Re-Allocation: Aligning Political Priorities and Budgetary Funding

Note by the Editors

The following five articles contain reports on national practices in five Member countries for reallocating budgetary resources. The five countries are Finland, Germany, Korea, Switzerland and the United States. The reports were presented at a special OECD meeting in the year 2000 where senior officials from Member countries met to discuss these issues.

The **Finnish** report surveys the drastic budgetary measures taken in the early 1990s in response to the unprecedented economic shocks experienced. It highlights the various "emergency" budget packages that were developed in order to effectively deal with the situation.

The **German** report outlines the government's *Future Program* 2000, which aims to consolidate government finances and improve the general conditions for business and individuals by means of sustainable tax relief measures. The *Program* incorporates strict spending limits.

The **Korean** report focuses on how the government responded to the economic crisis of the late 1990s. The government had to reallocate massive amounts of funds, from a drastically shrunken revenue base, in order to implement the necessary economic restructuring measures.

The **Swiss** report highlights the recently adopted constitutional amendment calling for a balanced budget, and the detailed schedule of measures taken in order to achieve the consolidation of the budget.

The **United States** report focuses on the process adopted in order to close military bases that were no longer needed, highlighting the politically neutral decision-making structure that was employed.

Finland

By
Helena Tarkka and Sirpa Tulla*

1. The Finnish Economy Heading for a Crisis

Traditionally, public finances in Finland have been fairly balanced. State debt in Finland was, in fact, one of the smallest in Europe in 1990. Throughout the 1980s, the Finnish economy grew at a steady and vigorous rate. The unemployment rate remained low (even as low as 4%), leading to labour shortages in some sectors of the economy and certain regions of the country. The inflation rate was faster than in a number of other economies, consumption was excessive and the current account was deteriorating. State expenditure and tax rates continued to climb, and pay rises became excessive. Although all the problematic symptoms seemed relatively mild, they were continuous and building up.

In the late 1980s, the economy drifted into a crisis. One of the underlying factors derived from the sequence in which the gradual money market deregulation was carried out in Finland. Private sector borrowing was fuelled by general optimism and by specific features in the tax system. High interest rates attracted foreign capital in the country. Easy access to credit gave rise to excess liquidity in the market that could not be absorbed, whereas domestic deposits were still regulated.

As a result, domestic demand and especially private consumption became overheated. The prices of assets such as real estate and shares first rocketed and

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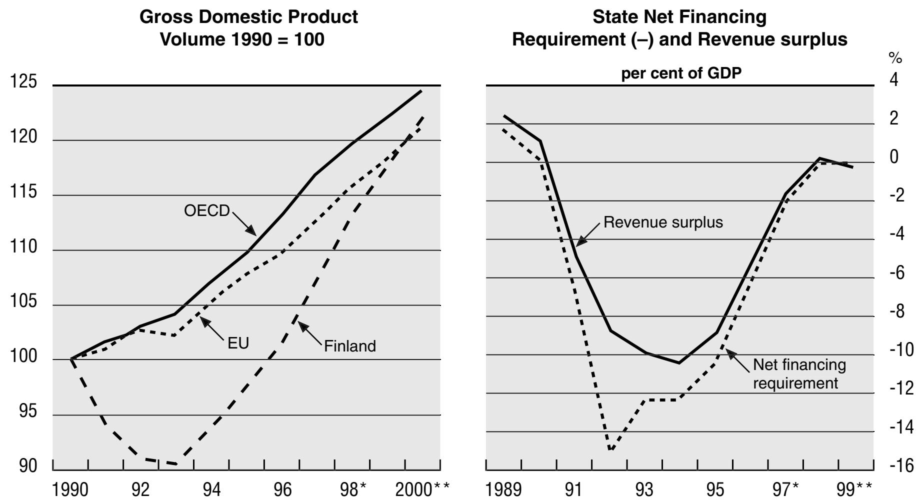
Figure 1*a* & *b*. **Gross Domestic Product & State Net Financing Requirement (–) and Revenue Surplus**



then plummeted. Investments, on the other hand, were channelled excessively to the domestic services sector.

Exports drifted into a weaker competitive position in the Western markets, while simultaneously Finland's trade with the Socialist countries, notably with the Soviet Union/Russia collapsed.

Notwithstanding these developments, a surplus was still recorded in central finances for a few years in the late 1980s, partly attributable to revenue growth. However, a number of improvements were also carried out in the statutory transfer systems and other areas of public expenditure. These changes were implemented in part by postponing cost effects to a later date, but many social reforms introduced in the late 1980s were underpinned by an overly optimistic assumption of the underlying trend rate of growth in the economy.

In hindsight, it can be said that the 1991 budget, submitted to Parliament in September 1990, epitomised the optimistic view of the future of central government finances, with the government and Parliament, preparing for elections, voting for fiscal expansion. At the same time, however, general mistrust was spreading as interest rates continued to rise and private sector saving was growing rapidly.

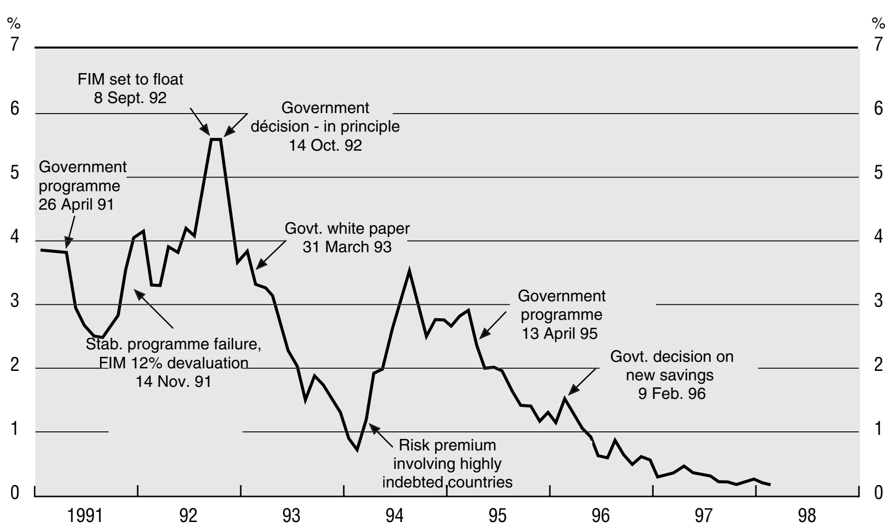
When the bubble burst, the plunge of the economy was fast and steep. In 1991-1992 alone, GDP declined by a total of more than 10%. Even in 1993, GDP continued to contract. By 1993, the unemployment rate had shot to 18% from the 4% of 1990. By virtue of legislation, government social expenditure grew sharply while tax revenue fell at the same time.

2. Stabilisation of Public Finances

It took some years before society was prepared to accept expenditure cuts. Political decision-makers, the media, and public opinion all had a weak understanding of the situation and were unwilling to take sufficient measures. It took time to comprehend the full extent of the new position and to reverse the course of the economy.

It was not until early 1991, when the recession was at its deepest, that the first tentative expenditure cuts were achieved. A new government came into office in spring 1991 and introduced a Government Programme that aimed at freezing state expenditure. Nonetheless, even the 1992 budget still provided for relatively few savings measures as several significant expenditure cuts failed to be passed by Parliament.

Figure 2. **Long-term Interest Rate Differential between Finland and Germany**



Eventually, strong fiscal consolidation measures became necessary, forced by financial market reactions. The government attempted to reach an extensive labour market agreement, whereby wages, salaries and other earnings would have been lowered. In November 1991, having failed in this attempt, it became necessary to devalue the Finnish markka (FIM).

A distinct mistrust continued in the financial markets, however, causing pressure on interest rates and the currency. One Friday in April 1992, the situation finally got out of hand. The government was then forced, in order to calm the markets, to decide during one weekend on an extensive package of savings measures. Before the closing of the financial markets on that April day, foreign currency was flowing out of the country at an extremely fast pace. However, the government managed to stabilise the situation by announcing savings measures, representing 2% of GDP, to be carried out in 1993. It was the beginning of a series of major expenditure reduction programmes, which were to continue until 1999. The Finnish markka was set to float in September 1992, and an increase in exports led the economy towards recovery.

Table 1. **Central Government Expenditure Cuts During the Years 1991-1999**

Expenditure item	Impact on the budget of the year 1999 FIM, billion
Transfers to local governments	14.5
Unemployment benefits, level and eligibility	5.5
Increased cost-efficiency in active labour market policies	3.7
Nullification of public sector obligation to employ	2.5
Pensions	4.5
Sickness insurance benefits	3.5
Family subsidies	1.0
Housing subsidies	5.0
Financial aid for students	0.5
Other social security	0.5
Subsidies to agriculture	1.5
Subsidies to industries	3.0
Central government administration	4.0
Central government fixed investments	2.8
Game monopolies increased share in financing public expenditure	1.0
Development aid; target level decreased from 0.7% to 0.34% of GDP	2.0
Total	56

Major improvement has been achieved in the economy by the pursuit of savings policies. In 1999, central government expenditure reached a level estimated to be almost 8% of GDP, lower than would have been the case without savings measures. Expenditure cuts have mainly involved state transfers to municipalities, the financing of welfare services, family support, unemployment benefits, public obligations related to the unemployed, compensation of medical expenses, subsidies to industries (including agriculture), government administrative expenses, and development aid.

3. Savings Policies Step-by-step

3.1. 1991 *to* 1994

In February 1991, the out-going government decided on expenditure guidelines for the next four years, the average volume increase in central government outlays being 2%. Following the spring 1991 elections, the centre–right coalition government of Prime Minister Aho came to power. The general need for fiscal consolidation was also recognised by the new government in the Government Programme, but no specific actions to achieve consolidation were defined. By and large, decision-makers still remained unaware of the true nature of the economic crisis.

The Government Programme outlined several longer-term reforms; for example, possible changes in the ownership of state-controlled companies were to be examined. A number of tax reforms were proposed; in corporate taxation, for example, the tax rate was to be lowered and the tax base broadened. These structural policy statements bore fruit later, and were helpful in gaining a broad picture of fiscal consolidation.

Soon after the parliamentary elections, leading civil servants at the Ministry of Finance wrote a separate programme that called for stricter fiscal discipline. Spending cuts amounting to 0.6% of GDP, freezing pay increases, and cuts in the tax allowances of households' interest expenses were all proposed. In the same spirit, the new government aimed for freezing central government outlays at their current level in coming years.

3.2. *First Decision-in-Principle*

The first one in a long series of savings packages was put together by the Aho Government on 10 May 1991, in connection with the spring 1991 supplementary budget. The first package amounted to about FIM 1.5 billion (0.3% of GDP) in expenditure cuts for 1991. Only about half of the cutbacks were permanent.

The expenditure cuts defined in this and the coming decisions-in-principles were implemented in several budgets and supplementary budgets. Further deterioration in the economic outlook gave rise to the need for frequent budget revisions. Indeed, in the years 1991-1993 numerous supplementary budgets were presented to Parliament (three in 1991, four in 1992 and five in 1993, while normally there had been two per year). The rate at which the economy declined was unanticipated and the regular budget process reacted inadequately to the developments under the circumstances. Moreover, a lack of adequate political commitment to cut expenditure prevailed in the first years of stabilisation, related in some respects to the unpredictability of economic developments.

The budget proposal for 1992, submitted to Parliament in September 1991, included around 40 different savings measures in order to meet the expenditure freeze decided earlier in the spring. The proposed measures would have decreased public expenditure by FIM 8.5 billion (1.7% of GDP). This budget proposal met with fierce resistance in Parliament. In the end, less than half of the proposed savings were implemented and were, in part, replaced by tax increases. Savings included, for instance, abandoning statutory index adjustments to income transfers and other benefits.

At the end of February 1992, the government drafted guidelines for central government expenditure for 1993-1995 and agreed that central government outlays should be frozen at the 1991 level in the coming years.

3.3. *Crisis of 5 April 1992*

In the early months of 1992, mistrust in the financial markets was reflected in pressures on interest rates and the currency. The situation culminated in early April and the government was then forced, in order to calm the markets, to decide during one weekend on an extensive package of savings measures. This reduced central government expenditure by FIM 10 billion (2% of GDP).

It was estimated that in the early 1990s, 75% of appropriations were tied-up by legislation (*i.e.* not discretionary). At that time, the Finnish Constitution contained a provision unknown in the constitutions of other countries; namely that a minority of one-third could vote to postpone a bill beyond the next parliamentary elections. In the late 1980s, the previous government recognised that this minority rule could threaten to foil every proposal for fiscal restraint and, therefore, started a process aiming to amend the Constitution. The size of the expenditure cutbacks that those behind the constitutional reform had in mind in late 1980s was to the tune of millions, rather than the billions of markka, that the cutback sums eventually turned out to be in the 1990s.

In 1991, many government proposals for spending cuts were rejected by Parliament. When submitting its proposals in April, the government came to the conclusion that the proposed amendment to the Constitution would be the only way to accomplish the required cuts in expenditure. Fortunately, a temporary amendment restricting the set of provisions on postponing a bill was now due for its decisive reading in Parliament. In June, both the opposition and the government voted for the amendment. Initially, the temporary amendment to the Constitution abolished the minority rule in spending cuts for a period of one year. Later, basic economic and social rights that had earlier been secured by provisions on the postponement of a bill were included in the Constitution. This constitutional reform was of crucial importance in getting government expenditure under better control.

The 1993 budget proposal was submitted to Parliament in early September with the optimistic assumption that an economic recovery of some kind would take place during the following year. By autumn, it became clear that economic developments would be worse than anticipated and outlays on unemployment benefits and bank support would be higher than forecast. Furthermore, tax revenue estimates had to be lowered.

3.4. 14 *October* 1992 *Decision-in-Principle*

In early October 1992, the government announced a White Paper on measures to be adopted in employment and industrial policies in both the short- and medium-term. Some structural measures, such as the obligation by the public sector to employ all long-term unemployed, were abolished, the public sector monopoly of employment services was removed, and employment benefits were reduced. These measures were aimed at increasing the credibility of government economic policies but they failed to meet the need for budget corrections. The approaching local government elections added to the government's pressure.

The constantly rising central government deficit was cause for concern at the Ministry of Finance. The budget proposal for 1993 needed to be corrected. Two days before the local elections, on 14 October, the government issued a Decision-in-Principle on measures to be taken for improving general government finances. The Decision contained expenditure cuts for 1993 equivalent to 0.7% of GDP. By 1995, the measures in this Decision-in-Principle had decreased central government expenditure by FIM 20 billion (3.5% of GDP). An amended 1993 Budget proposal was submitted to Parliament after the government's decision. One month later, the labour unions threatened the government with a general strike if cuts in unemployment benefits were implemented. A compromise was reached when government agreed to refrain from reducing unemployment benefits but would increase taxes instead.

The responsibility for introducing the inevitable budget corrections fell on the Ministry of Finance. On the whole, the general attitude of the ministries responsible for the expenditures during the years of spending cuts was a passive one.

3.5. 31 *March* 1993 *Decision-in-Principle*

The fiscal position in central government finances further deteriorated in early 1993. From the autumn of 1992 to the spring of 1993, possible disturbances in the availability of financing for government debt was considered a risk factor. The lack of confidence in Finland's ability to stabilise public finances still continued. This meant that government had to tackle the question of public expenditure cuts once more. In the Government White Paper published at the end of March, the government set a ceiling of 70% for the debt-to-GDP ratio. In March 1993, it was estimated that this commitment would mean FIM 20 billion (3.5% of GDP) in expenditure cuts.

The budget proposal for 1994 assumed a gradual cyclical recovery, with a forecast GDP growth of 1%. The outcome proved to be much more favourable, with GDP growth recorded at 4.5%. The budget proposal continued the programme of consolidation of public expenditures. It contained a number of savings measures with an estimated total impact on government expenditure of FIM 13 billion, which corresponded to about 2.5% of GDP. The budget included several one-year expenditure cuts effective in 1993 and extended to 1994. The budget proposal for 1995 continued the implementation of the list of measures decided earlier.

3.6. 1995 *to* 1999

After the spring 1995 national elections, the new "rainbow" government of Prime Minister Lipponen presented its fiscal policy in detailed terms and annexed an itemised list of expenditure cuts to the Government Programme, together with a timetable for further decisions on expenditure cuts. This proved a successful new procedure.

The government adopted as its main objective to reduce unemployment. The main fiscal policy target was defined in terms of curtailing state indebtedness;

state debt in relation to GDP was first to be stabilised and then reduced. Credible fiscal retrenchment, falling interest rates and economic expansion complemented this objective.

Permanent central government expenditure cuts amounting to FIM 20 billion (4% of GDP) during the four-year term were sought. This procedure secured political commitment to the savings package, which was planned to be front-loaded over its term of office. Measures worth FIM 16 billion were identified in the Government Programme, and a further FIM 4 billion worth of measures were decided upon in August 1995, as scheduled in the Programme. Precise and detailed savings plans in the Government Programme were deemed essential in restoring credibility in the stabilisation process.

More than half of the planned FIM 20 billion worth of expenditure cuts were completed in the 1996 budget. A temporary slowdown in economic growth in 1996 risked endangering the government's goal for the debt-to-GDP ratio. In February 1996, a package of new spending cuts worth FIM 1.6 billion was introduced.

On top of the expenditure cuts outlined in the Government Programme, the Lipponen Government was able to retrench central government expenditure on several occasions. Importantly, taxes on labour were also cut by almost 2% of GDP between 1995-1999.

3.7. *Central Government Outlays in 1990-1999*

Severe expenditure cuts and the restructuring of functions in central government limited overall state budget expenditure to less than FIM 200 billion in the 1990s. At the same time, direct unemployment-related expenditure (unemployment benefits, active labour market policies and housing allowances) increased rapidly. These were four times higher in 1997 than in 1990. Interest outlays on central government debt also quadrupled. In 1993, support granted to the banking sector raised central government financial investment to FIM 17 billion. The most recent estimates suggest that the overall losses from the support to banks, excluding interest expenses, will total around FIM 33 billion (just short of 5% of GDP), taking into account forthcoming extra redemptions and the expiration of remaining guarantees.

Table 2 presents the developments in central government budget expenditure. Some technical changes in budgeting (*e.g.* net budgeting of certain agencies) decreased the total outlays during the 1990s. The estimated impact of technical budgeting changes is FIM –2.5 billion in the period between 1991-1995.

Membership in the European Union at the beginning of 1995 introduced payments to and from the EU budget, increasing both budget revenue and expenditure.

In the late 1980s, several improvements were made in the statutory transfer systems and many reforms were launched. In the 1990s, while the existing systems were not abolished, the level of many benefits was lowered. In the years of fiscal consolidation, the welfare system saw almost no expansion. The only fiscally notable addition to the prevailing social system was every child's right to public day-care, which was introduced in 1995.

Table 2. **Central Government Outlays by Economic Category in 1990-1999**

	1990	1991	1993	1995	1997	1999	1999/91, %
Pensions	8.7	9.9	11.2	12.1	12.9	14.0	42
Operating expenditure	30.3	38.8	37.8	39.7	39.8	41.8	8
Consumption expenditure	**41.3**	**51.4**	**52.2**	**54.5**	**57.2**	**59.3**	**15**
Transfers to:							
➤ local governments	38.1	42.2	43.2	40.2	30.8	29.7	-30
➤ agriculture and industries	14.3	16.0	14.5	18.6	13.8	13.3	-17
➤ households and social insurance funds	28.1	37.0	44.5	44.7	44.7	43.7	18
➤ other domestic agents	3.3	4.7	6.6	5.4	5.3	4.8	1
➤ abroad	3.7	3.2	2.3	6.8	7.7	8.7	170
Total transfers	**87.5**	**103.2**	**111.1**	**115.8**	**102.4**	**100.1**	**-3**
Direct unemployment-related transfers	5.1	9.3	19.6	21.7	18.0	15.8	71
Net of unemployment-related transfers	**82.4**	**93.9**	**91.4**	**94.0**	**84.4**	**84.2**	**-10**
Fixed capital formation and land acquisitions	4.4	5.6	5.1	3.6	4.3	2.7	-52
Loans and financial investments (support to banking sector)	2.9	1.7	17.7	0.5	0.6	1.9	7
Investment outlays	7.3	7.3	22.7	4.0	5.0	4.5	-38
Interest payments	4.8	5.9	16.2	23.9	22.8	29.3	400
Total outlays	**140.9**	**168.0**	**202.2**	**198.3**	**187.4**	**193.3**	**15**
Memorandum items							
Unemployed jobseekers	103 200	213 200	482 200	466 000	409 000	345 000	
Consumer price index, 1990 = 100	100	104.2	109.7	112.0	114.0	117.0	
Central government salary index	100	105.4	107.1	111.0	118.0	124.9	

4. Structural Improvements in Central Government Administration

4.1. *Reform of Local Government Subsidies*

Structural improvements in public administration have improved efficiency and brought about further savings. Some improvements have been directly connected with acute fiscal consolidation, but most stem from a longer-term development process in public administration started at the end of the 1980s. One of the most important improvements was the new legislation governing transfers to local governments, the preparation of which dates back to the late 1980s.

Local governments provide social and health care services, as well as educational services (except universities). In 1993, a new system of central government subsidies to local governments was launched. The basic principle was to replace the earlier cost-based system of transfers with a new lump sum subsidy (per capita subsidy allowing for *e.g.* the age structure and the population density of the municipality). Compared to the old system of transfers, the new subsidy system gave local governments a strong incentive to produce services as cost-efficiently as possible, thus compensating for the adverse effects of the spending cuts in the 1990s.

4.2. *Result-oriented Management*

Result-oriented management was adopted on a large-scale in the early 1990s. Since 1995, all ministries and agencies have operated on a result-oriented management principle, bringing added discipline to central government management. Target results are assigned to administrative units, which are also given greater powers of decision on how to allocate their appropriations, as well as greater accountability for reaching the targets. Result-orientation also gave agencies greater flexibility in their personnel policy.

Each ministry is responsible for assigning targets to the administrative units in its branch of administration. Preliminary formulations of the targets are included in the budget proposal submitted to Parliament. A number of budget items were combined during the reform process into larger appropriation items to allow more flexibility and efficiency.

The result-oriented management approach also increased the administrative units' possibilities to collect service charges and fees. New legislation, which defined the criteria for these charges, was passed in 1992. At the same time, net budgeting was introduced in administrative units, which draws income from charges and fees.

4.3. Role of Market-type Mechanisms

Government organisations have become more competitive in a market-oriented operating environment through actions such as corporatisation and privatisation measures. In the 1990s, government functions such as computer services, printing services, catering, real estate maintenance, telephone services, postal services, the state railways, driving licence operations, motor vehicle inspection testing, electrical inspection functions, grain storage and improvement, minting, and banking services through Postipankki were all corporatised, with these companies being either partially or fully privatised.

Between 1994 and 1999, revenue from privatisation proceeds totalled FIM 40.3 billion (6% of GDP). The majority of these proceeds have been allocated to reducing the needs for further borrowing in recent years by being applied to reducing the budget deficit. It was not until 1999 that privatisation proceeds could be used to service state debt.

4.4. Human Resources in the 1990s

As a result of the economic recession, contractual pay increases were frozen from 1 April 1991 to 28 February 1995. Discretionary appropriation outlays that exceeded budget ceilings were no longer budgeted. The new general principle was that agencies are expected, by means of the new powers in personnel policy arising from result-oriented management, to accommodate operations and outlays to the appropriations allocated to the agencies.

These arrangements were also reflected in the budgeting of contractual pay increases. First, in the form of the above-mentioned wage freeze. Second, in the shape of a savings agreement contracted in 1993, which gave impetus to cuts in operating appropriations. The next pay settlement at the union level, signed in early 1995, was contracted on condition it would not imply any increases in budget spending. A period of comprehensive and moderate settlements prevailed from 1996-1999.

The savings policy adopted by the government also took the form of decisions on personnel cuts over the period. Originally, the government had started to reduce the number of personnel in 1989-1991. At that time, appropriations were reduced only partly in connection with the staff cuts. The budget proposals for 1993 and 1994 included direct cuts in operating appropriations amounting to 5.5%, and the 1996 budget proposal still included cuts of 1%.

Government staff numbers fell by about 93 000 man-years between 1989 and 1996. This is largely explained by extra-budgetary transfers deriving from corporatisation, privatisation, and vocational institutions being transferred to the jurisdiction of local governments. The effect of these measures amounted to around 80 000 man-years. The reduction of 13 000 man-years was achieved over the same period through central government savings measures, re-organisation of tasks in government agencies and through revamping of government functions.

Since 1997, a net growth of 3 000 man-years has occurred owing to new functions being allocated to the state and due to an increase in existing tasks. Based on a survey by the Ministry of Finance on personnel management in 1997, over one-half (58%) of government agencies experienced cutbacks in resources. Over a quarter (29%) of government agencies and organisations saw an increase in resources instead, mainly in the form of more personnel and increased extra-budgetary funding. Approximately one-fifth of government agencies experienced no change in resources.

Although government staff numbers have been reduced, government agencies have been able to continue operating and have also improved cost-effectiveness. The responsibility for operations and effectiveness of the agencies has become clearer, calling for constant prioritisation and adjustment of functions and resources.

4.5. *Multi-year Horizon*

State expenditure policy is based on expenditure guidelines that are approved once a year in February for the following three to four years. Although the expenditure guidelines are only politically binding, governments have been quite disciplined in respecting them.

In spring 1991, the government adopted expenditure guidelines for the first time with the aim of steering the 1992 budget proposal and acting as a basis of the medium-term economic plans for 1993-1994. The spending ministries are to keep their budget proposals within the limits of the total cash ceiling given in the guidelines, even though the guidelines are not legally binding as such.

In the early 1990s, deteriorating public finances soon made the expenditure guidelines obsolete. Today, under more stable circumstances, expenditure guidelines are increasingly becoming instrumental in steering budget proposals and in placing government spending under better control. The current guidelines build on the goal in the Government Programme to reduce the volume of expenditure to the level of the 1999 budget.

5. Conclusion

Overall, the Finnish economy reacted in the desired manner to the strict savings policies. The interest rate level started falling sharply in the mid-1990s, and the interest rate differential *vis-à-vis* Germany, for example, narrowed to nil. In 1994, the value of the currency recovered to the level prevailing before the currency float. Since then, the economic fundamentals improved so that, for a number of years now, the inflation rate has been one of the lowest in the EU, the current account has been well in surplus, GDP growth continues vigorously, and unemployment has decreased from its record level of almost 17% in 1994 down to a projected 8% in 2001.

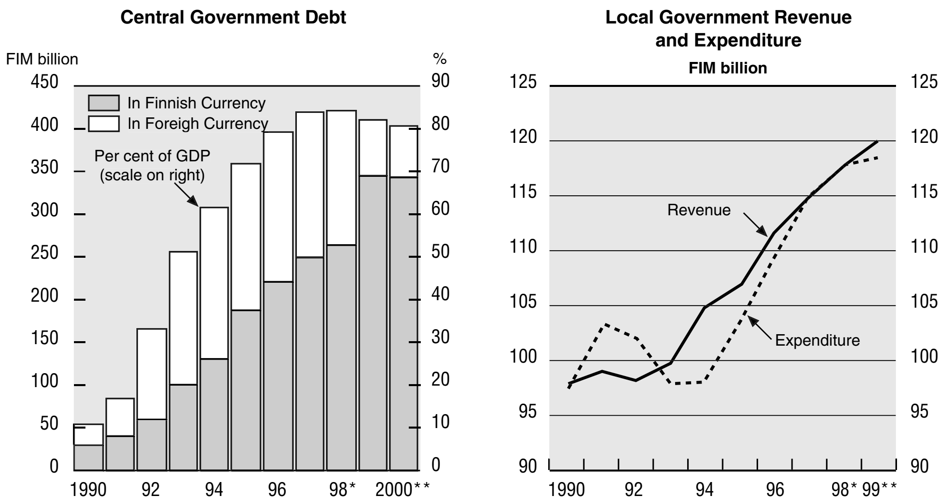
With the level of state debt being low in 1990, it was possible to sustain total demand by increasing state debt. If Finland's level of state debt had been at the average European level already in 1990, the financing difficulties that were later encountered would have hampered economic recovery more than proved to be the case.

The national goals aimed at stricter balancing of public finances than the criteria in the Maastricht Treaty required. In fact, the consolidation policy adopted in central government finances was at no stage based on the need to meet the Maastricht criteria. Rather, it was based on the need to regain the confidence of the financial markets and to restore government finances on a solid footing in order to meet the impending rise in pension expenditure arising from an ageing population.

Local governments carried a heavy burden of the cuts made in central government finances. In spite of all the cutbacks, indebtedness in municipalities has grown very little. On the whole, it can be said that local authorities have been able to adjust finances well to the spending cuts. Indeed, expenditure cuts give local governments a strong incentive to re-organise their services so that they are produced as cost-efficiently as possible. The balance in local government finances, when examined as an aggregate, barely weakened during the 1990s, although from one year to another, numerous local governments encountered economic difficulties. However, systematic problem areas didnot emerge.

The main purpose in reducing expenditure was to stabilise general government finances. Income tax increases were not resorted to because of their adverse effect on the economy and employment. In the 1990s, conditions of cyclical down-

Figure 3*a* & *b*. **Central Government Debt & Local Government Revenue and Expenditure**



Source: National accounts.

turn, increases in contributions to unemployment funds as well as to pension funds were inevitable, even though temporary legislation was introduced to allow social security funds to go into deficit during the deepest slump years. In the first recession years, the government was, on occasion, obliged to replace certain planned expenditure cuts by increases in social security contributions or taxes, because the proposed cuts were rejected by a qualified minority in Parliament.

The cutbacks in public expenditure were harshly criticised at first, but criticism has decreased in the course of the years as awareness of the full extent of the crisis became clearer to the general public. The Finnish population eventually accepted the volume of savings measures, perhaps because the crisis that Finland encountered was so grave. Despite the reductions in benefits, the distribution of disposable income remained unchanged even in the slump years. On the other hand, authorities have managed to improve efficiency in their activities so that no major deterioration in the level of services has occurred. At times, interest groups have strongly opposed the heavy savings measures, such as the cuts in unemployment benefits and agricultural aid. Nonetheless, successive governments have been determined to carry out savings measures even in sensitive areas.

Germany

By
Jutta Kalabuch*

1. Fiscal Policy between 1990 and 1998

After reunification in 1990, Germany faced exceptional financial burdens. In the following period the debt ratio rose from 41.5% of GDP in 1991 to 61.3% in 1997. During that period, the deficit ratio hovered around the 3% mark (the federal government's share was between 1.5% and 1.8%). One reason was that a large share of expenditure towards improving the infrastructure, boosting the economy and promoting research and development projects in the new *Länder* was funded by the federal government. For the most part, the necessary adjustment process in Eastern Germany was financed by means of borrowing. The federal government's share in total public sector debt and in the total government deficit rose disproportionately compared with the other levels of government. Reducing the debt and deficit ratios – and bringing the federal government debt ratio down from over 50% to the pre-unification level of 46% – have, therefore, become important fiscal policy goals of the federal government.

These fiscal policy goals were not achieved by 1998, although measures were taken to reduce the deficit – also with a view to meeting the criteria set out in the European Stability and Growth Pact.

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Important consolidation measures taken in the 1990s included:

- budget freezes and across-the-board spending cuts totalling DM 14 billion from 1990 to 1999, corresponding to around 0.3% of the overall budget volume over those years;
- DM 2 billion in relief through the *Federal Consolidation Programme* in 1993;
- relief totalling DM 16.8 billion (around 3.5% of the budget volume) through the *Savings, Consolidation and Growth Programme* of 1994 which contained a vast number of individual measures; and
- relief achieved by implementing the *Programme for more Growth and Employment* in 1997 amounting to DM 22 billion, or around 4.5% of the budget volume.

The impact of these cost-cutting measures, however, has generally been of limited duration only. In individual cases, it even led to increased spending in the following years or served only to close financial gaps owing to unfavourable cyclical trends (*e.g.* the recession beginning in 1993). The federal government has also trimmed the deficit by selling off a large volume of assets. This has not rehabilitated public finances on a sustainable basis, but has instead resulted in an annually recurring shortfall. Sustainable measures were the only way to close this gap.

2. Motivation and Political Direction for a Change in Policy

Eight years after unification, Germany was again in a difficult fiscal and macroeconomic position. In particular, this was reflected in the 1999 federal budget:

- stubbornly high unemployment, with correspondingly high labour market spending. Unemployment in unified Germany rose from 7.3% in 1991 to 11.1% at the end of 1998. In 1998, unemployment was around 9.4% in the former West Germany and around 18.2% in the former East Germany;
- the continuing erosion of the tax base; and
- insufficient provision for guarantees granted in connection with international financial crises.

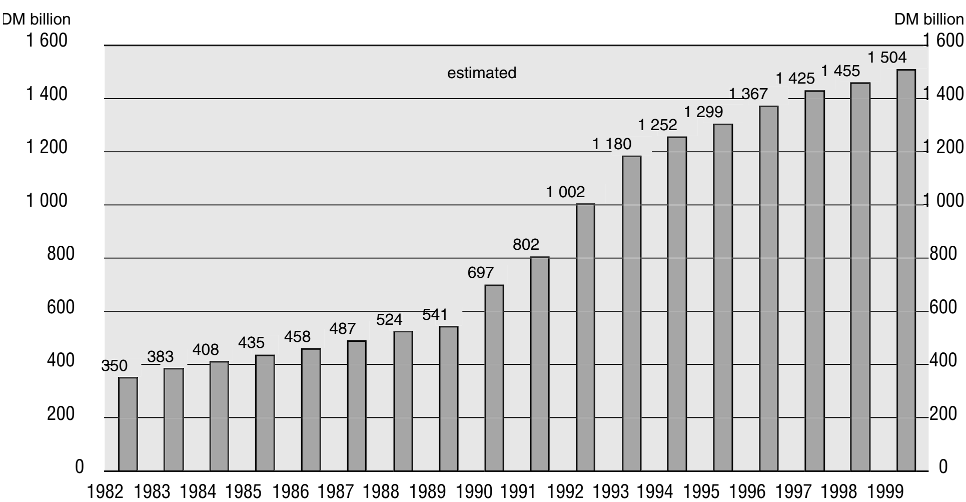
Against that background, it was necessary to reverse the trend in the development of federal finances, which had started to become disadvantageous – also in comparison with the other levels of government. The necessity of a fiscal policy turnaround is demonstrated in Table 1, which shows a comparison of various fiscal policy operating variables in the years 1980, 1991 and 1998.

Table 1. **Key Fiscal Policy Variables**

Federal budget		1980	1991	1998
Debt level (including federal special funds)	DM billion	233	680	1.454
Share of federal debt in total public debt	%	50.4	58.4	64.4
Federal debt as a % of GDP	%	15.8	23.2	38.4
Interest burden	DM billion	14.0	41.5	79.1
Share of the interest burden in total expenditure	%	6.4	10.3	17.3
Share of tax revenue consumed by the interest burden	%	7.9	13.1	23.2
Share of expenditure covered by tax revenue	%	81.6	79.1	74.7
Share of the federal government in the financial balance of the overall public sector budget	%	48.4	46.6	96.2

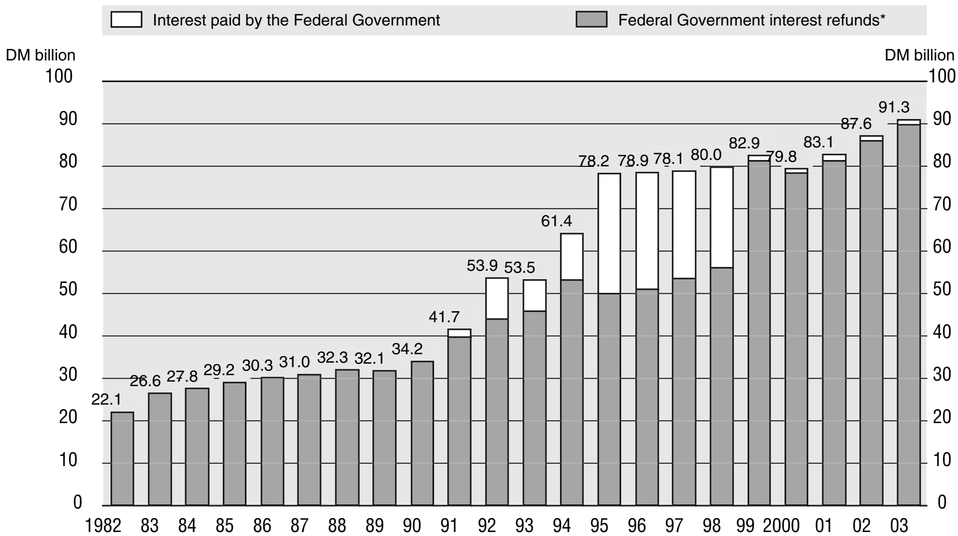
During the period under review, the federal government's debt level increased more than six-fold. This was mirrored almost exactly by the development of the interest rate burden in the federal budget during that same period (see Figures 1 and 2). Interest rate spending now accounts for almost one-quarter of tax revenue. One-quarter of federal budget spending was no longer financed by taxes but by other revenue – especially one-off revenue, *e.g.* from privatisations and the selling of other assets – and by borrowing.

Figure 1. **Development of the Federal Government's Debt Since 1982**



* including federal special funds

Figure 2. **Development of the Federal Government's Interest Rate Burden Since 1982**



* Federal Government interest refunds for the following special funds :
– Fund, German Unity
– Erblastentilgungsfonds (ELF)
– Federal Railways Fund (BEV)
– Coal - Generated Electricity Fund
Pursuant to the Act on the Absorption of Debts of the Special Funds in the Federal Debt, since 1999 the Erblastentilgungsfonds, the Federal Rauilways Fund and the Fund for the Generation of Electricity have no longer received interset refunds. Interest payments on those special funds debts absorted by the Federal Government are now made in the same manner as those on Federal debt itself.

Bearing macro-economic inter-relationships in mind, the need to comply with the rules of the European Stability and Growth Pact, and to keep new borrowing sustainably below the limit set forth in Article 115 of the Constitution (pursuant to which investment must be higher than net borrowing), lasting consolidation was imperative.

By continuously curtailing public sector deficits, the **Future Programme 2000** (***Zukunftsprogramm* 2000**), adopted in the summer of 1999, will systematically rehabilitate public finances while at the same time strengthening the forces of growth and improving the investment climate by implementing comprehensive tax reforms.

3. Dual Fiscal Policy Goal in Tax and Budget Policy

The federal government's fiscal policy is aimed at achieving two goals: to consolidate government finances by achieving a budget without any net borrowing by the year 2006, and to improve the general conditions for business and individuals by means of sustainable tax relief measures. The strict spending limits are intended to create scope for fiscal action in the future; the tax cuts are designed to strengthen Germany's position as an industrial location and to give impetus to increased employment. These fiscal consolidation objectives require the implementation of structural reforms.

4. Consolidation by Means of the Zukunftsprogramm 2000

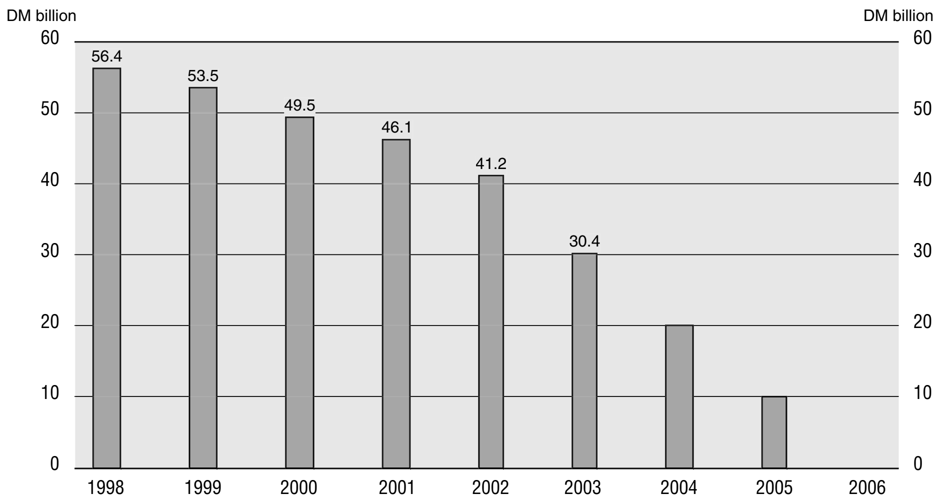
Within the framework of the *Zukunftsprogramm* 2000, the federal government initiated a comprehensive austerity programme in its draft budget for 2000 which intended to tackle the federal budget's structural problems, with total savings amounting to some DM 28 billion in 2000, rising to some DM 46.5 billion in 2003. This corresponds to around 5.5% of the budget volume and around 0.7% of GDP in 2000, and around 8.5% of the planned budget volume and around 1% of GDP in 2003. The consolidation programme is thus designed to stretch over several years. Some two-thirds of the measures will be implemented within the context of the normal annual budget procedure. Around one-third of the measures have, in the meantime, been statutorily fixed through legislative channels. The main goal is to achieve a balanced budget with no new borrowing by the year 2006. (See Figure 3.)

4.1. *Institutional Arrangements*

In view of the magnitude of the task, the savings package was designed from the outset as a joint task shared by all Cabinet ministries. The volume of savings deemed necessary for a sustainable consolidation (DM 30 billion for 2000, going up to DM 50 billion in 2003) was thus distributed across all Cabinet ministries in accordance with the share of their individual budgets in the total budget for 1999. In consultation with the Federal Chancellor, the Federal Minister of Finance then requested that all ministries put forward proposals stating how they intend to achieve the pre-determined level of savings.

The basic idea was to take the DM 30 billion being saved in the 2000 budget and to extrapolate that in equal increments to DM 50 billion in 2003. In the first step, the budgeted amount for each ministry in 1999 were taken as a starting point, and their percentage share in the total budget excluding interest paid was calcu-

Figure 3. **Planned Development of New Borrowing by the Federal Government up to 2006**



lated. The 1999 federal budget was taken as the baseline. As the first budget of the new federal government, it reflected the change of focus from earlier budgets. The figure calculated in this manner then indicated how much each ministry would have to contribute to the savings package of DM 30 billion/DM 50 billion. The amount each ministry had to save was thus specified in marks and pfennigs. On the basis of the volume of the 1999 budget, the savings of DM 30 billion/DM 50 billion correspond to a reduction in the budget estimate by 7.4%/12.3%.

Then, in the second step, an assessment was made for each ministry as to whether any adjustments were urgently needed to be included in the 2000 budget and in the financial plans of the individual ministries up until 2003. An example would be adjustments for changes in key indicators (which would be decisive for, e.g. unemployment assistance and federal grants paid to pension insurance funds). Each particular ministry's financial plan for the years 2000 to 2003 – as established on the basis of the negotiations on the 1999 budget/financial plan up to 2003 – was either reduced or increased in line with those variables urgently in need of adjustment. The pro rata amount of savings calculated for each ministry in the first step was then subtracted from that particular ministry's budgetary appropriations. The resultant figure was then intended to set the fiscal framework for the forthcoming budget talks.

In the third step, each ministry was then requested to provide concrete proposals for the cuts which needed to be made. In parallel, the Federal Ministry of Finance worked on proposals it thought practicable in order to have complementary measures which it could provide on short notice if they became necessary. After each ministry's proposal reached the Federal Ministry of Finance, the Finance Ministry and the other ministries jointly worked out which proposals were best-suited to implementing the savings package, taking the policy goals of each ministry into account. The outcome was the consolidation package passed in the summer of 1999.

Important consolidation measures in this package include:

- The adjustment of pensions to demographically related burdens in the coming years. The increase in pensions in the years 2000 and 2001 will be geared towards the objective of securing real incomes, *i.e.* the pensions will be adjusted for the inflation rate of the previous calendar year. As with pensions, the raising of other social benefits, such as unemployment benefits and unemployment assistance, will be geared to the inflation rate of the preceding year in 2000 and 2001.
- Social security contributions for recipients of unemployment assistance will in future be geared to the actual amount of unemployment assistance paid. Up until now the assessment basis was 80% of the earner's last gross salary prior to unemployment.
- Subsidies will start to be dismantled on the expenditure side (*e.g.* reductions in gas oil subsidies, need-based adjustments in low-rent housing construction).
- Linear job cuts in the federal administration over the next four years.

4.2. *Market Economy Mechanisms*

Considerations on which activities can best be performed by the private sector via the markets and which activities urgently require government action are inherent in the consolidation programme. Moreover, the question presents itself as to how the government can perform its tasks most efficiently and, as appropriate, in a market-related manner. In that respect, market economy thinking has gone into all points of the consolidation programme. Some examples are:

- the dismantling of subsidies;
- staff adjustment in the federal administration;
- the increasing use of fees for government services;

- the introduction of market economy aspects in building management;
- rent adjustments for federally-owned rental property and the sale of property no longer needed; and
- the prioritisation of tasks.

4.3. *Overall Lessons Learned*

From the standpoint of political viability, it seemed appropriate to cut each ministry's budget by the same percentage. This not only led to quantitative consolidation. Within individual ministries' budgets, it sparked off political decisions as to where spending could be cut, and to what extent. Within individual plans, this has, therefore, also resulted in a change in the structure of spending as a whole and to increased emphasis on focal points.

In addition, the federal government has taken on a pioneering role with its consolidation policy and is thus putting pressure on other levels of government to reassess their own spending practices. In this manner, the government has given an important boost to the objective of achieving a balanced budget. A balanced budget will lead to a stabilisation of, or reduction in, the debt ratio and thus to a stabilisation of, or reduction in, the interest burden in public sector budgets. With GDP on the rise, the federal government's interest-to-tax ratio will decline, creating or expanding fiscal policy latitude.

5. Tax Measures of the Zukunftsprogramm 2000 and the Tax Reform for 2000

The *Zukunftsprogramm* 2000 contains not only spending cuts but also the implementation of comprehensive tax reforms comprising income tax reform and reform of family taxation. These measures were supplemented by an ecological tax reform and a tax reform 2000 which consisted mainly of a reform in corporate taxation.

Table 2. **Tax Reform Measures**

	Tax Relief Act			Tax Reform 2000		
	1998	**1999**	**2000**	**2001**	**2003**	**2005**
Basic tax allowance (DM)	12,365	13,067	13,499	14,093	14,525	15,011
Bottom rate	25.9%	23.9%	22.9%	19.9%	17%	15%
Top rate	53%	53%	51%	48.5%	47%	45%
Top rate for industrial income	47%	45%	43%	-	-	-
Corporation tax	45%/30%	40%/30%	40%/30%	25%	25%	25%

The tax reforms already implemented by the federal government and those adopted – especially the tax reform of 2000 (including corporate tax reform), the Tax Relief Act and the Family Assistance Act – will bring taxpayers a net total of around DM 70 billion in relief between 1998 and 2005.

The corporate tax reform was announced by the federal government on 21 December 1999, to take effect on 1 January 2001. The objective is to enhance international competitiveness and to create incentives to invest. In addition, corporate tax law is to be brought in line with the rest of Europe. The plan envisages net relief amounting to just over DM 8 billion in its first year.

Korea

By
John Ming Kim*

1. Introduction

As a policy issue, reallocation of budgetary resources had not attracted serious attention in Korea before the foreign exchange crisis of late 1997. The need to adjust funding priorities for individual projects and sectors had been continually raised in academic and government circles, which included concerns over the long-term viability of the nation's pension system and the forecast increase in demand for investment in social infrastructure. However, the discussions remained mostly limited to issues specific to the concerned sector, without being developed into a broader framework which explicitly addressed the issue of budgetary resource allocation – *i.e.* the balancing of a sector's funding priority against the needs of other sectors competing for the same limited resources.

Several factors underlay this apparent indifference. First, government policy had been deliberately moving in the direction of decentralisation for some years. An initiative that even remotely suggested central planning would not have met with a very favourable reception in this atmosphere. This would have been especially true if the initiative was one so fraught with political ramifications as in the case of adjusting resource allocation priorities. Similarly, the economy had been doing too well for some time for such a painful and daunting task to garner much interest and support. Reinforcing such thinking, the nation's budget had been in

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balance or slight surplus for over a decade. Such a strong fiscal position gave the government even less reason to start thinking about re-examining its spending priorities.

All this changed, however, with the foreign exchange crisis of late 1997. The catastrophe that had started as an abrupt melt-down in the country's foreign exchange market quickly spread to the economy's banking system and the real sector, dealing a severe blow to seemingly all economic activity. Faced with a crisis of such a magnitude as to be quickly dubbed "the greatest national emergency since the Korean War", the newly elected government had to come up with a programme to arrest the economy's freefall and ensure its quick recovery. Forced to come up with the massive funds to implement the restructuring plans throughout the economic system despite a drastically shrunken revenue base, the government had to deal seriously and decisively with the issue of adjusting the nation's budgetary priorities.

2. Motivation for Resource Reallocation

The government-led national response to the economic crisis called for a thorough restructuring of the economy, to be concentrated on four major targets: the financial system, the business sector, labour, and the public sector. The restructuring programme in each of the first three sectors required substantial fiscal support from the government. The public sector not only had to shoulder a large part of the restructuring burden of the other sectors, but also needed to undergo restructuring for its own sake as a sector claiming a major portion of the economy.

Motivated by these considerations, the reallocation of budgetary resources had four main priorities. The first was to restore the economy's financial system to normalcy as quickly as possible. This entailed freeing banks and other financial institutions from their burdens of massive non-performing loans, paying deposit insurance to customers of banks that were closed, and recapitalising some of the banks. Public bonds totalling 64 trillion Won were issued to finance such operations. The government's role in this was to guarantee payment on the bonds and to assume payment of interest.

The second major priority was expanding the social safety net. Because Korea's official welfare system had been relatively underdeveloped, this was absolutely necessary to make corporate restructuring possible, with its inevitable large layoffs. Expanding the social safety net also played a crucial role in securing co-operation from the country's militant labour unions. Funding was increased in this sector to provide temporary jobs through public work programmes, to offer more vocational training opportunities, to subsidise the education of children in low-income households, and to broaden coverage of transfer programmes to ensure minimal subsistence standards.

Third, budgetary priority was shifted to spending programmes to boost the economy. In the short-run, this was to use fiscal policy in its traditional counter-cyclical role by providing the economy with a large stimulus. In the long run, the increased spending aimed to preserve the economy's industrial base, which was in grave danger of serious corrosion from disrepair and neglect amid the chaos. Another long-term focus of the increased government spending was to start laying the foundation for new sources of growth in the coming years. Social infrastructure investment was expanded, as was support for activities that would create new jobs, especially for venture start-ups and areas related to information technology.

The final objective of resource reallocation was reforming the public sector. The national crisis provided the motivation for a serious attempt at correcting the sector's inefficiencies that had built-up over the years. Besides the purely economic rationale, finding itself in a leadership role of pushing the painful restructuring process, the government had a moral obligation to set an example for the other sectors to follow. This was especially important in the Korean political and cultural setting. In contrast to other sectors, the effort here concentrated on reducing expenditure while boosting efficiency to maintain the level of public services provided.

3. Extent of Budgetary Reallocation

Reflecting the policy directions explained above, some major adjustments were made in the composition of the national budget. These are outlined below in Table 1.

The table shows that interest payments on public bonds issued for financial restructuring have increased steadily since 1997, as bonds worth 64 trillion Won were issued from 1997 to 1999.

Similarly, the category "unemployment" parallels the economy's unemployment rate, which soared from virtual full employment before the crisis to a peak of 8.7% in February 1999. Spending in this category mostly went to temporary policy measures to combat rising unemployment, such as temporary jobs provided through public work programmes and to vocational training and assistance in job searches. The drop in the year 2000 budget reflects the falling unemployment rate as the economy recorded a sharp recovery from the negative 5.8% growth of 1998 to the strong positive growth in 1999.

Table 1. **Key Fiscal Policy Variables**
(in billions of Won)

Budget Expenditure Category		Fiscal Year				
		1996	**1997**	**1998**	**1999**	**2000**
Financial Restructuring	Financial Restructuring	NA	NA	3 600	5 318	5 955
Social Safety Net	Unemployment	NA	NA	5 663	9 585	6 418
	Welfare	3 524	4 039	4 553	5 060	5 724
Fiscal Stimulus	Support for SMEs	2 489	2 853	3 909	4 490	3 782
	Infrastructure	8 148	10 130	11 500	13 409	14 077
Investing in the Future	Science & Technology	2 380	2 773	2 702	3 106	3 531
	Information Technology	328	474	770	1 200	1 108
	Environment	1 658	2 174	2 359	2 296	2 757
Public Sector Spending	Education	15 565	18 171	17 486	17 903	19 172
	National Defence	12 736	14 351	14 376	14 337	15 043
	Civil Service Salaries	7 886	8 568	8 245	7 760	8 645
	Law Enforcement	1 125	1 210	1 170	1 170	1 172

N*ote*: Figures in the table include expenditures from both the general and the special budget accounts. Only budget categories involving key reallocation decisions are shown in the table. The columns do not add up to the total budget for the respective fiscal years. The Korean fiscal year is the same as the calendar year.

Besides these unemployment policy measures, the social safety net was also strengthened through more active social welfare. In contrast to unemployment programmes, spending in this category has kept on increasing through 2000 despite the economic recovery. In large part, this reflects the widening income distribution gap as the economy accelerates toward a more market-oriented system.

Fiscal stimulus for the sagging economy was provided by increased support to small- and medium-sized enterprises (SMEs), as shown by the large increase after 1997. The drop-off in this category in the year 2000 is explained by the decline in temporary credit offered to SMEs to help them over spots of tight liquidity problems. Fiscal stimulus was also provided through large increases in social infrastructure expenditure, mainly to the construction of new transportation facilities, including highways, railways, ports, and airports. Besides the immediate boost that such investment would provide to the economy, these projects are being pushed with the goal of improving economy-wide efficiency by bringing down transportation and storage costs.

Despite the pressing concerns of dealing with the immediate crisis, the importance of long-term investment was also recognised. In science and technology, funding for research and development has steadily increased, notwithstanding a cutback in 1998 when the economic crisis was at its worst. Spending on information technology has also increased at a rapid rate, driven in large part by new investment in high-speed communications networks. Environment is another area that has seen steadily increasing funding support.

The increased spending in these other sectors was made possible mainly by reducing or freezing expenditure levels in the public sector. The reduction in education and national defence budgets during 1998 or 1999 are admittedly not that large in absolute amount. However, as large budget categories that have historically been very rigid, the mere fact that spending was actually reduced takes on great symbolic significance. Especially in the case of national defence, the budget cut in 1999 was the first ever in the nation's history. The civil service took on a large sacrifice in the form of salary cuts during the crisis to support the economic restructuring. The large increase in 2000 is explained by the restoration of former salary levels. Also playing a role in the increase is the implementation of a programme to gradually raise the low salary scale of the civil service in line with private sector salary levels, introduced as part of the reform drive to make government more competitive.

4. Institutional Arrangements

Bringing in such sweeping changes to the national budget, as opposed to incremental adjustments to the existing budget process, required that a new budgetary authority be designated and empowered to initiate swift changes. The newly elected government was quick to turn the urgency of the crisis into momentum for change and promptly undertook a re-organisation of the executive branch to realign the government with the new national priorities.

Under the new arrangement, the Planning and Budget Commission (PBC) was established as a special commission reporting directly to the president. The PBC was given the responsibility of directing the budget process and had final authority over the executive branch's budget decisions. Additionally, the PBC was also given the mandate of directing the public sector reform programme. The actual formulation of the national budget, however, remained the responsibility of the National Budget Office (NBO), at the time technically under supervision of the Ministry of Finance and Economy. Until the PBC and NBO were later consolidated into the Ministry of Planning and Budget (MPB) during the second government reorganisation in May 1999, however, the NBO was in practice directly supervised by the PBC.

Budget reallocation was necessarily a centralised process under the PBC and NBO, and later, the MPB. Instead of simply dictating changes, however, these organisations went to extraordinary lengths to secure the co-operation and understanding of the general public and the ministries, agencies, and other parties in the public sector that would be affected by the changes in budgeting priorities. Issues have been aired and consensus sought through weekly Cabinet meetings presided over by the president, regular meetings among the "economic" ministries, and other ad hoc channels of communication at the ministerial and vice-ministerial level.

Besides frequent consultation with budget officers at other line ministries and agencies, the PBC (MPB) has also set up formal and informal channels through which the concerns and opinions of a wider spectrum of interest groups and the general public can be voiced. These include budget hearings with mayors and provincial governors; public hearings in which scholars, officials, and other parties participate; and a web-based bulletin board that carries discussions on the budget and public sector reform. Overall, the aim is to solicit input and feedback from as broad and representative slice of society as possible on the nation's spending priorities and how the taxpayers' money is being spent.

The annual budget process in Korea begins in March when the budgetary authority transmits the budget guidelines for the year to the line ministries and agencies. For 1998 and 1999, the budget guidelines issued by the PBC requested that excepting the priority areas explained above – financial restructuring, social safety net, social infrastructure and technology – the ministries hold down the annual increase in their budget requests below a certain level.

To enable the line ministries to better cope with their tighter budgets, the budget ceiling system was introduced to some parts of the budget. First, the budget process was modified to handle multi-year projects (*e.g.* large-scale construction projects in social infrastructure) or programmes with regular annual expenses (*e.g.* upkeep of national monuments) as a separate category. Projects designated for inclusion in this category would only have budget ceilings specified for the project or programme, with details of spending to be determined by the concerned ministry or agency. Aggregate expenditure ceilings were also applied to the basic operating expenses (transportation, facilities, consumables, etc.) of the ministries. In 1999, the ministries were asked to accept a 10% cut in their operating expenses.

5. Evaluation and Performance Measurement

Regular evaluation of ministries and agencies has been traditionally done through internal audits and by external audits conducted by the national Board of Audit and Inspection and the Office of the Prime Minister. However, these audits and inspections have not been carried out with a view to reallocating budget resources.

Currently, evaluation and performance measurement for purposes of resource reallocation is done by the Budget Management Bureau at the MPB, which was newly established for that purpose. The Budget Management Bureau is in charge of preliminary feasibility studies for large-scale national project proposals and also keeps track of spending in large-scale multi-year projects. Due to limited manpower the Bureau currently has difficulty in expanding its activities into other areas in government spending. The Bureau's evaluations serve as the basis for amending relevant laws when necessary, and are also incorporated into budgeting decisions for subsequent years.

A study is currently under way at the Government Reform Office of the MPB for wide application of performance-based budgeting in government. Upon completion of the study, the recommendations will be legislated.

6. Accrual Accounting and Multi-year Budgeting

The Government Reform Office has recognised the necessity of introducing accrual accounting to government to raise fiscal transparency and efficiency. A committee was formed in December 1998 for this purpose. The committee commissioned a study in for implementing accrual accounting in the central government. For local governments, two local governments have been selected as pilot cases, and a similar study was commissioned. Upon review of the recommendations by the study groups and the results from pilot cases, the current plan is to introduce accrual accounting to local governments in 2002 and to the central government by 2003.

The need for explicit multi-year planning was recognised early in the economic crisis, in no small part because the national budget would be required to run a deficit amounting to 3-4% of GDP for several years in order to cope with the economic crisis. Accordingly, the PBC drew up a medium-term fiscal plan in late 1998, which outlined a plan to return the budget to balance by the year 2006 and net government debt by 2016. The plan does not specify budget items in detail, but rather outlines expenditure plans by broad spending categories, outlining the nation's priorities for the coming five years or so. Although it is not legally binding, the medium-term fiscal plan takes precedence over the annual budgets, which adhere to the policy directions specified in the multi-year plan. Finally, the medium-term fiscal plan is a flexible, indicative plan, subject to annual updates to respond appropriately to new developments in the economy. For example, because the economy recorded such a strong and swift recovery in 1999, the schedule for returning the budget to balance has been brought up by two years from the originally projected 2006 to 2004.

7. Conclusion

Korea's recent exercise in budgetary resource reallocation was an extraordinary effort in response to an extraordinary event, rather than a change that came about naturally out of gradually evolving new developments in the economy. Because decisive action was required under the pressure of a national emergency, the process was necessarily somewhat more *ad hoc* in nature than it would have been under more favourable circumstances. With the crisis behind them now, the focus of public sector reform has shifted to keeping up the momentum of change by integrating the process for change itself, including budget reallocation decisions, into regular institutionalised procedures of government.

Switzerland

By

Peter Saurer and Olivier Kungler*

1. Introduction

In Switzerland, we consider one of our big achievements in the 1990s to have been the efforts to eliminate the budget deficit at the federal level. We consider this experience of possible interest to other OECD Member countries as the process of deficit reduction went beyond pure technical issues and encompassed new forms of political bargaining. To some extent, our experiences might be considered as a paradigm of political economy.

1.1. General Features of Swiss Public Finance

Switzerland comprises a federal state, 26 cantons and approximately 3 000 communities. Over time, a tightly knit network of co-operation has been established between the three levels of government and within the two lower levels. It goes without saying that this development has resulted in increasing flows of fiscal transfers. Thus, the share of transfers (including to recipients in the private sector) of the federal budget has increased from 42% in 1960 to 73 % currently.

In addition to the three levels of government just mentioned, we distinguish in our statistics of public finance a fourth sector, social security. Adjusting the

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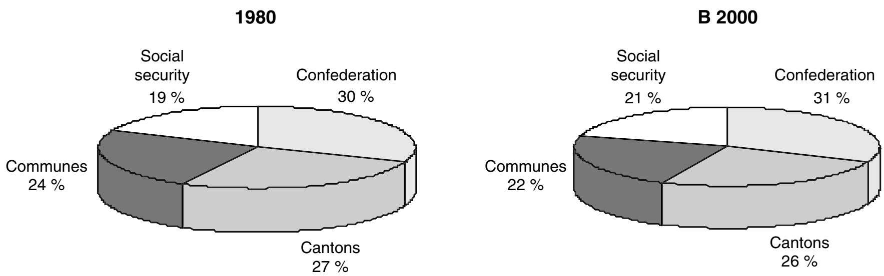
Figure 1*a* & *b*. **Shares in the Financing of Public Expenditures 1980/2000**



accounts of the four entities for flows of payment among them, and attributing the expenditures to the sector that originates them, the four sectors have evolved over time as shown in Figure 1.

These graphs reveal a remarkable stability over time. This stability, however, disguises an important fact i.e. the huge increase in spending for the social security sector. This increase has been financed to a large extent by the Confederation and the cantons. This spending is not attributed to social security, but mainly to the Confederation and the cantons shown in Figure 1.

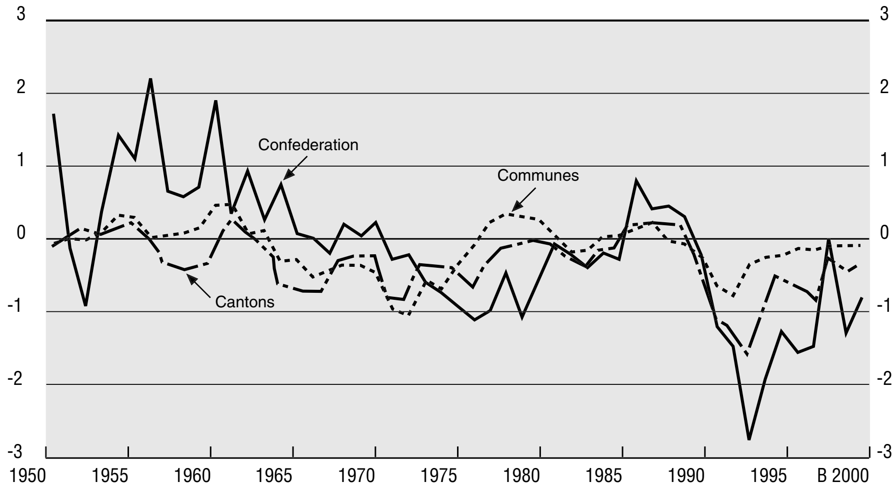
All three levels of government have been struggling with periods of public deficits. In the very long-run, average deficits as a percentage of GDP have been largest for the cantons with 0.33%, followed by the Confederation (0.16%) and communes (0.13%). The Confederation has shown, by far, the greatest fluctuations in its deficits over time e.g. the standard deviation of its deficits amounted to 0.99. Regarding the more recent past, Graph 2 reveals larger problems at the federal level, followed by those at the cantonal and local level.

As we shall focus in the main part on resource reallocation on the federal level, some issues and features of federal public finances are described in more detail below.

1.2. *Dramatic Deterioration of the Federal Budget Position Until 1998*

The size of the deficits and the increase in public debt in the 1990s was unprecedented by historical standards since World War II. The debt ratio doubled; it increased by 12 percentage points. Accumulated deficits reached 30 billion

Figure 2. **Deficits and Surpluses of the Confederation, Cantons and Communes as a percentage of GDP 1950-2000**



Swiss francs or 7.5% of GDP at its 1999 level. This can be attributed to an increase in spending in real terms from 1.7% on average in the 1980s to 2.8% in the 1990s. The difficulties were further exasperated through a long period of economic slack up to 1996.

The pattern of public spending at the federal level over the last twenty years reveals some interesting characteristics:

- the deviation of spending for different activities from trend was small in the 1980s;
- looking back, 1990 stands out as a year of profound change. Since then, expenditure for different types of public activity has evolved in a disparate way:
  - *defence* expenditure has declined, not only in relative terms, but in absolute terms as well;
  - the other extreme has been spending for social security and for unemployment insurance, in particular. The Confederation granted loans to the
  - unemployment insurance scheme in the early 1990s which are treated as expenditures in the federal accounts;

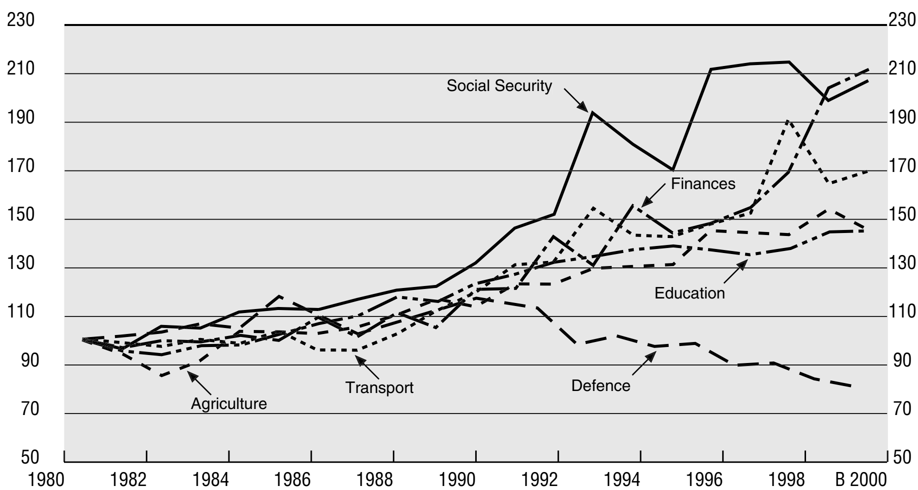
– cantons share in the revenues of the federal income tax (30%) and the withholding tax (10%). These transfers and higher interest payment explain the development of finances; and
– expenditure for transportation (public transport, investment in transport infrastructure) has grown faster than expenditure on average.

Before going into the details of the Budgetary Target 2001, the Stabilisation Programme and the planned Expenditure Rule, some public finance figures are provided to illustrate the worsening situation in Switzerland during the period up to 1998.

As mentioned earlier, the increase in public debt reached a 40-year high in 1997. The continual loss of fiscal discipline is expressed in the following figures:

- after having been balanced in 1990, the federal budget was in deficit for the following years with a peak in 1993 (2.2% of nominal GDP);
- the dramatic deterioration is best shown in the development of the gross federal debt as a percentage of GDP, which more than doubled from 12.1% in 1990 to 27.7% in 1998.

Figure 3. **Development of Federal Expenditures by Sector 1980-2000 (real, Index 1980 = 100)**



This development of Swiss public finance strongly contrasted with the successful consolidation in the countries of the European Union at the same time. All members of the EU reduced their general government deficits; some of them even achieved a surplus.

For a better understanding of the political context in which the Swiss Budget Consolidation Programme is taking place, the following introduction to the political system in Switzerland may be useful.

2. A Brief Introduction to the Political System of Switzerland

In Switzerland, the tradition of direct democracy is an essential element of its political system and hence in the political economy of public finance as well. By collecting 100 000 signatures, anyone in the country can initiate a change in the federal Constitution. For any changes to the Constitution or to "urgency laws" that run counter to the Constitution, the voters' approval must be obtained through a referendum. Other changes to federal laws are subject to optional referenda which are held in the case that 50 000 signatures are collected. This system has a direct effect on the political economy of government finance and can help to lower the principal-agent problem that may be observed in representative democracies. These political characteristics have contributed to Switzerland's high political stability. The other side of the coin, however, is a certain inertia. It goes without saying that such a system may obstruct substantial reforms in the short-run.

Another important aspect of the Swiss regime is the so-called "Konkordanzsystem". In contrast to a conventional coalition system, all four big political parties - two members of the Socialist Party (SPS), two of the Christian Democratic People Party (CVP), two of the Liberal Democratic Party (FDP) and one of the Swiss People's Party (SVP) – are represented in the Federal Council (government). This composition, known as the "magic formula", again has a certain stabilising impact on the political agenda since each of the seven Federal Councillors is forced to make concessions. Overly hasty decisions are unlikely; many projects may, however, lose some of their rigour.

The Federal Council is obliged, before passing an important government bill to the Parliament, to submit it to the cantons, political parties and certain interest groups (employers, unions, professional associations) for comment. In case of strong opposition, the government then has the opportunity to make adjustments so that the threat of a referendum can be reduced. This procedure of consultation is called "*Vernehmlassungsverfahren*" and, like the "*Konkordanzsystem*", may have a diluting effect on government decisions.

After having passed the consultations and negotiations, the government bill often represents a compromise solution. The members of Parliament, therefore, do not feel obliged to vote for the government's proposal and may bring their own motion. If Parliament then approves this motion, it is not considered as a vote of no confidence, but rather as part of the political process in Switzerland.

With respect to fiscal policy, an important asymmetry between revenues and expenditures should be emphasised. The opening of any new source of public revenue in Switzerland is subject to a compulsory referendum, whereas new expenditures can be enacted by Parliament, without any possibility for the people to intervene. Despite the stabilising effect of direct democracy, this legal asymmetry between introducing revenues and expenditures may have had a certain negative impact on the central government's financial balance at the beginning of the 1990s, when fiscal policy was mainly directed at deficit spending.

3. The Budgetary Target 2001

Given the dramatic deterioration of the federal budget in the early 1990s, the Swiss Parliament re-acted by passing a constitutional amendment which introduced budgetary principles and targets. The constitutional amendment is composed of two elements. First, it has introduced the general principle of sound public finances i.e. debt reduction and balanced budget in the medium-term. Second, it has established a detailed schedule for the consolidation of the federal budget.

In a popular vote in 1998, this constitutional amendment was ratified with a clear majority. This fact has demonstrated that budgetary consolidation is not such an unpopular policy objective as many politicians and government officials seem to believe. It also indicates that, in the case of Switzerland, a major part of the structural budget deficit has to be attributed to the mechanism of indirect, rather than direct, democracy. It would be an interesting research topic to study the relative strengths of direct versus indirect democratic institutions in budgetary consolidation.

The constitutional amendment represented only the first step towards budgetary consolidation. As there is never a guarantee that any constitutional provision will be fully met in practice, further steps were necessary. (Note: Switzerland does not have a Constitutional Court which could enforce the constitutional provisions. Parliament has full sovereignty over budgetary expenditures.)

For the constitutional amendment to have an immediate impact, it was crucial that it explicitly contained a detailed schedule for budgetary consolidation. In particular, a maximum federal budget deficit of 5 billion Swiss francs for 1999, 2.5 billion for 2000, and 2% of the revenues for 2001 have been written into the Constitution. Moreover, the amendment specifies that these budgetary targets have to be achieved primarily through expenditure cuts.

Despite such a clear schedule for fiscal consolidation having been established in the Constitution, the most difficult step, namely its implementation, still remained to be taken. Shortly after the amendment had been passed, the Finance Minister took the initiative to launch the Stabilisation Programme that is described in some detail below.

4. The Stabilisation Programme

As mentioned before, the Budgetary Target 2001 was approved in a referendum in June 1998. However, the aim of the deficit not exceeding 1 billion (i.e. 2% of the revenues) contrasted drastically with reality. For the year 2001, the financial plan drawn in 1998 forecasted a deficit of SFR3.1 billion. The required improvement of about SFR2 billion could not be achieved by a conventional budgeting and planning process since Switzerland's six-year economic stagnation period has had a negative effect on the relation between employers and employees. A proposal by the Federal Council to make several small cuts in unemployment benefit payments was rejected in a popular referendum. It seemed that any cuts in the social security system would not be accepted. The political system, as described above, did not favour a solution within the traditional institutions either.

In November 1997 the Finance Minister introduced a plan in the Federal Council, which was adopted, containing the following principles:

- establishing a programme compatible with the Budgetary Target 2001;
- focusing on the big spending areas "Social Security", "Transportation" and "Defence";
- stabilising the social security funds substantially;
- not "misusing" the programme for radical reforms of the social security system (this shall be done in a broader political context);
- including an appropriate financial contribution of the cantons, which, if possible, shall be fully compensated in the framework of the system of grants between the Confederation and cantons;

- taking all the measures in one package, which shall guarantee an appropriate symmetry of sacrifices; and
- the package must be supported by all decision-makers in the political process.

4.1. A Programme in Four Phases

In the first phase, November 1997, consensus talks at the so-called "Round Table" were held. The constituent assembly was composed of:

- a delegation of the Federal Council (chaired by the Finance Minister);
- a delegation of the Conference of the Presidents of the cantonal governments;
- the Presidents of the four parties represented in the Federal Council;
- delegates of employers' organisations; and
- delegates of workers' union organisations.

The "rules of the game" were fixed. Among them was the idea that once the "Round Table" had come to a decision; the participants were pledged to agree to the whole package, in public as well as in their own sphere of influence. Members of Parliament did not directly participate in the negotiations. However, the Presidents of the Budget Committees of both Chambers of Parliament as well as the President of the Finance Delegation of the Parliament were continually informed.

In the second phase, bilateral hearings on the proposed measures took place in a broader circle. The cantons, all political parties, and the most important associations and unions could all give their opinion on the proposed measures. These hearings replaced the conventional procedure of consultations with all interest groups.

The third phase consisted of examining and discussing the results of the hearings. Three working groups ("contributions of the cantons", "social security" and "other areas") were set up to clarify the financial consequences of the proposed measures.

On the basis of the consolidated facts and figures, the decisive debates took place at the "Round Table". The individual measures as well as the proposed financial volume of the whole programme remained undisputed, in general. However, the schedule as well as the mix of the measures gave rise to long and intensive discussions.

4.2. The Results

In April 1998, a consensus was found, and at the end of September the Federal Council submitted the Stabilisation Programme to the Parliament. In Table 1 below, one can see the proposed measures of the "Round Table" with the respective amounts of relief for the federal budget (column "BR") as well as the final figures passed by Parliament in spring 1999 (column "Parl.").

As Table 1 reveals, the total relief for the year 2001 proposed by the Federal Council amounts to SFR 1.8 billion:

- Defence (SFR540 million) has to make substantial sacrifices as well as the cantons (SFR500 million). This also includes a reduction of federal contributions to the cantons for public transportation of SFR250 million.
- Several cuts in social security were proposed by the Federal Council with an overall potential of relief of almost SFR400 million.
- Swiss Rail has to cut its budget by SFR200 million.

Table 1. **Total Relief of the Federal Budget as a Result of the Stabilisation Programme**

	1999		2000		2001		2002	
In millions SFR	BR	Parl	BR	Parl	BR	Parl	BR	Parl
Expenditures	702	771	1 241	1 524	1 834	2 037	1 655	2 087
Defence	190	190	370	370	540	540	551	551
Civil Defence	17	17	19	19	22	22	22	22
Swiss Rail Company	100	100	150	150	200	200	200	200
Support to Refuges		69		283		406		432
Contributions to the Cantons	185	185	332	332	500	500	510	510
Social Security	29	29	188	188	394	191	193	193
Linear Cuts 3%	181	181	182	182	178	178	179	179
Revenues	0	0	0	0	0	0	91	21
Adjustments in the tax system	-	-	-	-	-	-	91	21
Total Relief of Federal Budget	702	771	1 241	1 524	1 834	2 037	1 746	2 108

As mentioned above, there was an agreement by all political parties that a "Stabilisation Programme" was needed. Since Parliament was not included in the talks of the "Round Table", an uncertainty remained as to what extent members of Parliament would try to bring in their own interests and dilute the overall effect.

- In the area of "Social Security", a one-year postponing of adjustments of pensions, with a one-off saving of SFR200 million, was rejected by the Parliament.
- In addition to the package of the "Round Table", Parliament charged the Federal Council to cut spending in the area of "Support to Refugees" by more than SFR400 million. However, this reduction was taken subject to the condition of a reduction and absence of international tensions. The Kosovo crisis eventually let the potential relief shrink to SFR100 million.
- A last important difference was Parliament's disagreement with the Federal Council's proposals for selected adjustments in the tax system.

4.3. *The Key Factors*

The Stabilisation Programme definitely helped to consolidate the federal budget. What were the key factors that made it a "Round Table" not a "chatter table" and that prevented the Federal Council's proposals from being cut by Parliament?

- It needed the Budgetary Target 2001. Knowing that these targets had to be met, pressure was put on all participants in these talks.
- All important political decision-makers were invited to the "Round Table" so that no time-consuming "Vernehmlassungverfahren" was necessary and the pressure on all interest groups involved was kept high.
- "Rules of the game" were fixed and they were never broken (e.g. all members of the "Round Table" always had the same information, there were no leaks within the whole period of the secret talks).
- Once the "Round Table" had come to a decision, every single measure, as well as the whole package, had to be supported by all members…
- …which put Parliament under pressure not to untie the package again.
- Finally, Parliament passed the Stabilisation Programme as a "skeleton law", which means that a referendum could only be initiated against the whole package. This procedure was close to the limit of constitutionality and explains why such a programme must not become a habit.

In the Stabilisation Programme, the Ministry of Finance played three parts:

- it was the Minister of Finance's mission to build a stabilisation package that helped to meet the criteria of the Budgetary Target 2001;
- especially in the third phase, when the results of the hearings were examined, the Ministry of Finance had to supply the (technical) information needed to the "Round Table" (*i.e.* financial consequences of measures that were proposed); and
- wherever new "fronts" were formed, the Minister of Finance was the mediator.

5. The Planned Expenditure Rule

5.1. A *New Expenditure Rule*

The above description illustrates the important interplay between the constitutional (Budgetary Target 2001) and the structural (Stabilisation Programme) level. Without the constitutional amendment, no structural reform would have been successful; without the structural reform, the constitutional provisions would not have been implemented in practice. This interplay, in our view, has been the key to successful fiscal stabilisation in Switzerland.

The Swiss Government now plans the next step towards long-term fiscal stability. Once the Stabilisation Programme is fully implemented, no structural deficit will be left. The next step will then be to ensure that no structural deficit re-emerges. In order to achieve this objective, the Swiss Federal Council is currently proposing a new constitutional amendment. It is proposing a rule that establishes – for each year – a maximum level for total central government expenditures. The objective of the proposed Expenditure Rule is not to enforce a balanced budget annually, but rather to ensure a balance over the business cycle. Although the Expenditure Rule follows the long tradition of balanced budget provisions introduced in other countries (and in some cantons in Switzerland), it is not a copy of any one of the existing rules.

More specifically, the proposed Expenditure Rule requires that total expenditure in any given year does not exceed the level of revenue that would be realised in normal macroeconomic conditions. The precise formula is the following:

$$G^{max}_{t+1} = R^{exp}_{t+1} / k_{t+1},$$

where G^{max}_{t+1} is the cap on government expenditure for the next year, R^{exp}_{t+1} is expected government revenue for the next year, and k_{t+1} is an index for the economy's position on the business cycle. k_{t+1} is defined as the ratio between expected real GDP in t+1 and the trend real GDP. In years of recession, k will be below 1, while in a boom phase k will lie above 1. Statistical methods will be used to calculate the trend GDP, using past information as well as estimates for the future development of real GDP.

5.2. An Institutional Mechanism for Implementing the Rule

As in the case of the Budgetary Target 2001, writing the Expenditure Rule into the Constitution will not guarantee its realisation. Therefore, the Federal Council is proposing at the same time institutional reform of the budget process.

The proposed institutional mechanism can be summarised as follows. The budget submitted to the Parliament by the government must respect the Expenditure Rule for that particular year. In principle, Parliament shall also respect the Expenditure Rule, unless it foresees certain extraordinary events, such as e.g. major natural hazards or a war. In any case, Parliament shall only be able to pass a budget that violates the Expenditure Rule by a qualified majority. The qualified majority constitutes a barrier for any deviations from the basic rule. At the same time, it offers sufficient flexibility for the Confederation to maintain its ability to react to extraordinary requirements at any time.

United States

By
David H. Morrison
with* William N. McLeod *and* Christopher Johns

1. Imperatives for Change

1.1. The Fiscal, Political, and Security "Stars Aligned"

Prior to 1988, attempts to close unneeded defense facilities were fraught with difficulty. The public's concern about adverse economic effects on surrounding communities made US military officials and congressional representatives reluctant to propose closures. Moreover, these attempts were tainted by a perceived lack of political impartiality in the decision-making process. Thus, legislation enacted in the 1970s requiring the US Department of Defense to undertake cumbersome notification and reporting procedures effectively precluded military bases from being closed. In the late 1980s, however, several important fiscal, political and international security trends combined to create an imperative to close excess military bases that could not be ignored.

The most important of these trends was the waning and eventual resolution of the Cold War. As the conflict with the Soviet Union wound to a close, the United

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States was presented with an opportunity to reduce the size of its military force structure and supporting infrastructure – bases, supply depots, weapons maintenance shops, and the like. Beginning in 1990, the US proceeded to cut roughly 33% of its active duty military manpower, with corresponding reductions in its military forces of 36% in Army units, 42% in number of combat ships, and 45% in tactical Air Force wings.

The end of the Cold War also fostered a change in the American domestic political environment from one of solid support for the 1980s military expansion under President Reagan to seeking the fruits of the so-called "peace dividend". This was reflected in increasing pressure from the public to convert military facilities and industries into productive non-defence activities. US congressional representatives, heretofore unwilling to subject their constituents to the economic vagaries of a local military base closure, were provided a clear rationale (if not the political will) for eliminating excess US defence facilities at home and abroad. Eventually, a consensus was achieved in the US body politic about the need to maintain a US military ready to respond immediately to overseas crises, though at smaller force and support infrastructure levels.

A third, and equally significant, trend underlying the need to close military bases was the change in the US federal government's fiscal situation; that is, the growth of the federal budget deficit. As the Reagan defence build-up peaked in the mid 1980s, so too did the acceleration of US federal government entitlement payments to retired, disabled, and less well-off individuals through such programmes as Social Security and Medicare. Coupled with the economic recession of the early 1980s which initially depressed revenues, these policies – while successfully achieving the desired ends – resulted in budget deficits the magnitude of which had not been experienced in Washington since World War II. By the end of the decade, measures to constrain federal spending and reduce the budget deficit had become the focus of the national political debate. Thus, the fiscal, political, and national security "stars aligned" to create the imperative to close unneeded military bases.

1.2. The Base Closure Imperative

The rationale for closing excess military bases was relatively straightforward: cut waste; adapt the military base structure to support the evolving force structure; and reallocate savings from base closures to more critical programmes such as training, operations, and weapons modernisation.

Efforts to trim waste from the Department of Defense (DoD) budget focused on reforming the weapons acquisition system, streamlining support activities, and closing bases. The most lucrative and compelling of these was closing bases. As units were eliminated from the military force structure, the need to maintain the base structure supporting these units diminished. Also, as US forces were reconfigured to tackle the post-Cold War security environment, the need to close certain military bases was the obvious by-product of realigning and adapting the infrastructure to support these forces. Finally, and perhaps most persuasive, Executive branch and congressional leaders were confronted with the need to meet military funding requirements within a constrained fiscal environment, making reallocating savings from base closures and other reforms a preferable alternative to cutting non-defence programmes or increasing the budget deficit.

Even though the rationale for closing bases was clear and persuasive, it was insufficient to generate the political will among individual US congressional representatives to volunteer their local bases for closure. In the absence of political will, governments will establish a process – in this case the US Congress approved, and the President signed into law, two pieces of legislation (in 1988 and 1990) which prescribed in detail what became known as the Base Realignment and Closure, or BRAC, process. Once established, this process has been a controversial element of the US national defence debate ever since.

2. The Base Realignment and Closure Process

2.1. The Law

The first of the US BRAC laws was passed in 1988 and was different in scope and character than the more comprehensive sequel passed in 1990. The 1988 version approved a special commission chartered by the Secretary of Defence to identify bases for realignment and closure and provided relief from previous legislation that had hindered DoD's past efforts. Though this legislation resulted in a BRAC round being completed in 1988 (16 out of 495 major bases in the United States were closed), concerns were raised about the fairness and impartiality of the process. The concerns arose, in part, because the commission was appointed by, and reported directly to, the Secretary of Defence. Also, critics claimed that the list of closures targeted bases in districts of certain congressional members. As such, follow-up efforts by the Secretary in January 1990 to initiate the closure of additional bases – without enabling legislation – encountered difficulty and were not completed. Still faced with the need to eliminate excess military base capacity and free up resources for other defence programmes, Congress passed the Defence Base Realignment and Closure Act of 1990, landmark legislation which created an independent commission and authorised three BRAC rounds in 1991, 1993, and 1995.

Mindful of the historical disincentives to closing bases brought to the surface by the 1988 round, Congress established a process in the 1990 BRAC Act which incorporated politically neutral base selection procedures and powerful community protection provisions. Under this process the military services (Army, Navy, Air Force, and Marine Corps) were required to evaluate and rank each base according to published criteria: military value; return on investment if closed; environmental impact if closed; and economic value to the surrounding community. Using these criteria, the services developed a list of recommended closures for submission to the Secretary of Defence. After reviewing the services' lists, the Secretary was to develop a consolidated list and forward his recommendations to the BRAC commission. This eight member commission was appointed by the President based on nominations received from congressional leaders of both political parties, as prescribed in the law. After analysing the Secretary's recommendations and holding public hearings, the Commission was free to modify these recommendations as it saw fit. But once a final list of base closure recommendations was released by the commission, the President and the Congress could only accept or reject the list in its entirety.

2.2. *Strengths and Weaknesses of the Process*

Despite the critics' claim that the 1995 (and last) BRAC round was marred by political gamesmanship, the 1990 law clearly made possible a series of military base closures that likely would not have occurred otherwise. Given the traditional barriers to closing bases, and the understandable lack of political will among individual elected leaders, the results clearly justify the law's emphasis on creating a politically neutral selection process and protecting adversely affected communities. For all of its strengths, however, the law lacked clear prescriptions for reallocating the savings that were to accrue from closing military bases:

- the law did not include any mechanism or suggest an incentive structure that would ensure savings from base closures be reallocated to important defence activities;
- there was no role assigned to the central budget office – the Office of Management and Budget (OMB). Oversight of the costs and savings associated with base closures was confined to OMB's traditional review of the Defence Department's annual budget proposals; and

- as a result, DoD's civilian leadership relied on the military services to reallocate base closure savings to other programmes as they saw fit. While having its merits, this decentralised budget oversight scheme provided little incentive to the military services to accurately account for base closure savings.

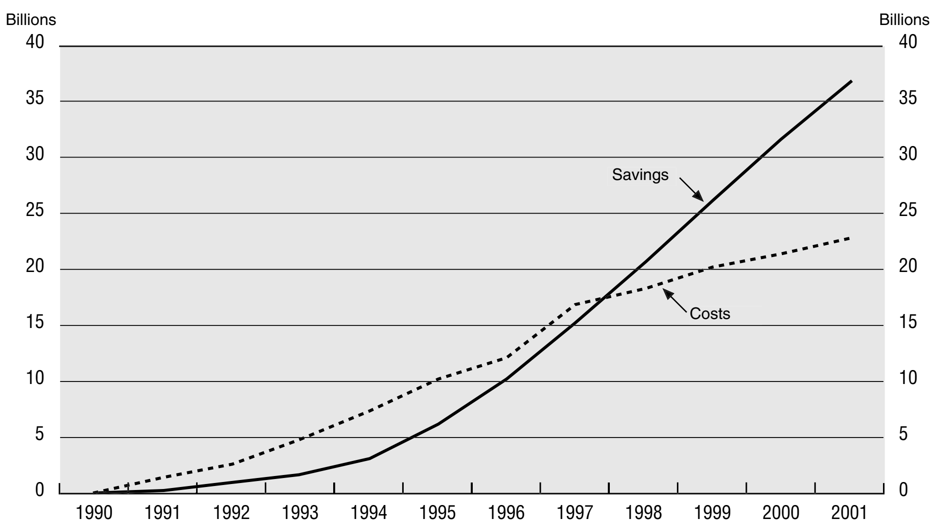
2.3. *The Results*

By 2001, DoD estimates it will have spent US$23 billion and saved US$37 billion in costs if BRAC actions had not occurred, for a net savings of US$14 billion. Beyond 2001, DoD expects to save US$5.7 billion annually as a result of BRAC actions. However, the cost estimates exclude certain types of federally incurred costs, some of which are funded outside of the DoD budget. Figure 1 displays the projected costs and savings for these closures.

Physical Changes: When the four base closure rounds began there were 495 major military installations operated by US active duty military forces within the 50 states. Over the decade 1991 to 2001, the Department of Defense expects to have closed 97 major domestic military installations, or about 20%.

According to some estimates, DoD ultimately will transfer some 464 000 acres of military base land and buildings to other US federal agencies, state and local

Figure 1. **BRAC Costs and Savings (1990-2001)**



authorities, and private organisations. Another significant share of land and buildings (an estimated 330 000 acres) has been transferred to the US military reserves and National Guard.

Savings Estimates: DoD defines BRAC savings as the difference between (1) what the Department would have spent in the absence of the BRAC process to operate its base structure; and (2) what the Department actually spent (or plans to spend) for this function, plus gains in efficiency that would not have been possible without BRAC. BRAC creates savings because it permits the department to avoid costs that it would have incurred otherwise:

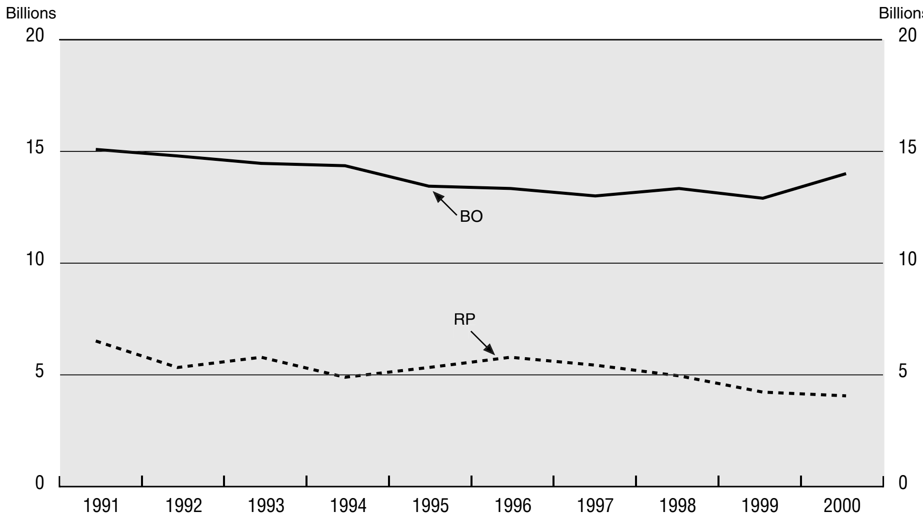
- *First*, BRAC *saves base operating support costs*. When bases are closed, DoD no longer needs to pay for physical security, fire protection, utilities, property maintenance, accounting, payroll, and a variety of other costs that are linked specifically to operating the base.
- *Second*, BRAC *saves other costs because consolidation tends to increase efficiency*. In the absence of the BRAC process, the DoD would be effectively prohibited from gaining efficiencies through relocating and consolidating major functions. For example, suppose two activities that perform similar functions are housed in two separate facilities, each of which has substantial excess capacity. If BRAC permits the consolidation of the activities at a single location, and the consolidation results in more efficient operations, then the savings that result from the efficiency gains can be properly attributed to BRAC.

BRAC savings can be grouped into those that recur and those that are one-time savings. The vast majority of BRAC savings are recurring i.e. they represent a permanent, ongoing reduction in planned spending. Personnel positions eliminated through BRAC are an example of recurring savings. One-time savings do not recur year after year. Cancelled military construction projects are an example of one-time savings. Over time, the value of recurring savings is the largest and, therefore, most important component of BRAC savings.

All organisations face similar challenges in estimating savings. Accounting records can provide detailed, factual, and accurate information on costs. But, like most businesses, the Department of Defense does not have an accounting system to track savings and to determine how these savings are reallocated. *No audit trail, single document, or budget account exists for tracking the end use of each dollar saved through* BRAC.

Analysis: We would anticipate that a one-fifth reduction in DoD's major installations clearly would affect its base operation and maintenance costs. Indeed, base operating and support (BOS) costs have decreased over time, as shown in Graph

Figure 2. **Support Costs Constant 2001$**



2. [Note: The cost trends shown below do not include costs associated with base closures, such as transportation, personnel relocation, environmental clean up. These costs were budgeted for in a separate account established by the 1988 and 1990 BRAC laws.] From 1991 to 1999, the number of major domestic installations decreased by 18%. Over the same period, BOS costs declined by about 15%. Likewise, over the same period building maintenance costs (RPM) declined by 38%, suggesting that DoD reaped savings not only from the number of base closures, but those bases that were closed were in comparatively worse shape.

Closing military bases, however, was not the only activity affecting base operation and maintenance costs during this time. Over the same period, DoD had undertaken a significant force drawdown which had at least an indirect effect on operations costs. In addition, it implemented other cost reduction programmes such as management reforms designed to improve supply and logistics operations. While it is logical to assume that base closures would lead to lower base operation and maintenance costs, without an accurate accounting of base closure savings we cannot know for certain the degree to which base closures or any other cost reduction activity actually worked.

The logic of base closures reducing operation and maintenance costs has been confirmed by several audit agencies that have reviewed DoD's BRAC activities. These audits also agree that any stronger conclusion about the actual costs saved by base closures or, more importantly, how savings have been reallocated to other critical defence programmes, is hampered by the lack of good accounting data. The following conclusion from a US General Accounting Office study on the base closure process is typical: "Because DoD is relying on BRAC savings to help free-up funds for future defence programmes, such as weapons modernisation, and has adjusted its prospective budgets to reflect savings, it is important that savings estimates be adjusted to reflect experience. The [military] services have updated costs annually, but they have not routinely updated savings. The lack of current data on savings raises doubts about the precision of net savings estimates, and estimates should be considered a rough order of magnitude.... Despite these omissions and the lack of current savings data, our prior work and the work of others, such as the DoD Inspector General, indicate that BRAC net annual savings will be substantial once implementation costs have been offset."

3. The Prospect of Reallocating Savings from Base Closures

Without solid accounting data, gauging the prospects of the base closure process actually freeing up funds for future defence programmes must rely on an assessment of the incentive structure incorporated in that process. Clearly the fiscal, political and international security environments presented strong incentives for closing excess military installations. What we must consider now is whether the base closure process – as prescribed in law and implemented by the Department of Defense – incorporated sufficient incentives to lower costs through eliminating excess infrastructure and to reallocate these savings to other defence programmes.

3.1. *Incentives to Close Bases and Save Costs*

The strongest element of the US federal government's base closure programme was the clear set of incentives to actually close excess military facilities incorporated in the legal framework underpinning the BRAC process. As described earlier, the 1990 BRAC law established a base closure selection process that emphasised political neutrality and protection for affected local communities. By prescribing a method to rank bases and an open decision-making process, the BRAC law provided the Department of Defense and military services a measure of insulation from inevitable claims of political gamesmanship. This insulation, coupled with clear indications of little-to-no growth in the defence budget for years to come , served as perhaps the strongest incentives for the military services.

Additionally, the law provided DoD the authority to set up separate budget accounts to fund the costs of base closures. Even though DoD received no topline funding increase to cover base closure costs, the mere fact that these costs were apparent to Congress and the public afforded them some protection in the event costs rose to higher levels than anticipated. Finally, DoD required the military services to reflect estimated BRAC savings in their annual budget requests. Estimated amounts of savings projected at the beginning of each BRAC round were subtracted from the expected future base operations and construction costs of each service's plans in DoD Future Years Defence Programme. The military services were able to use these savings for other programmes, at their discretion.

3.2. I*ncentives to* R*eallocate* B*ase* C*losure* S*avings*

While the 1990 BRAC law provided important incentives to DoD to actually close bases, the law included little in the way of prescribing a reallocation scheme which ensured that savings from base closures would be used for higher priority military programmes. Thus, the military services, having been given full discretion to apply base closure savings as they saw fit, had minimal incentive to account for savings and/or report on the use of these savings. Though DoD's planning guidance required the military services to annually update BRAC savings estimates, this was rarely done. By and large, the savings estimates the military services use today have not changed since the estimates were generated at the outset of each BRAC round. Among the reasons the services claim for savings estimates not being updated were the lack of an accounting system to track savings, the cost associated with implementing such an accounting system, and that updating savings estimates were not a high priority. Underlying these reasons was a fear by the military that updating savings estimates could result in the loss of funding, if the updated estimates were considerably higher than the initial predictions.

4. Conclusions

There are four important lessons to be learned from the US federal government's experience with closing military bases:

- The fiscal, political, and international security environments were ripe to accept the need for closing military bases. Without this confluence of events, the imperative to pass the BRAC laws would not have occurred.
- The BRAC laws, especially the 1990 Act , incorporated a policy and procedural focus that minimised potential political conflict and protected constituent interests, rather than establishing clear policies for reallocating

funds to address critical defence needs. As such, the process for closing bases worked well, compared to past efforts.

- As the BRAC laws were implemented, the lack of focus on reallocation procedures served as a disincentive for the military services to account for BRAC savings. This limits our ability to judge whether or not the BRAC process served to meet one of its chief goals - freeing up funds for higher priority defence programmes.
- The military services efforts were complicated by the lack of an accounting system dedicated to tracking BRAC savings.

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