely different matter from ineffectiveness or inefficiency. A programme might be highly effective and efficient, but still be very low priority because the outcomes which it aims to achieve are not very important to the community or are not rated as such by the government of the day.

The DIPRES evaluation system does not focus much on assessing programme priority. This is true also for DIPRES appraisal of new spending proposals, which is largely confined to assessing whether the proposed new spending is likely to achieve its stated outcomes rather than assessing the relative importance of those outcomes.

This observation is not a criticism of the system, because priority analysis is very different from evaluation. Priority analysis is inherently much more political, often requiring judgments influenced by perspectives on the appropriate role of the state and the nature of the key problems facing the society and economy.

It is therefore something of a problem that, in the Chilean system, there has been no institution with a specific responsibility for reviewing the priority of programmes (as opposed to their effectiveness and efficiency). This gap in the system leads to the next point: the absence of a spending review mechanism.

1.4.4. Lack of a spending review mechanism

The analysis so far has focussed on the efforts to increase the impact of performance information on the budget by improving the quality of that information – for example, by making evaluation more budget-oriented, by strengthening efficiency analysis, and by developing priority analysis. However, to maximise the impact of performance information, there is one further step which could usefully be taken: the creation of a spending review process.

The problem at present is that, even when evaluations do provide information which could be used to make recommendations for cuts to baseline spending, such recommendations are usually not developed and put forward during the budget preparation process. This is an institutional problem, in that there is no clear assigned responsibility for identifying and recommending options for cuts. The sectoral budget analysts do not necessarily see this as their responsibility, and in any event these decisions are too sensitive and political to be taken by middle-level technical staff alone. Nor does the group within DIPRES which manages the evaluation system (the *División de Control de Gestión*) see this as its function.

Spending review – as the term is used here⁶ – involves the creation of a spending review team with the explicit responsibility of assembling options for cuts to baseline expenditure and putting those options forward for consideration by the political leadership during the preparation of the annual budget.

The spending review team draws on evaluations and efficiency reviews (as well as the opinions of budget analysts) but does not carry these out itself. Options for cuts are of three types: savings from measures to improve efficiency; the elimination of programmes (or elements of programmes) that are ineffective and that cannot readily be reformed to make them effective; and the elimination of programmes that are low priority.

The need for the spending review team to focus on priorities as well as on efficiency and effectiveness makes it important that it should not only be technically competent, but also sensitive to the priorities of the government of the day. It may also be useful for the team to include not only DIPRES officials, but also personnel from the Presidency.

Consideration would have to be given to the appropriate frequency of spending review, and in particular to whether it would be an annual or periodic process. One possible approach would be to have periodic in-depth spending reviews, and then a lighter spending review on an annual basis in the intervals. Because cuts to existing programmes usually create some political resistance, the best time to carry out an in-depth spending review may be at the start of each presidential term of office.

1.4.5. The use of formula-based performance budgeting

Chile funds a number of public services on the basis of formulas, including health and education. These formulas can be based on expected input needs, on payment per activity, or on actual outputs. For example, the primary education system is funded on a quasi-market voucher basis in which the government pays private and municipal schools according to student attendance. Higher education is also premised on running on a quasi-market basis, where competition is meant to ensure the good performance of institutions.

Some countries have tried to extend the formula-based funding mechanism to outputs and even outcomes in order for public institutions to focus on delivering value. More than 20 countries across the world today fund public hospitals on an output basis known as the “Diagnostic Related Group” funding system (see Box 4). Research has clearly demonstrated the success of this system in improving the efficiency of service delivery. Under the DRG funding system, public hospitals in a number of countries are funded principally on the basis of the services they actually deliver, with a different price set for every output type. For example, each treatment of a hip fracture patient is funded at a certain price. This means that hospitals make a loss (profit) if the actual cost of the service delivered exceeds (is less than) the price they receive. The hospital is only paid for the

services it delivers to patients (“payment by results”), so a failure to deliver the expected volume of services results in reduced funding. Assuming appropriately calculated prices, the system creates a strong financial incentive for efficiency.

Box 4. The DRG hospital funding system

The DRG-based hospital funding system uses the “Diagnostic Related Group” output classification system for acute in-patient hospital treatment. DRGs are categories of patient treatment episodes that are relatively homogenous with respect to the resources used and that are therefore often referred to as “ISO-cost” output classes. By providing valuable information about the cost of providing the “same” type of product in different hospitals, DRGs facilitate the identification of significant inefficiency problems. As such, they were initially used, along with other performance information, as the basis for improved performance management – that is, for non-budgetary forms of managing for results. From the late 1970s, DRGs also began to be used as the basis of hospital funding systems.

The crucial move came when, following what were perceived as successful state experiments, the United States federal government in 1984 introduced the so-called Prospective Payment Systems (PPS) for Medicare payments to hospitals (subsequently extended to Medicaid also). Under this system, hospitals are paid fixed prices per unit of output actually delivered, with specific prices for each DRG output type. Any difference between the actual cost of treatment and the DRG price represents either a loss or a profit to the hospital. The setting of the DRG price is important. For example, if prices are set on the basis of the DRG costs of hospitals on average – approximately what happened when PPS was introduced in the United States – then hospitals which are more-than-averagely inefficient (efficient) are penalised (rewarded). To the extent that the tougher approach is taken of setting prices closer to the costs of the most efficient hospitals, the system even penalises average levels of inefficiency.

Since the way was paved by the United States, output-based funding using DRGs or similar output classifications has been adopted for public hospital funding in many other parts of the world, including Portugal (1990), Australia (from 1993), Norway (1997), Singapore (1997), and the United Kingdom (2004). There has also been increasing interest in the use of the DRG-type methodology in health service areas beyond hospitals.

DRG funding has multiple advantages. Because hospitals are only paid for the treatments they deliver, they have a strong incentive to increase their output with any given level of funding (i.e. improve their efficiency). In addition, funding follows patients rather than the other way around, which improves both client responsiveness and waiting times. Funding between different hospitals becomes more equitable, without (for example) the inbuilt funding inequities which tend to favour well-established hospitals over newer hospitals in traditional hospital funding systems.

Many countries use a somewhat similar approach for funding public education, with payments to schools and universities being based primarily on the number of student courses delivered (the output) and sometimes partly also on the basis of student success rates in passing exams (an outcome measure). One example is higher education funding in Denmark, where variable funding is tied to the number of students that actually pass their exams.

While Chile is at present making use of formula funding in various ways, it may be possible to tie funding and outputs closer together in particular fields. It might be beneficial to strengthen the analysis done by the Budget Directorate of the current formulas, to assess whether they are precise enough and whether they result in good performance.

1.5. Suggestions for reform

On the basis of the above discussion, the Chilean government could consider the following recommendations.

1.5.1. A modified budgetary programme structure

The programme classification in the budget should be reformed and developed so as to better serve the goals of performance budgeting. More specifically, this means making the programmes as useful as possible as a tool for expenditure prioritisation and, as part of this, for the integration of budgeting and strategic planning.

It would be helpful to overhaul the budgetary programmes on the basis of good practice from other countries. Concretely, this means:

- ensuring that the programme structure provides a more detailed classification of expenditure by objective, by i) breaking up certain highly aggregate programmes into two or more programmes, and ii) by introducing sub-programmes;
- giving priority to programmes that have particular political goals, not to inventing categories for activities to fit into the programme structure (i.e. purely administration in departments);
- for programmes that are not defined as cross-sectoral, eliminating the practice whereby the budgets of programmes include money that is in fact not part of the programme concerned but represents transfers to other programmes. In this way, the principle will be established that programme budgets should cover all direct expenditure on the programme's objectives;
- reviewing programmes to ensure that they are defined as groups of outputs with common outcomes, and not on some other basis;
- identifying more clearly the specific objective (intermediate outcome) of each programme;
- linking relevant outcome and output indicators to each programme and sub-programme.

For the implementation strategy and timing, the first step in the revision of the budgetary programme classification should be the rapid development of methodological guidelines (a manual) that clearly state the principles to be observed in the definition of programmes and in the linking of programmes to strategy. This is important because there are matters that, if not clearly resolved in such guidelines, will cause confusion and lead to conflicting approaches in different ministries or agencies, such as:

- the relationship of budgetary programmes to internal organisational units;
- the treatment of ministry-wide support services.

The overhaul of the programme structure could initially be piloted in a small number of ministries/agencies (e.g. food inspection, subsidy payment, social programme spending, health, education). The reform of the programme structure should then be extended to all ministries and agencies.

1.5.2. Linking government-wide priorities to the budget

The modified programme structure should be used to explicitly link the budget to government-wide programmes. Government-wide strategic objectives should in general relate to “high-level” outcomes such as strong economic growth. The objectives of programmes, by contrast, are in general “intermediate” outcomes that contribute to the higher-level government-wide outcomes. Once programme-specific outcomes are defined, they will serve as the means of making an explicit link to relevant government-wide priorities.

Regarding the implementation strategy and timing, the government-wide strategic objectives can be linked to the programme structure during its overhaul.

1.5.3. Introduce spending review

The creation of a spending review mechanism would enable priority analysis and create fiscal space. The spending review needs a political mandate at the presidential level to identify options for cuts to baseline spending to create more fiscal space for new priority spending. These options would then be considered and finally decided upon by the President and the Cabinet during the budget process, and subsequently endorsed by Congress as part of the budget.

The reasons for cuts should be: i) efficiency improvements; ii) programmes that are low priority; and iii) programmes that are not cost-effective and that cannot readily be fixed by changes in policy or management. However, the government should avoid the illusion that efficiency improvements alone will be enough to create substantial fiscal space in the short term. If significant fiscal space is to be created, it is essential also to be willing to cut programmes. Spending review does not focus on saving poorly performing programmes by policy or management changes. This is the responsibility of others in government.

There is always the political danger that a spending review will be attacked as a “small government” exercise. It is, of course, an essential tool for any government which wishes to reduce the size of the public sector. However, assuming that this is not the goal of the Chilean government, it should be stressed publicly that the objective is to reallocate rather than reduce aggregate government expenditure. The point should be made that reallocation is an essential way to fund new priorities while maintaining Chile’s well-known fiscal discipline.

The institutional structure of spending review should include several elements:

- Create spending review as a function within (not outside) the civil service. *Ad hoc* external reviews (e.g. conducted by notable businessmen) have often not been successful internationally.
- Recognise that spending review is not a purely technical function. It should be under the direction of politically appointed officials who are sensitive to the priorities of the Presidency.
- In the light of this, a possible model for spending review would involve it being carried out by a small number of Ministry of Finance staff assigned full-time to the task, whose work would be guided by a small task force of senior officials from the Ministry of Finance and from the Presidency.

Regarding the frequency of spending reviews: because cuts to existing programmes usually create some political resistance, the best time to carry out an in-depth spending review may be at the start of each presidential term of office. The best approach to the conduct of spending review may therefore be to carry out an in-depth spending review in the first year of each presidential term of office, plus more limited spending reviews in other years.

It is too late to conduct significant spending review for the 2012 budget. Instead, the main options are:

- Option A: Start with an in-depth spending review during 2012 with the ambition of making major reallocations of expenditure in the 2013 budget. However, this may be politically difficult given the proximity to the 2013-14 presidential election.
- Option B: Establish spending review now, but conduct limited spending review during 2012 and 2013. Aim to develop the mechanism so that the first in-depth spending review can effectively be carried out in 2014. By not waiting until 2014, this makes it possible for spending review to create some fiscal space for presidential priorities during the term of the current President.

1.5.4. Improve analysis to support spending review: Ex post evaluation and efficiency reviews

The success of spending reviews in identifying options for cuts depends critically on ensuring that the officials who have responsibility for conducting a spending review have access to evaluations which are more focused on providing information that is useful in the budget preparation process, as opposed to evaluations which are primarily focused on recommending policy and management improvements. To this end:

- While it is tempting for the selection of programmes for evaluation to be focused on programmes that look like potential candidates for budget cuts, this has to be balanced against the fact that the evaluations will be met with strong resistance by the ministry concerned. Thus, selection should be balanced.
- The scope of the impact evaluations carried out should be tightened considerably to focus exclusively on issues relevant to budget preparation (e.g. by eliminating the standard requirement to review management processes).
- In order to more clearly identify programmes or elements of programmes which can be cut, the standard terms of reference of impact evaluations should be revised to require a clear assessment of the practicality of fixing (making effective) programmes that, as currently designed, are assessed as ineffective. This includes an assessment of the probable cost of fixing the programme. Parallel modifications should be made to the terms of reference of EGPs (evaluations of government programmes).
- Consideration could be given to whether the timelines of impact evaluations might be shortened (from the current 18 months to, say, 12 months or less) to make their findings more timely.
- Consideration should be given to whether the institutional evaluations (*Evaluaciones Comprehensivas de Gasto*) – which seem to be focused entirely or mainly on policy and management improvement – play a useful role in supporting the budget and, if not, whether the Ministry of Finance should cease carrying them out.

- Efficiency reviews – that is, reviews aimed at identifying opportunities for savings by delivering services at lower cost – should be given greater emphasis than at present. To ensure their relevance for budget preparation, the terms of reference of these efficiency reviews should require them not only to identify specific areas where efficiency can be improved, but also to quantify the potential efficiency savings involved and the time frame for their potential realisation.
- Efficiency reviews should include reviews of transversal efficiency issues (efficiency issues that affect many government agencies, such as the organisation of support services or procurement practices).
- Efficiency reviews should actively benchmark agencies and public institutions against each other, against relevant private sector entities and against similar institutions in other countries.
- Efficiency review should be carried out by business process experts, and not only by professional evaluators.

1.5.5. *The assignment of institutional responsibilities for evaluation*

It is recommended that the mandate of the evaluations be reviewed, in particular to decide:

- whether they should be re-defined to focus primarily on evaluation to support budget preparation, and more specifically to provide the information necessary for spending review;
- whether the role of evaluation in supporting policy and management improvement of programmes and institutions should be reassigned to other institutions (e.g. the planned new evaluation agency and the Ministry of Social Development);
- how to co-ordinate the role of the new Ministry of Social Development with regards to *ex ante* evaluations and evaluations of the existing stock of programmes. The potential for overlap and bureaucratic conflict between the Ministry of Finance and the Ministry of Social Development concerning this area cannot be discounted.

1.5.6. *Introduce a productivity savings mechanism (efficiency dividend)*

Another useful means of creating fiscal space is the introduction of a productivity savings mechanism. Under this mechanism, the current baseline budget of each ministry or agency is reduced by a small percentage (typically around 1.5-2%) each year. The justification is that ministries/agencies should be able to make such savings on a routine basis by improving their efficiency (e.g. from the savings created by information technology). The productivity savings mechanism creates some additional fiscal space which the government can then apply to new priorities.

Certain types of expenditure – particularly transfers – need to be excluded from the application of the productivity savings. Before introducing the mechanism, it is necessary to carefully define the expenditure to which it will apply. Consideration could be given to initially introducing the productivity savings at a quite low rate – say 0.75% – so as to make sure that any unforeseen design problems do not cause major problems for ministries. The rate could be kept at this low level for, say, two years while the design is perfected. After that, the permanent rate (1.5-2%) could be safely applied.

1.5.7. Improve institutional strategy and indicators

In order to tighten the institutional strategic planning framework and integrate it properly with the budgetary programmes, the following steps should be taken:

- Align institutional strategic definitions with the reformed programme budget classification in order to facilitate the integration of planning and budgeting. In particular:
 - ❖ Statements of programme outcomes should replace the present “strategic objectives”. In other words, for each budgetary programme, the institution should be required to clearly specify the programme’s intended outcome. Expressed differently, strategic objectives would be linked to programmes, and would as a rule refer to outcomes rather than outputs or processes.
 - ❖ Each institution’s outputs – “strategic products” as they are called in the current strategic planning framework – should be clearly identified with the programme under which they fall.
 - ❖ Institutions’ definitions of their strategic products (outputs) should be reviewed to eliminate strategic products that are processes or inputs rather than outputs.
- Provide methodological guidance to institutions on the strategic framework so as to ensure that institutions clearly state their outcomes and correctly state their main outputs.
- Review and further develop the key performance indicators reported to DIPRES and the Congress to improve their relevance, including by the development of more outcome indicators.
- Shorten and improve the accessibility of the budget information papers (*Antecedentes Complementarios Control de Gestión Pública*), particularly by replacing the long evaluation reports with brief summaries (not more than a half page) with guidance on where to find the full evaluation documents on line.

The methodological guidelines for the revised budgetary programmes should include guidance on the reformulation of institutional “strategy statements” (*definiciones estratégicas*), linking them to programmes and clarifying them.

1.5.8. Strengthen the use of formula-based performance budgeting

While Chile is at present making use of formula funding in various ways, it may be possible to tie funding and outputs closer together in particular fields. It might be beneficial to strengthen the analysis done by the Budget Directorate of the current formulas, to assess whether they are precise enough and whether they result in good performance.

It would be useful to investigate whether more output-based funding mechanisms are appropriate and viable, and to strengthen the scrutiny of the formulas currently in use in order to assess value for money. Institutions could be benchmarked against each other and compared to relevant private sector institutions where applicable.

In the absence of a more detailed review of the current position, it is not possible to specify the appropriate implementation strategy or to suggest the best time frame for this reform. The first step should therefore be to conduct feasibility studies.

2. Medium-term budgeting

2.1. Introduction

Chile is facing a challenging fiscal environment in the wake of the global financial crisis and the major earthquake of 2010. When the financial crisis hit, Chile wisely suspended its budget balance rule in order to engage in a substantial fiscal stimulus (of the order of 4% of GDP). The earthquake subsequently put considerably further pressure on expenditure as a result of the large reconstruction bill. Consistent with the country's strong bipartisan commitment to sound fiscal policy, however, the government has mapped out a clear fiscal exit strategy which sets annually reducing deficit targets, with the medium-term objective of reducing the deficit to 1% of GDP by 2014.

The fiscal situation puts the spotlight on the quality of existing medium-term budgeting processes. In the context of a medium-term fiscal consolidation programme, it becomes particularly important to be able to accurately measure the fiscal space available to government. The accurate measurement of fiscal space – and, underpinning that, the accurate measurement of baseline expenditure – is at the very core of a good medium-term expenditure framework (MTEF). As discussed further below, good projections of baseline expenditure and fiscal space are precisely what make possible the reconciliation of “top-down” fiscal policy and “bottom-up” expenditure and revenue policies under the MTEF. Chile at present produces medium-term baseline and fiscal space estimates. However, the Ministry of Finance believes that there is room for improving the quality of these estimates so as to make them a better guide for budget decisions.

2.2. Overview of the use of medium-term frameworks in OECD countries⁷

Medium-term frameworks are a top-down tool that strengthens the Ministry of Finance's ability to plan and enforce a fiscal path. They also help offset the annual focus of budgets which tends to impede effective expenditure management decisions on resource allocation covering a number of years. Many policies require an extended time horizon, such as large capital projects, new programmes and organisational restructuring. The forward estimates of spending beyond the budget year make clear the medium-term implications of budget decisions.

From the point of view of agency managers, medium-term frameworks put them in a better position to plan their operations, as they have some indicative level of funding beyond the next budget. This is especially relevant in a downsizing environment. Many saving options involve more than one year in order to reap the full benefits. Naturally this should be balanced against the need for budgetary flexibility.

Many OECD countries have introduced multi-year forward estimates (baselines) into the annual budget preparation process since the late 1970s and early 1980s. Today such estimates are presented to the legislature in 29 OECD countries. In preparing forward estimates, about one-third (12) of OECD countries present forward estimates at an aggregate whole-of-government level to the legislature, five prepare them at a ministry level, and eight at a line-item level.

Multi-year ceilings are prepared and presented to the legislature in 21 OECD countries, among which 11 set ceilings at an aggregate level. Some countries like the Slovak Republic and the United Kingdom establish medium-term ceilings at a ministry level; a few others like Belgium set them at a line-item level.

Most OECD countries (24) have expenditure estimates that are updated annually as part of the budget preparation process. Three countries prepare estimates twice a year (Australia, Canada, United States), while Ireland and the United Kingdom prepare them every two years. Turning to ceilings, 13 countries update the multi-year ceilings every year and four update them after an election (Austria and the Netherlands) or a change in government (Japan and Finland). The United Kingdom is the only country that revises estimates and ceilings together every two years.

While multi-year expenditure estimates have been nothing short of a “cultural revolution” for government, their use has often encountered certain challenges. In particular, countries have experienced difficulties modifying multi-year expenditure estimates *ex post*, since ministries tend to view them as entitlements even if they are based on unreliable macroeconomic forecasts. Moreover, the use of real rather than nominal values has placed pressure on public finances during times of high inflation or recession. In preparing multi-year estimates, 21 OECD countries base expenditure estimates on current legislation, 16 countries base them on anticipated legislative changes, and 11 do it for both. Four countries have estimates in real terms. Twenty-one OECD countries adjust estimates in accordance with official macroeconomic forecasts or adjust for demographic changes (17 countries).

It should be emphasised, however, that, in order to achieve the full benefit of the practice, it has to be part of a wider debate about the countries’ fiscal position in the medium term. In other words, if the estimates show a spending increase in the medium term above the fiscal objectives, compensating cuts should be inserted into the estimates. In this way, the estimates will stay in line with the fiscal objectives and thus enforce fiscal discipline on a continuous basis.

2.3. The current situation in Chile

Since 2001, Chile has had a clear macro-fiscal framework featuring a rule with respect to the annual structural budget balance. Prior to the global financial crisis, the rule required a structural surplus of 0.5% of GDP (it was set at 1% from 2001 to 2007). During the crisis, the rule was suspended to permit a large fiscal stimulus, equivalent to 2.8% of GDP. Following the crisis, the government declared its intention to move back to sustainable fiscal settings over the medium term, and to this end has set a medium-term objective of reducing the structural deficit to 1% by 2014. It has also mapped out a transition path, setting annual structural budget balance targets for each year up to 2014, and will gradually move to this medium-term objective. In 2011, the aim was to reduce the budget deficit to 1.8%, followed by 1.5% in 2012, 1.3% in 2013, and finally 1% in 2014. The intention is that from 2015 a new structural balance rule will be put in place (see below).

For some years, the government has prepared medium-term fiscal projections and presented them to the Parliament together with the budget law (Table 1 shows the projections published with the 2011 budget). The aim of these projections is to show “the fiscal space which exists to expand or create programmes, and also to anticipate the need to take action to avoid any possible future disequilibrium”. To this end, projections are composed of:

- the level of aggregate expenditure permitted by the budget balance rule or (in the present context) target, given projected revenue; and

- the level of committed expenditure (*gasto comprometidos*) – by which is meant what is often referred to in other countries as “baseline” expenditure.

The fiscal space is the difference between these two levels.

Table 1. Medium-term fiscal projections in Chile, 2011-14
Consolidated balance of central government; convergence to a structural deficit

	2011 proposed budget	2012 projection	2013 projection	2014 projection
Consolidated balance of central government (million pesos in 2011 and per cent of GDP)				
1. Total income	25 769 646	26 540 282	27 386 419	28 406 489
2. Total committed spending	26 693 480	27 134 671	27 353 534	27 145 499
3. Balance (1-2)	-923 834	-594 389	32 886	1 260 990
4. Balance (% of GDP)	-0.8%	-0.5%	0.0%	0.9%
5. Structural income	24 660 461	25 798 173	26 809 354	28 037 130
6. Structural balance (5-2)	-2 033 019	-1 336 498	-544 179	891 631
7. Structural balance (% of GDP)	-1.8%	-1.1%	-0.4%	0.6%
Convergence to a structural deficit of 1% of GDP in 2014				
8. Structural deficit target (% of GDP)	-1.8%	-1.5%	-1.3%	-1.0%
9. Spending level compatible with target	26 693 480	27 645 225	28 437 838	29 412 873
10. Spending difference (9-2)	-	510 554	1 084 305	2 267 374
11. Spending difference (% of GDP)	0.0%	0.4%	0.8%	1.6%
12. Actual balance compatible with target (1-9)	-923 834	-1 104 943	-1 051 419	-1 006 384
13. Actual balance compatible with target (% of GDP)	-0.8%	-0.9%	-0.8%	-0.7%

Source: Government of Chile (2011), *Informe de Finanzas Públicas Proyecto de Ley de Presupuestos del Sector Público para el año 2011*, Santiago, p. 62.

This type of fiscal forecasting exercise is at the very heart of good medium-term budgeting (see Box 5), the aim of which is to ensure the compatibility of tax and spending policies with good aggregate fiscal outcomes.

One other important feature of medium-term budgeting in Chile should be noted. This is the legal requirement that DIPRES provide the Congress with medium-term cost estimates of every new spending proposal which is placed before the Congress.

2.3.1. Quality of the forward estimates

Chile has clearly taken the right approach in seeking to estimate fiscal space over the medium term in order to know the room for new spending or, alternatively, obtain advance warning of the need for adjustments in spending or in tax policy. It is also commendable that these medium-term projections are made public in order to keep the Congress and public informed of the fiscal prognosis.

However, it will be clear that the value of the medium-term projections depends entirely on the quality of the forward estimates. Only if the forward estimates are of good quality will it be possible to have faith in the estimates of fiscal space and to let them guide policy makers in deciding how much new spending can be implemented.

DIPRES has put a great deal of effort over the years into revenue forecasting, and believes that the revenue forward estimates are of relatively good quality. This is not, of course, to say that revenue forecasting is easy. For example, projecting copper revenues is particularly difficult, given the sensitivity of copper prices to the international business cycle and the impact of exchange rate fluctuations on the copper revenues in local currency terms.

Box 5. Core elements of medium-term budgeting

The most fundamental aim of good medium-term budgeting is to ensure the consistency of bottom-up expenditure and revenue policies with top-down aggregate fiscal policy. Medium-term budgeting is therefore, above all else, a mechanism for strengthening the centre's capacity to enforce top-down limits on aggregate expenditure. In the top-down process, the highest executive budget decision-making institution – e.g. the Cabinet or the President – sets aggregate expenditure ceilings which reflect macro-fiscal and revenue policy objectives prior to any consideration of ministry spending requests. The challenge is then to ensure that these aggregate ceilings are adhered to during the budget preparation process. Medium-term budgeting is a powerful tool for ensuring this.

Medium-term budgeting requires good quality expenditure and revenue **forward estimates** in order to ensure the consistency of budgetary expenditure allocations with the aggregate expenditure ceilings. Forward estimates are medium-term estimates of expenditure and revenue on a “current policy” basis – that is, projections that indicate what the expenditure and revenue will be in each of the next three or four years if there are no new spending initiatives, no changes to tax laws, and all commitments of future expenditure (including political promises) are taken into account. Forward expenditure estimates cover what is often referred to as baseline expenditure.

The other requirement of medium-term budgeting is medium-term projections of the maximum level of aggregate expenditure that is compatible with aggregate fiscal policy goals (i.e. targets or rules for the budget balance and/or also for stock variables such as debt) given projected levels of revenue. For example, if the government has a rule that the budget should be structurally balanced, the maximum aggregate expenditure each year will be equal to projected structural revenues plus or minus any purely cyclical expenditure. In countries that set **aggregate expenditure ceilings** as part of their fiscal framework, these ceilings will by definition give the maximum permissible level of aggregate expenditure in any year.

Armed with these two elements, it becomes possible to compare the “top-down” aggregate expenditure limits with the “bottom-up” projections of baseline expenditure. The difference between these two is widely referred to as **fiscal space**. Positive fiscal space – that is, baseline expenditure below the permissible level of aggregate expenditure – gives a measure of the amount of new spending (or tax cuts) which can be undertaken consistent with aggregate fiscal policy. Negative fiscal space – that is, baseline expenditure in excess of maximum permissible aggregate expenditure – indicates that existing expenditure policies must be changed to reduce baseline spending (or, alternatively, taxes must be increased) if aggregate fiscal policy goals are to be achieved.

Within this framework, estimates of the medium-term cost of each potential new spending initiative and capital project can be used to ensure that the amount of new spending approved never exceeds the available fiscal space.

The quality of the forward estimates could however be improved with regards to providing a better measure of fiscal space.

What happens at present is that sectoral budget analysts within DIPRES each year prepare expenditure forward estimates for the ministries to which they are assigned. The principle is firmly established that these forecasts cover only the expenditure required by current law and policy, and exclude possible new expenditure laws. The sectoral budget analysts apply common assumptions about the evolution of key macroeconomic variables.

They also seek, for example, to adjust their projections to eliminate temporary expenditures which should be coming to an end. Once the sectoral budget analysts have prepared the forward estimates for their ministries, they are reviewed and consolidated by the studies group within DIPRES.

DIPRES acknowledges, however, that there is not yet sufficient methodological consistency in the approaches used by sectoral budget analysts for their ministries. For example, the demographic assumptions used are not necessarily uniform. There is also no clear common understanding of the level of service which “current policy” requires for those public services where there is no explicit government commitment about the level of services to which citizens are entitled. Does “current policy” require the maintenance of the same level of real government expenditure, or the same real per capita spending?

The Ministry of Finance is therefore working on gradually improving the methodology for the expenditure forward estimates. In doing so, it is grappling with a challenge which has not proven easy anywhere in the world. Projecting expenditure is inherently more difficult methodologically than revenue projection, where current policy is in general clearly laid down in law.

An important matter to consider in this context will be the respective roles of Ministry of Finance officials and spending institution officials in the preparation of the expenditure forward estimates. At present, the forward estimates are largely prepared within the Ministry of Finance, with limited spending institution involvement. However, it is often in the spending institutions that the greatest understanding of expenditure dynamics is to be found. Developing more of a partnership in the preparation of the estimates might therefore be a key means of improving their quality.

2.3.2. Ministry expenditure ceilings

Chile at present has strictly annual budgets. In other words, the budget authorises spending institution expenditure only for the coming financial year. Annual budgeting is, of course, the predominant international practice. There are, however, a limited number of advanced countries, such as the United Kingdom, that have multi-annual budgets in the sense that the government gives spending institutions firm medium-term spending ceilings covering a large part of their expenditure. There is a school of thought in Chile that would like to see the country move to this type of system. Thus in the first year of every presidential term of office, the Chilean Congress could approve a multi-year budget providing institutions with the funding required to carry out a government strategy that was also conceived in terms of medium-term objectives (like the *Objetivos Estratégicos* set out by President Piñera).

This innovation would undoubtedly present a desirable future direction for the Chilean budgeting system. However, there is an important obstacle to moving to firm multi-year ceilings in the short term: the quality of the expenditure forward estimates. If firm multi-year ceilings are to be set, DIPRES needs to be able to prepare accurate forward estimates of institutions’ baseline expenditure requirements not merely for the coming year, but for several years into the future. If DIPRES is not yet able to prepare reasonably accurate medium-term expenditure forward estimates, there will be a high risk that the ceilings set for many institutions in the out-years will be either too low or too high. This is not a problem if the ceilings are only indicative, but it is a major problem if they are firm. If the ceilings are too high, the available fiscal space will be underestimated and the capacity

to fund new policy commensurately reduced. But if the ceilings are too low, the risk will be that, when the out-years arrive, the unrealism of the supposedly firm institutional ceilings will become apparent and the ceilings will end up being modified upwards. Expressed differently, the ability to make firm multi-year ministry ceilings stick depends upon the credibility of those ceilings.

This problem suggests that, however attractive a regime of fixed medium-term ceilings may be, it is not a move which Chile should make immediately.

However, it is not necessary to wait until it is technically feasible to introduce such a regime to realise some of its benefits. It is generally acknowledged that there are two key benefits of well-developed medium-term budgeting: first, it strengthens the ability of the finance ministry to steer spending via the top-down set ceiling; second, it reduces uncertainty for spending institutions about future funding levels, leading to better planning and management on their part. This reduced uncertainty is greatest when the government gives institutions firm medium-term funding levels. However, even when firm ceilings are not set, good medium-term fiscal forecasting can greatly reduce funding uncertainty. This is because, to the extent that the forecasting process ensures that all expenditure policy decisions are fully consistent with aggregate fiscal policy over the medium term, it greatly reduces the fear that institutions' budgets will need to be suddenly cut in order to avoid breaching targets for the budget balance and other key aggregate fiscal variables. Under such circumstances, spending institutions can have considerable confidence that – at least barring government policy changes – they will receive funding for their projected baseline expenditure as shown in the forward estimates. Their forward estimates are, in a real sense, indicative ceilings.

In Chile at present, the expenditure forward estimates do not yet play the role of reducing spending institution uncertainty about future funding levels. This is because ministry-level forward estimates are purely internal to the Ministry of Finance and are not made available to the ministries and institutions concerned. This is deliberate: the estimates are kept confidential precisely to avoid creating any sense of a commitment to the future budgetary funding levels.

However, as the quality of the expenditure forward estimates is improved, it is important that they are used to realise the benefits of medium-term budgeting as an instrument for enforcing a centrally set top-down fiscal path, reducing funding uncertainty and improving planning and management. This requires, as a minimum, that ministries are aware of their forward estimates – a development which would be closely related to their participation in the preparation of the estimates.

Following this, the ministry forward estimates can progressively change from being mere projections to become the basis for ministry expenditure ceilings. Initially, the forward estimates should be used to set indicative (rather than firm) ceilings. In other words, it should be made quite clear to ministries that they are not firm commitments on the part of government, and that the government retains the prerogative to change expenditure policies at any time with consequent changes to the indicative ceilings. The forward estimates can also be used as the starting point for annual budget preparation, as in Australia. In the longer term, Chile can then, if it wishes, move to a regime of firm medium-term ministry ceilings.

2.4. The fiscal rule and the long term

From 2001 up to the financial crisis, Chile applied a fiscal rule pertaining to the structural budget balance. Initially the rule stipulated a surplus of 1% and, from 2007, this was reduced to 0.5%. This policy was designed to ensure fiscal sustainability while permitting counter-cyclical policy actions. In addition, it aimed at:

- protecting the competitiveness of the export sector and reducing the volatility of the exchange rate;
- reinforcing the Chilean government's credibility as a borrower on the capital markets;
- building public sector savings.

The surpluses accumulated with the application of this rule went into two funds – a Pension Reserve Fund and an Economic and Social Stabilisation Fund – as well as into bolstering the depleted capital of the central bank.

Even after the suspension of the rule during the global financial crisis, the structural budget balance has remained central to the Chilean fiscal policy. A strong feature of the Chilean system has been the high level of transparency in the application of the rule. The methodology for measuring the structural budget balance is clearly formulated and publicly available, and has been progressively refined over time. The actual calculation of the structural balance each year is done by DIPRES.

In the wake of the crisis, Chile is in the process of defining a “second-generation” fiscal policy. In 2010, the government appointed an independent committee of eminent economists and policy makers to give advice on these questions. After 33 working sessions, the work of the committee ended in January 2011 and the final report was uploaded to the Ministry website in June 2011. The issues addressed by the report were the following:

- the merits of rules versus targets for the structural balance;
- what the required structural balance should be (e.g. what percentage of GDP);
- whether the rule or targets should be set for the overall or primary balance (i.e. including or excluding interest payments);
- how to permit more scope for active counter-cyclical policy;
- whether to focus policy on the *ex ante* or *ex post* structural balance.

The committee's answers to these issues and others include:

- It is proposed to change the term “structural balance rule” to “cyclically adjusted balance rule” but maintain the methodology that was previously used: budget headings that are affected by the deviation of domestic GDP and the price of copper and molybdenum from their trends are adjusted, without considering other sources of deviation of transitory revenue to permanent revenue.
- The committee does not make an explicit recommendation regarding the cyclically adjusted target, leaving it up to the government. However, it is mentioned that, in order to define the cyclically adjusted target, it is essential to consider that the future contingent liabilities or deficits are the same as those presented in the report by DIPRES on contingent liabilities and deficits. In addition, it is advised to increase the coverage of the annual report on contingent liabilities.
- It is proposed to move to a target based on the primary balance.

- It is proposed to use an *ex post* criterion to adjust expenditure when relevant changes occur to the variables that determine the fiscal rule. When facing important changes in any of the parameters that would affect the cyclically adjusted revenues, partial adjustment mechanisms should be considered by the government to smooth the convergence towards a fiscal equilibrium. As a legal requirement, such deviations – and the measures that will be taken to correct them – should be reported in the annual government report on evaluation of the financial performance of the public sector.
- It is recommended to complement the rule with a component that would allow the executive authority to use *ex ante* counter-cyclical policy. Such a component would establish a variable target as a function of the estimated GDP threshold. The definition of the parameters that will activate such a component shall be made by the executive authority at the beginning of every presidential term of office.
- It is suggested to establish an independent fiscal council with the following functions: i) evaluate the methodology of the fiscal rule; ii) provide the economic assumptions and projections for the adjustment of the cyclical adjustment variables; iii) evaluate fiscal policy, the application of the rule, and the sustainability of medium and long-term fiscal policy; iv) produce an assessment on possible changes of principles and accounting methodologies used in the budget; v) evaluate the escape clauses and convergence strategy towards the cyclically adjusted balance; and vi) provide an opinion on the contingent liabilities report and the impact of such estimation on policy goals.
- Give official status to the Consultative Committee on Copper.
- Give legal status to the regular delivering of long-term actuarial fiscal projections.
- Improve financial information contained in proposed new legislation.
- Broaden the annual presentation of financial and fiscal medium-term projections, using a higher level of disaggregation in the medium-term financial programme and providing estimates of the cyclically adjusted balance rule year to year in a similar time horizon. This should include details of the main economic assumptions in order to evaluate the viability of achieving fiscal targets.

The budget office has recently published a report (Larrain et al., 2011) that includes the main elements of a second-generation structural balance rule that incorporates many of the measures proposed by the independent committee. The most relevant are:

- The term “structural balance rule” will be changed to the “cyclically adjusted balance rule” to better reflect its purpose. It will only be adjusted for cyclical incomes derived from GDP and from the price of copper and molybdenum.
- Other changes in incomes due to one-off factors will not be adjusted for.
- No cyclical adjustments will be made on interest gains on government assets. No adjustment will be made to “other incomes”.
- The long-term price of molybdenum will be estimated on the basis of a moving average of the actual price for the last seven years.
- The rule will be calculated on the basis of the global balance of the central government.
- An *ex post* criterion for implementing the rule will be used. A section will be incorporated into the annual report on evaluation of the financial performance of the public sector describing the impact of adjustments and deviations from initial projections in the established policy targets.

- An independent fiscal council is to be created with the following functions: i) participate in the consultative committees for GDP tendencies and for the copper referential price; ii) verify that the mentioned variables are correctly reflected in the rule and its implementation; iii) provide advice to the Ministry of Finance on specific aspects regarding the cyclically adjusted balance rule; iv) assess eventual methodological changes to the rule proposed by the authorities; and v) verify mid-term projections of structural results included in the public finances report.
- The information about the methodology, variables and rationale for calculating the fiscal rule will be made available to the public.

2.4.1. Long-term fiscal projections

As a prerequisite for achieving these goals, the Ministry of Finance is focusing considerable effort on the preparation of long-term fiscal projections. This is an area to which OECD member countries have paid increasing attention over the past decade or so (see Box 6). The Chilean Ministry of Finance has carefully studied the practice of other countries in this area, including the European Commission's projections of the fiscal costs of ageing.

Box 6. Long-term fiscal forecasts: selected international practice

- Australia: Since 2002, the national government has published an *Intergenerational Report* every five years, providing 40-year fiscal projections.
- New Zealand: A report on the long-term fiscal position, with a 40-year time horizon, has been prepared every four years since 1993.
- United Kingdom: Since 2002, the Treasury has regularly produced a *Long-Term Public Finance Report* with 30-year projections.
- United States: The United States was one of the first in this area. The Office of Management and Budget (i.e. finance ministry) has published 75-year fiscal projections annually for the past 40 years.
- A number of other OECD countries, such as Norway and Switzerland, have recently started producing similar reports.

There are a few countries that link their budget balance targets explicitly to long-term fiscal considerations. One such country is Sweden (see Box 7), where one of the key motives for the choice of 1% as the target value for its long-standing structural budget surplus rule is preparation for the pressures on public finance that will arise as a result of population ageing. In other words, Sweden is seeking to pre-fund a significant portion of the future rise in age-related expenditure. Sweden does not, however, make public any specific methodology for this linkage.

In seeking to develop a clear link between its budget balance rule/targets and long-term public finances, Chile is addressing an issue which is at the cutting edge of fiscal policy at the present time.

Box 7. Rationale for the Swedish choice of 1% for the budget surplus rule

“The motives for the surplus target are that it shall contribute to:

1. The long-term sustainability of the public finances so that citizens, firms and financial markets have confidence in fiscal policy.
2. Adequate margins for avoiding large deficits during economic downturns even in connection with an active contracyclical policy. The surplus target contributes to a buffer being available for countering sharply falling economic activity without risking an unsustainable increase in debt.
3. A uniform distribution of resources between generations. In Sweden, as in many other countries, the proportion of elderly people in the population will become appreciably larger in the coming decades. Relatively high medium-term public saving during demographically advantageous years means that the large cohorts which will need medical care and social services in the years ahead are themselves contributing to the financing of these services.
4. Economic efficiency. The surplus target promotes economic efficiency by providing better conditions for a tax take which does not have to be increased, and does not vary over time on account of demographic changes.”

Source: Swedish Ministry of Finance (2011), *The Swedish Fiscal Policy Framework*, March, Ministry of Finance, Sweden, www.government.se/sb/d/14625/a/164299.

2.5. Suggestions for reform

On the basis of the above analysis, there are a number of recommendations which the Chilean government could consider in order to further improve the medium-term budgeting framework and strengthen the longer-term budgeting perspective.

2.5.1. Medium-term forward estimates

As noted above, forward estimates need to become more reliable and disaggregated in order to permit more accurate estimation of the fiscal space available to Chile over the medium term. To achieve this:

- DIPRES should develop and apply a standard methodology for producing expenditure forward estimates (e.g. clearly distinguishing baseline expenditure from new initiatives, and defining the assumptions for the projection of baseline spending) which is critical to achieve a reliable multi-year path to the government’s fiscal target.
- Revenue projection methodology should continue to be improved, and should in addition be formally documented.
- As recommended by the independent committee on the fiscal rule, Chile should provide estimates of the cyclically adjusted balance compared to the fiscal rule for the medium-term out-years in order to make it possible to evaluate how realistic the fiscal goals are. The proposed annual report on the financial performance of the public sector should serve this purpose well.

2.5.2. *Medium-term budgeting and resource certainty for ministries/agencies*

In order to enable the government to enforce a fiscal consolidation path more easily, one option is to give spending institutions greater certainty about future funding in order to permit them to plan and manage their expenditure more effectively. To achieve this:

- After the strengthening of the expenditure forward estimates (not before), ministries/agencies should be advised routinely of their medium-term baseline estimates, while making it quite clear that these are not a commitment by the government (i.e. they are not fixed ceilings) and that the government retains the right to change these as the result of spending review. By letting ministries/agencies know what they would receive if policy did not change, all things being equal, uncertainty about future funding would be reduced and improved planning and management would be facilitated. Possible productivity cuts and multi-year reform cuts should be part of the forward estimates.
- Each institution's baseline should then be used as the starting point for annual budget preparation, as in Australia.
- In the longer term, consideration can be given to the use of fixed multi-year ceilings, on the model of, say, the United Kingdom.

2.5.3. *Long-term budgeting and fiscal rules*

With respect to the longer-term budgetary perspective, Chile needs to focus on two key areas. The first is improved forecasting of longer-term expenditure and revenue trends, including in relation to the fiscal impact of demographic trends. The second is the linking of fiscal policy (specifically, the budget balance target or rule) to long-term sustainability considerations.

The recommendations of the independent committee address these issues in a prudent and appropriate way. Maintaining a structural balance rule which allows for a "time out" in exceptional circumstances of fiscal stress gives a sound basis for the fiscal framework of Chile. Importantly, a number of institutional efforts support this effort, including:

- an independent fiscal council;
- a stronger mandate for the Consultative Committee on Copper;
- transparency efforts in the form of enhanced reporting on liabilities and deviations from the targets.

These efforts should be pursued. DIPRES should continue to give priority to improved analysis of the long-term expenditure trends, particularly with respect to entitlement spending and health spending. Consideration should be given to investigating appropriate long-term objectives with a focus on fiscal sustainability which should guide fiscal policy. The new fiscal council could be charged with this matter.

3. Services flexibility and efficiency

3.1. Introduction

Most OECD member countries are placing a larger emphasis on budgeting, management and accountability to take them away from controlling inputs towards achieving results. There is a tendency to relax input controls to give government organisations greater flexibility and autonomy to achieve their objectives efficiently and effectively. The basic assumption is that heads of individual government organisations are

best positioned to achieve their policy and programme objectives if enough flexibility in the management of financial and human resources is granted. Flexibility would allow taking into account the differences in the priorities and the functions performed by government ministries and agencies. In this context, flexibility can be defined as the extent to which an organisation can adjust budget appropriations and empower and enable public managers to adjust the number and competencies of the public workforce to the business needs of their organisation.

In this sense, the aim of this section is to review the Chilean management practices regarding budget execution and human resources. The Chilean government sector is characterised by high-quality civil servants and high performance standards. However, the current state of management procedures lead to the assumption that further efficiency and effectiveness could be achieved by modifying a number of managerial rules. This section explores the rules governing budget execution in the central government.

More managerial flexibility in Chile's central administration may constitute a driver for better performance. Less input controls in budget execution and human resource management have the potential to enhance efficiency in the management of public organisations and resources. Management flexibility is considered a necessary condition to motivate managers to improve their performance by rewarding them for accomplishing the goals or expected results. When agencies are allowed to retain surpluses, then they will strive to improve efficiency. If Chile is to improve the efficiency of the public administration by, among other things, enhancing managerial flexibility, then it has to find a healthy balance between accountability and control on one side and performance and autonomy on the other. It is not reasonable to make managers accountable for performance if they are not free to manage; and it is not prudent to give them operating freedom if their performance does not matter.

3.2. Towards more flexibility in budget execution

3.2.1. The situation in Chile

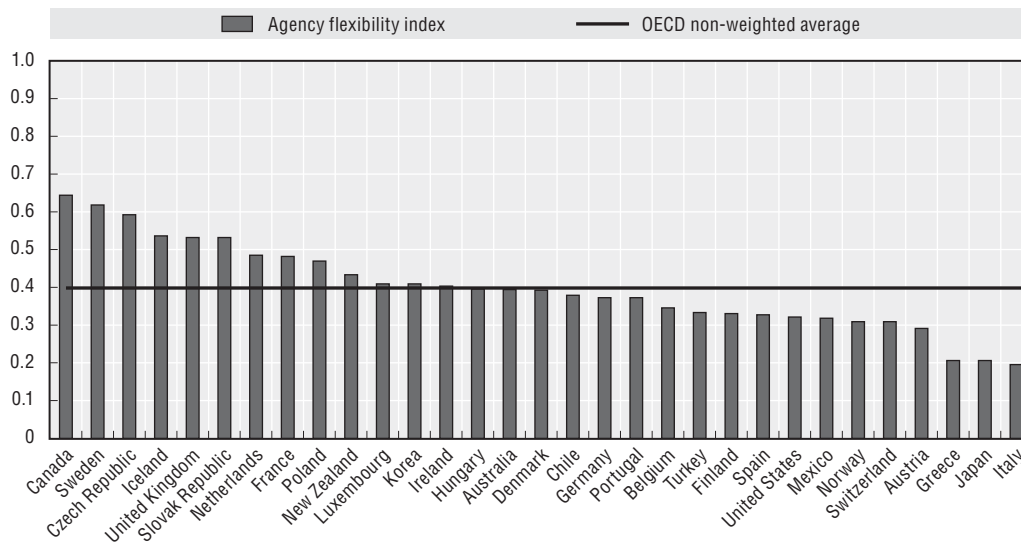
One of the fundamental challenges for Chile to improve the efficiency of budget execution and the management of the public workforce is to move from expecting conformity with tightly defined rules to a flexible system where managers are given the scope to achieve wider goals. This means that the management model should evolve to value management that takes calculated risks and that makes decisions based on performance rather than rules.

Article 26 of Law No. 1263 of 1975 regulates the procedures for transfers, increases and decreases of the budget. Article 26 states that the rules for changes in appropriations are to be determined in a decree issued in December of the previous year by the Minister of Finance. In Decree No. 1531 of December 2009, it is specified that carry-over and reallocations can take place by a decree issued by the Ministry of Finance. Certain appropriations, however, require a new law (transfers between ministries, transfers to state enterprises, and increasing the global amounts of a given appropriation). Both carry-over and reallocation require a special authorisation from the Ministry of Finance in the form of a decree. While this is legally the same process, it should be noted that – due to the broad programme definitions in Chile – relatively few reallocation decrees are necessary.

In Chile, the government may cut, cancel or rescind spending once the budget has been approved by Congress, with certain limitations. In principle, reallocation from

investments to current spending is not permitted. The spending envelope permitted by the budget is firm; no overspending may occur without prior approval of a supplementary appropriation law by Congress. No borrowing against future appropriations is possible, but ministries may carry over unused funds or appropriations into the next budget year by decree of the Ministry of Finance. As Figure 1 shows, the level of agency (services) flexibility during budget execution in Chile is roughly in the middle of the field of OECD countries. Chile's level of flexibility is higher than in some of the most advanced OECD member countries like Germany, Japan, Norway, and the United States.

Figure 1. **Agency flexibility in budget execution**



Note: Index comprised between 0 (no agency flexibility) and 1 (high agency flexibility level). Cronbach's alpha: 0.470 (computed with SPSS). A Cronbach's alpha close to 0.6 or 0.7 indicates a high degree of correlation among a set of variables.

Source: OECD Budget Practices and Procedures in OECD Countries (database), www.oecd.org/gov/budget/database.

These results concur with the findings of the OECD mission. Except for specific issues, there is little evidence of fundamental line ministry or agency frustration with the level of flexibility. However, given Chile's well-functioning public sector, and its clear ambition to be at the forefront of budget reform, there is still room for injecting more flexibility into budget execution with the purpose of enhancing the efficiency and effectiveness of spending.

For operating expenditures, each ministry and agency (*servicio*) receives one appropriation for human resources and one appropriation for the purchase of goods and services. These are global amounts with no subdivisions among individual items of expenditure. The appropriations are considered maximums, and there is no obligation to spend appropriated funds. There are two types of restriction for each account. The first is common to all accounts and includes a maximum amount that can be spent on four items of expenditure: overtime, travel, training, and consultants. This degree of input control is somewhat unusual for OECD countries. The amount of the restriction originates with the Ministry of Finance in the budget proposal presented to the Congress. The budget also contains a ceiling on the number of staff (posts) and the number of vehicles that each ministry and agency may have. The second type of restriction is for specific appropriations: these generally earmark parts of a larger appropriation for specific projects.

The need for DIPRES approval (by decree) of reallocation makes the process somewhat heavy. For example, changes in Sub-title 29 (Acquisition of non-financial assets) between items 06 (IT hardware) and 07 (IT software) require the approval of the budget office and the corresponding line minister. Evidence indicates that, in reality, reallocation rules are not always followed. It should be noted, however, that changes in the appropriations for programme expenditure are in fact quite possible, since the appropriation is given at a relatively high level of aggregation – i.e. often to a group of programmes.

All expenditure transactions must be pre-approved by the Comptroller General in order to ensure their legality. There are very few instances where the Comptroller General vetoes a transaction. This would seem to indicate that this process is overly bureaucratic and does not add much value.

3.2.2. *Suggestions for reform*

While Chile does not have a strong need to enhance flexibility, there are cases where flexibility would probably enhance spending efficiency, especially if these measures are linked to a stronger performance management system.

In other OECD countries, reallocation rules usually vary according to the kind of expenditure to which they relate. Line ministries/agencies are typically allowed to reallocate a percentage (2-5%) of current expenditure appropriations within programmes and a smaller percentage between programmes. Usually, the approval of both the Ministry of Finance and Parliament is required for larger reallocations or for reallocations across ministries. Appropriations for salaries can typically be reallocated to other operational spending but not the other way around. Countries have different regimes regarding capital spending. Since entitlement spending is sanctioned in law other than the budget, the amount appropriated is usually a non-binding estimate.⁸

As mentioned above, reallocation is in general not a problem in Chile, due to the broad programme classification. There are, however, some minor changes (between categories within capital and operating expenditures) that could potentially be relaxed. Should a more detailed programme budget structure be put in place, as argued in Section 2, reallocation rules would have to be re-examined to maintain the current flexibility.

Borrowing against future appropriations is another practice that increases managerial flexibility, since it enables agencies to spend the year's funds without holding back spending to be sure to have sufficient funds. However, it goes against the one-year nature of most annual budget laws and decreases the power of the Parliament and the Ministry of Finance. Consequently, a vast majority of OECD countries do not allow ministries or agencies to borrow against future appropriations regardless of the type of expenditure. A few countries allow it, though: Mexico (with approval from the central budget authority), Belgium (for selected agencies), and Canada, Denmark and Sweden (within a preset sub-limit). At this stage, there does not appear to be a need in Chile to introduce borrowing against future appropriations.

A carry-over of appropriations allows government organisations to use a portion or all of an unspent appropriation after the time period for which it was originally granted (see Box 8). By using a carry-over, an organisation may use unspent money in the next fiscal year. As with reallocation rules, there is a great variation between OECD countries with regards to the rules governing carry-over. In many cases, there will be a distinction between the types of expenditure (current, capital, salaries, and entitlements). Depending

on the country, carry-overs are allowed after a qualitative evaluation by the Ministry of Finance and/or based on a quantitative rule. Quantitative rules include: a limit on the amount of carry-over allowed in any given year (usually 2-5% of the appropriation); a ceiling on the amount of accumulated carry-overs; or limits on the draw-down of accumulated carry-overs. For instance, in Canada, unused funds from operating and capital budgets can be carried over up to a 5% limit. In Finland, most operating expenditures and investments may be carried over for a maximum of two years. In the United Kingdom, unlimited carry-over of both operating and investment budgets is permitted, but the approval of the finance ministry is needed to draw down the funds.

Box 8. **Preconditions for establishing a carry-over system**

End-year flexibility can simplify budget management and promote efficiency. However, before a country introduces a general system for carry-overs, the following six preconditions should be met:

- **Accurate appropriations.** Assuming that budget allocation is adequate for the task that is supposed to be carried out, the finance ministry must be reasonably confident that, if there are unspent appropriations, this is because of efficiency gains or implementation delays and not the result of over-budgeting. Past budgets can be compared with the outturns, to investigate if budget allocations were consistently bigger than the actual use of funds.
- **Well-developed accounting and reporting systems.** Carry-over regimes can only be implemented if it is possible to determine by how much the budget has been underspent at the end of the year. A government accounting regime that generates accurate outturn figures that can be compared with the budget is necessary. The outturn figures must be available reasonably soon after the end of the budget year, to give budget managers the information on how much carry-over is available in addition to the new year's budget allocation.
- **Access to financing.** The government must be in a position to finance payments when requested, so as to honour payments associated with end-year flexibility.
- **Well-functioning internal control and external audit.** The amounts that are carried forward should only be used for attaining meaningful government objectives. Unless this is the case, wasteful end-year spending would simply be replaced by wasteful carry-over spending. This points to the importance of internal control/audit and external audit systems that are able to prevent spending that is not in line with the government's intentions and that could be misused.
- **Devolved budget management powers.** One of the key ideas behind end-year flexibility is that wasteful end-year spending will be replaced by productive use of resources when the spending can be planned better. This pre-supposes a certain degree of managerial authority over the use of budget funds.
- **Medium-term approach to fiscal policy.** Implicit in the rationale for budget carry-overs is the assumption that the government is indifferent to the precise timing of expenditure. This is likely to be the case only where the government takes a medium-term approach to fiscal policy making.

A cautious approach is needed for general carry-over provisions for operational expenditures; in that case, many of these preconditions will be hard to meet.

Source: Lienert, I. and G. Ljungman (2009), "Carry-over of Budget Authority", *Public Financial Management Technical Guidance Note*, International Monetary Fund, Washington, DC.

It is recommended that Chile allows carry-over of appropriations for operating expenditures up to a set limit of, e.g., 2% of total appropriation within a finite time, after which the carry-over is lost. Any other changes should be subject to Ministry of Finance approval. A separate regime for capital budgeting should be in place, allowing the project to be fully funded from the outset and making the funds available for the entire project.

Less input control and less procedural control would relieve the Budget Directorate (DIPRES) and the Comptrollership of a great number of tasks. However, this might leave the government exposed to risk, which relatively free agents or managers are meant to manage. This should be countered by a phased, measured approach to new flexibility, enhanced performance management, a strengthened sense of collective responsibility among senior public servants, and strengthened accountability.

4. Conclusion

Table 2 sums up the public sector reforms in Chile, 2011-14.

Table 2. **Chile action plan overview**

	2011	2012	2013	2014
Programme classification (assuming a new structure needs to be developed)	Develop methodological guidelines/manual. Investigate whether a new programme classification should be developed or whether the existing one can be modified. Launch pilots in five agencies.	Programme budget annex with new structure for pilots. Pilot extended to all other ministries and agencies.	Programme budget annex covering all ministries and agencies.	Budget law based on the new programmes.
Institutional strategic framework	Revise framework of institutional strategy statements (<i>definiciones estratégicas</i>) and link to new programme framework.	As programmes are developed, clearly specify their intended outcomes and main outputs.	As programmes are developed, clearly specify their intended outcomes and main outputs.	
Link to government-wide priorities		Link the new programmes explicitly to the strategic objectives (<i>Objetivos Estratégicos</i>) of the government.	Link the new programmes explicitly to the strategic objectives (<i>Objetivos Estratégicos</i>) of the government.	
Performance report to Parliament	Develop a new, briefer and more accessible structure for the budget information papers (<i>Antecedentes Complementarios Control de Gestión Pública</i>).			
Performance indicators	Review performance indicators to improve their relevance.	Review performance indicators to improve their relevance.	Review performance indicators to improve their relevance.	
Spending review	Decide spending review mechanism.	Establish first spending review.	Second spending review.	Major spending review.
Performance-based budgeting	Initiate studies for the implementation of performance-based budgeting in the public hospital and education systems. Analyse the current formulas in place with regards to precision and value for money.	Complete studies and develop implementation strategy.		
Efficiency review	Create a new efficiency review mechanism.	Carry out the first cross-cutting efficiency reviews.		
Evaluation	Redefine the mandate of the DIPRES and make appropriate changes to the evaluation instruments.	Implement changes to the evaluation system.		

Table 2. **Chile action plan overview** (cont.)

	2011	2012	2013	2014
Productivity savings mechanism	Define the mode of operation of the productivity savings mechanism.	Apply productivity savings at initially low rate.		Raise the rate to the planned long-term level.
Baseline expenditure methodology	Develop methodological guidelines. Enhance the fiscal impact assessments of new legislation. Enhance the use of long-term budgeting.	Complete the methodological guidelines.		
Using the baseline in budget preparation				Begin using ministry baselines as starting point in preparing the budget. As part of this, let ministries/agencies know their baselines.
Medium-term revenue projections	Document revenue projection methodology.	Complete the documentation of the revenue projection methodology.		

Notes

1. See www.oecd.org/gov/budget/database.
2. For example, the Ministry of the Interior counts among its strategic outputs the “strengthening of state management of emergency operations and the management of risks” which is a process objective rather than an output.
3. Within Latin America, countries such as Colombia and Mexico also strongly emphasise evaluation as the cornerstones of their performance management systems.
4. The study did not provide any estimate of the extent to which evaluations led over time to budget savings through efficiency enhancements.
5. Technical commissions are the meetings held with institutions, during the budget preparation process, when each institution’s budget requirements are discussed.
6. There is no standard definition of the term “spending review” and it is used in different ways in different countries.
7. See www.oecd.org/gov/budget/database.
8. See www.oecd.org/gov/budget/database.

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