Budgeting and Management of Public Expenditure

A realistic vision of reforms for the next four years

Slovak Governance Institute

SLOVAK GOVERNANCE INSTITUTE
INŠTITÚT PRE DOBRE SPRAVOVANÚ SPOLOČNOSŤ

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The following documents served as inspiration and resources for the preparation of this publication:

- Brian Hogwood and Lewis Gunn: Policy Analysis for the Real World, Oxford University Press, 1984
- IMF: Government Financial Statistics 2001 Manual, IMF, 2002
- Barry Potter and Jack Diamond: Guidelines for Public Expenditure Management, IMF, 1999
- Salvatore Schiavo-Campo and Daniel Tommasi: Managing Government Expenditure, Asian Development Bank, 1999
- OECD: Economic Surveys - Slovak Republic, OECD, 2002
- OECD SIGMA: Financial Management and Control of Public Agencies, OECD, 2001

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1. Introduction

Public finances - funds collected and spent by the government, self-governments and other public institutions - are, along with laws, politicians' most important public policy instrument in democratic states with a market economy. We could even say that laws are only of limited value without finances for their implementation and enforcement. The system of public finance management is therefore important in its own right.

Management of public finances is evolving continually and at least since the creation of the Slovak Republic we have been able to observe permanent changes in it (not necessarily for the better). In the course of the years 1998 - 2002 many improvements have been introduced particularly in the area of raising transparency of public finances and integration of their reporting and management. In spite of this, in our view, the current system has major shortcomings.

The objective of this vision is to introduce a sum of realistic and mutually coherent recommendations for changes in budgeting and management of public expenditure, which will be available for use in discussions and can serve as a vision for the new minister of finance in October 2002, should he opt for reforms of the kind introduced in our vision.

Further reform measures should in our view move towards a system of management of budgeting and public expenditure that would:

- **Give the government/ministry a tool for the gradual reduction of the uncovered and hidden deficit of public finances**
- **Present a clear and realistic basis for financial decisions of governing politicians and allow for an appropriate combination of financial stability and strategic management of the state**
- **Give the various actors incentives to act efficiently in budget design and implementation, or at least, not give them incentives to behave inefficiently**

The vision represents an attempt to briefly, but comprehensively cover the technical aspect of changes required to make significant progress in the three areas mentioned. In presenting the vision, it is necessary to stress that reform of the management of public finances in Slovakia is neither a one-off process, nor a technocratic one. Reforms in general and demanding reforms in particular do not "self-implement" or get implemented technocratically on the basis of self-perpetuating changes in the apparatuses of individual ministries.

Significant changes in the management of public finances require real political determination on the part of the future government and particularly the future minister of finance and their identification with the proposals presented (or, of course, with any other set of proposals). The determination to invest time, people and political capital in such a reform can come from the recognition of the general benefits of systemic changes. In addition, there are several concrete reasons why it is in the interest of the future government to implement them:

- **Absence of strategic management.** The current system of management of public finances (along with other problems) does not allow the government to really manage the state in the horizon of the whole electoral term and turns its activity into a combination of many half-empty words and patching up the most pressing problems. A change in the management of public finances is a necessary condition for any government to be able to think in the horizon of its four-year mandate and really consciously manage public affairs.

❍ **The fact that the current public obligations and programmes are unsustainable in the long-term, inefficient and politically risky.** The Slovak Republic inherited from the past or generated after 1993 various legal, conceptual and other commitments for public finances from the construction of highways to the pension system. It is evident that the current level of taxation and other revenues does not allow the financing of all these commitments on a sustainable basis. Thus for over a decade, we have witnessed not only emergence of budget deficits and formation of the so-called acknowledged debts, but especially accumulation of the so-called hidden debts in almost all areas.[1] Alternatively, many commitments and decisions of the government are not fulfilled. However, it is not possible to live at the expense of the foundation for the long-term and we are gradually witnessing growing problems and even collapses. The functioning in an environment of permanent decay often leads to inefficient decisions and is a source of constant frustration for the public, employees in the public sector[2] and politicians. It is therefore necessary to create a framework to gradually put public finances on a sustainable footing.

❍ **Changes necessary for successful membership in the European Monetary Union.** Membership in the EU and EMU is one of the aspirations of the Slovak public and enjoys the support of all significant political forces in the country. Accession, as well as functioning in the monetary union, however, requires continual compliance with the so-called Maastricht criteria, as well as the criteria of the Stability Pact, according to which public finances have to be generally balanced and at no point may exceed a deficit of 3 % of GDP. If Slovakia is to meet these criteria on a sustainable basis in the upcoming electoral term, concrete reforms are required, framed by changes in the management of public finances.

On the other hand, it is necessary to warn clearly of the limitations of this vision and of public finance management as such.[3] The system of budgeting and management

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[1] Among hidden debt we include in particular the insufficient level of renewal of capital assets in the public sector.

[2] When in this vision we refer to the public sector, we have in mind what is usually termed "general government" in English - the public administration and other public organisations. In English, the term public sector denotes not only "general government" but also the central bank and state enterprises. We use the term public sector to denote general government in spite of the potential for misunderstanding, as the literal translation of general government sounds strange in Slovak and does not intuitively match the actual meaning of the term.

[3] Proposals for realistic reforms must, in our view, reflect in terms of process and content the following factors, which the document assumes as given in the medium-term: unstable internal political and economic environment, high degree of uncertainty in public finance management, existence of external obligations towards the EU and other foreign partners, existence of coalition governments and their effect on public policy and public finance management, only gradual changes in quality of the public administration as a whole, inability to prepare systemic reforms with the current human resources of the state administration.

of public expenditure can set a mirror for politicians, reflecting the true situation in the management of the state and thus aid in creating an environment of reform pressure. But it can neither force concrete reforms against the will of the majority of coalition politicians and the public nor prepare or implement them. Healthcare or pension reform cannot be conceived or implemented from the Ministry of Finance. The proposal therefore does not advance any specific position on the role of the state or an optimum level of its obligations or activities. A good system of budgeting and management of public expenditure must in our view present a suitable framework for the implementation of various views on the role of the state, but it should lead to qualified and public discussion, clear and sustainable decisions and financial responsibility. In this respect, we see as very important all measures, which make the broadest range of existing hidden debts and "gaps" in public finances visible at the very beginning of the electoral term. All these measures will, however, carry little weight unless the government introduces a hard budget constraint - so that individual ministers are aware that running up further debts will cost them their seat.

A system of public expenditure management requires four kinds of financial discipline: overview of total expenditure, effective means for allocating expenditure, which reflect the overall priorities, efficient provision of public services and minimisation of financial expenditure on the management of public finances.

This document addresses mainly the first three kinds of discipline and, due to the limitations of space, with some exceptions, abstracts from the fourth. It does not construct a vision of the target, desired state of affairs, but tries to outline a series of gradual measures to improve the current situation and give preference to the most effective measures possible. It tries to keep in sight that the measures chosen are conditional on each other. The vision is structured into five sections:

1. medium-term and long-term management of public finances
2. preparation and implementation of yearly public budgets at the highest level
3. public finance management and the programme way of thinking
4. budgeting and management of public expenditure at the level of managers of budgetary chapters and implementing agencies
5. institutional background of the reform

The vision presented here outlines the measures, which should lead to an improvement in the situation in each of the areas mentioned.[4] We want to stress that it concerns all four levels of the system of budgeting and management of public expenditure, which form a hierarchical pyramid where a higher level allocates funds to "its" subsidiary levels, oversees them and is to various degrees responsible for their actions:

[4] At the same time, it is necessary to point out that the management of public finances as a component of overall public sector strategic and operative management is closely tied to other components, particularly including the regulatory framework for employees in the public sector, regulatory framework for public procurement, regulatory framework and standards for accounting in the public and private sector and the system of auditing in the public sector (i.e., in particular the laws on the state service and the public service, the law on accounting, the law on audit in the state administration and the law on financial audit and internal audit). In these areas, the document derives from the current state of affairs and only if necessary, points to key barriers to change in the management of public finances contained in these components. Only where the authors are able to do so, they propose solutions.

- Level 1 - top level - the level of government, National Council of the Slovak Republic and Ministry of Finance as the body responsible for public finances as a whole
- Level 2 - level of a budgetary chapter - ministry[5], other central organ of state administration or other administrator of a budget chapter responsible for the public funds allocated within the given budgetary chapter
- Level 3 - the level of institutions financed from public funds, through which the budget chapter administrator carries out tasks, for which he receives funding from these sources. We will refer to these institutions as implementing agencies. Examples of implementing agencies are budgetary and contributory organisations, other organisations financed from public funds subordinated to a ministry[6], as well as the ministry itself.
- Level 4 - the level of organisational subsidiaries of implementing agencies, which carry out the individual tasks of implementing agencies.

We advise the reader at this point to move on to the actual chapters - the remaining part of the introduction consists of a brief summary of recommendations contained in the text of the vision.

Part 2 focuses on medium-term management of public finances. The conflict between available resources and the sum of claims on them results in various deficits and debts - from the formal, openly declared deficit of public finances through formal debts of various parts of the public sector to the low level of renewal of capital assets and not meeting formal obligations of the government.

In particular, this situation leads to the obsolescence or even collapse of some systems of public services, inefficient decisions arising from the high level of uncertainty and inability to plan strategically and frustration from living in an environment of permanent decay on the part of the public, public sector employees and politicians.

Reform of **medium-term horizon of public finance management** should lead to a political and public debate on the possibilities of public finances, introduce mechanisms exerting pressure on ensuring their sustainability and helping the government determined to make reforms in this direction, but also enable the public sector and its constituent parts to plan strategically.

According to our proposal, the Ministry of Finance, in cooperation with other departments and other major actors in the budgetary process and particularly on the basis of political decisions of the government, would prepare as the medium-term budget a document with three parts:

- **"commitments budget"**
- **"expected budget"**
- **proposal for addressing the difference between commitments and possibilities**

[5] In practice represented by the minister, section of financing and content sections of the ministry

[6] When we refer to a ministry, we use the term as an abbreviation for all administrators of budget chapters.

The commitments budget would contain an overall projection of expenditure development based on the current regulatory or conceptual situation, while maintaining the current or law-mandated standards of quality. This aggregate projection would comprise a sum of concrete projections for important programmes and an estimate of the development of further expenditure claims. It would therefore be an expert analysis.

The expected budget would contain an overall projection of the actual expected expenditure development based on the government's political objectives. This aggregate projection would subsequently be divided into concrete projections, on important programmes and an estimate of development of further expenditure claims. This would be a political decision based on expert analysis. The concrete formulation of the expected budget in future years will use the same methodology as the one mentioned in part 3 for the official yearly budget for the nearest year.

The expected budget would represent a basis for medium-term financing of individual departments/programs. It would thus offer a significant degree of predictability and stability for individual departments/programmes and would at the same time allow the government to give indication of its budgetary plans in a longer horizon.

On the other hand, the commitments budget would have no influence on the amount of public funding actually allocated. **The role of the commitments budget would be to present a combined picture of existing main commitments of the public sector on a sustainable basis. The total difference between the commitments budget and the expected budget would represent the deficit between commitments and possibilities of public finances.** The difference between the commitments budget and the expected budget in individual departments/programmes would show this deficit in specific areas and demonstrate the existing discrepancy between the government's commitments and its ability/willingness to finance them.

The need to present a proposal on resolving the difference between commitments and possibilities would create pressure to present proposals of changes that would in the medium-term deal with deficits between commitments and possibilities in specific areas.

Part 3 contains proposals concerning an essential and necessary part of management of public finances - the design and implementation of the overall public budget in the horizon of the respective fiscal year.

In our view, the government's most important decision in the annual preparation of public budgets is the determination of the total expenditure ceiling and especially its distribution among the individual budget chapter administrators. The philosophy of our approach to this issue derives from the existence of coalition governments without a significantly dominant party and the consequent need for formal rules for the determination of expenditure ceilings. Without such a rule (algorithm), the preparation of the budget every year turns into a drama, in which every minister has the incentive to advance his own interests at any cost regardless of anything. In 2001 the Ministry of Finance (MoF) introduced a division of expenditures into facultative and obligatory, which represents an attempt to change the thinking in public finances. In our view, in spite of certain progress, this system gives the administrators of budget chapters the wrong incentives and runs against the philosophy of several changes in public governance.

We therefore propose a different division of expenditure groups and a different way of their determination, which should resolve this problem. The proposed system has (like every other system) its shortcomings and reserves, but will introduce a clear method for determining which expenditures are funded "automatically", create pressure for their truthful budgeting already at the start of the budgeting process and eliminate the inappropriate incentives for budgetary chapter administrators and implementing agencies. At the same time, it will allow the government to fine-tune the pressure for savings in areas with lower priority.

The implementation of the approved public budgets is significantly hindered by the fact that their expenditure limits are not sufficiently binding. We therefore propose that **in addition to the binding public budget deficit, public expenditure should be an equally binding indicator,** at the level of the total expenditure limit, as well as the limits at the level of budget chapters. We also propose **the strengthening of the role of the government's reserve,** which should resolve the discrepancy between the approved expenditure and actual developments and should therefore reach several billion crowns, specifically 2-3% of expected expenditure. **After the government's reserve is exhausted, the expenditure limit of a chapter could be exceeded only with the parliament's approval at the government's proposal, through an amendment to the law on the public budget.** The system would be more functional if it were connected with the introduction of a system of mandatory expenditure and their purpose earmarking.

The present system of public finances in Slovakia displays a significant imbalance between the government's responsibility and its powers. Not all parts of the public finances, which have their own budgets outside of the state budget, are governed by equally strict budgetary rules. At the same time, the government or the state budget guarantees their solvency but has only limited means at its disposal to manage and influence the implementation of and compliance with these budgets in the course of the fiscal year. The problem of integration of public budgets cannot be addressed solely by reform of the management of public finances. We will therefore limit ourselves to a few basic recommendations, which are important for more effective management of public budgets. There is an essential distinction between different parts of public finances, depending on whether or not they are financially independent and self-sufficient. In our view, for instance the Social Insurance Agency, National Labour Bureau and health insurance agencies are not financially independent at present. On the other hand, the Slovak Land Fund, municipalities, self-governing regions and the National Property Fund can be viewed as financially independent.

In the preparation and implementation of the overall public budget, the budgets of financially independent institutions should mainly have reporting obligations towards the MoF. The current system, stipulated by the law on budgetary rules, is essentially suitable. Budgets of institutions that are not financially independent should be included in the law on the public budget. At the least, the state should introduce strict budgetary limits for them equivalent to the limits in the state budget - the requirement to comply with the approved budget deficit and expenditure limit.

Pursuant to concrete reforms in the individual areas in the next electoral term, the government should opt for one of the two alternatives for every institution that is not financially independent. The first is a reform leading to a fundamental degree of financial independence and self-sufficiency and consequent budgetary autonomy. If the government does not wish to take this step, it should integrate them in the state budget. The decision on the status of a specific part of public finances is a matter of political persuasion and individual specifics. No part of the public finances should, however, in our view, "fall between" the two options with all the negative consequences we recall from the 90s.

A shared problem of information on the composition and compliance with the public budget is the accuracy and informative value of the information provided. Credibility of the balance of the public budget depends on **a clear definition of revenues and expenditures, which the state must include in the public budget.** Several methodologies exist for the reporting of revenues and expenditure of public finances. We propose to use the ESA 95 methodology, which is based on the notion of capturing revenues and expenditure not on the basis of cash-flow, but depending on the moment when they arise - the so-called accrual accounting.

The introduction of this methodology would not for instance permit the misrepresentation of expenditure on the realisation of state guarantees on loans, the settlement of debts for example in the healthcare sector or on the so-called operations in the public interest (railways).

Part 4 focuses on a common element, which in our view affects all levels of public finance management. It is the so-called programme way of thinking about public finances.

Every system of public finance management with an ambition to contribute to efficient and transparent use of public funds must at every level of public finances provide for a clear "owner" of funds responsible for their use. A higher level must be able to determine the **objective** for which it is allocating funds to a lower level and enforce their usage for the set purpose.

In traditional approaches to budgeting based on economic classification of expenditure one must determine what portion of funds allocated to budget chapters is allocated to wages, mandatory social contributions, goods and services and transfers. There is also a distinction between current and capital expenditure. What is missing is information on the **intent** defined in a **certain area of activities and a connection between the allocation of funds and achievement** of **goals** determined in advance. The programme way of thinking introduces these very principles. It not only concerns the highest level of the public sector - the government and parliament. It can be applied at all levels.

The current programme budgeting carried out in Slovakia has the ambition to create an obligation for ministers and other administrators of budget chapters towards the government. Subprogrammes and their further subdivisions represent an attempt to transfer this way of thinking to relations between budget chapter administrators and implementing agencies. So far, a unified system that would attempt to introduce the programme way of thinking into internal management of organisations does not exist.

Implementation of the programme approach in the management of public finances started in part from 1999 through programme budgeting. The state budget for 2004 was supposed to be implemented with a programme structure in its entirety. In our view the programme approach to the management of public finances in Slovakia should be implemented in a way that would allow the government to strategically manage public expenditure, allow a better-qualified discussion on priorities at all levels and greater pressure for a closer connection between results and funds provided to achieve them.

The current implementation does not meet these conditions. It contains programmes with allocated funds from 1.2 **million** Sk to 10.6 **billion** Sk. In terms of internal structure, in 2002 the government approved, on one hand, programmes with no internal structure whatsoever and on the other hand, programmes with tens of subprogrammes and elements, some of which only had a few thousand crowns allocated to them. This represents a fundamental systemic problem - if the government makes decisions on a large number of programmes and if these programmes differ in their size by orders of magnitude, the government cannot effectively discuss the priorities or strategically manage public finances and the purpose of programme budgeting is lost at the level of the government. The current system assumes the definition of intent of the programme practically only at the level of the programme, while some subprogrammes have been put forward where the intent was missing completely or was only of formal nature. In our view it is important that the three characteristic elements - intent, goals and measurable indicators - be defined at each level of the programme structure. **Without the scrupulous application of principles, programme budgeting turns into the allocation of finances for a certain area without an obligation to "produce" an outcome and the key incentive element of the programme approach is therefore lost.**

According to our proposal, the key to the implementation of the programme approach should be especially in creating an integrated system of programme financing relationships between the government and budget chapters and between budget chapters and implementing agencies. The creation of an integrated system of programme financing relationships should take advantage of the possibilities of the programme approach in the area of planning/strategic management, budgeting and financial policy.

A set of programmes at the government level implementing its strategy in individual areas should become the unifying element of the proposed integrated system. **The number of programmes at this level should be restricted so as to enable the government to discuss the system of programmes as a whole (we recommend 60 - 80). The system of programmes should be created on the basis of the government programme manifesto as a result of centrally coordinated work of individual departments. The minimum size of a programme in terms of the allocated funds would be stipulated,** which along with reduction of the number of budget chapters to 20 - 25 would facilitate strategic management of public finances. Individual ministries and other central organs would be responsible for programme implementation. The tasks of every ministry would be divided into the main areas, each of which would be covered by one or several programs. In other words, departments with significant amounts of funding would probably administer several programmes each and the effects of programme budgeting would appear mainly in the preparation and implementation of budgets of these chapters.

Part 5 is devoted to the issue of public finance management at the level of budget chapter administrators and budget units.

Within the management of public finances, decisions are made not only on the overall volume of funds but also on the internal distribution of this amount in accordance with other criteria. The question of whether and to what degree the internal structure of allocated funds should be determined as binding has major practical implications for the efficiency of public spending.

We propose **that for contributory organisations and public institutions such as universities, the public budget should not only include the contribution in the form of a transfer (the so-called net transfer), but overall revenues and expenditure of the organisation (the so-called gross transfer).** We also propose considering **a reduction in the degree to which economic classification remains binding for budgetary organisations following the implementation of programme budgeting** within the chapter, as long as the MoF considers it truly objective-oriented. We also propose **to apply pressure on budget chapter administrators after the introduction of programme budgeting to consider to what degree and especially in what way they wish to bindingly structure unstructured transfers of their own will for contributory organisations and other implementing agencies.** We particularly recommend the use of programme budgeting instruments for structuring funds in such a binding way.

One of the general characteristics of the budgeting used until now is the ban on transferring unused budgetary funds into next calendar year. Aside from its rational core, this measure has major negative effects - the so-called "December madness" used to refer to the phenomenon when implementing units do not want to let funds "expire" and try to use them at any cost even on things, on which they would not normally spend them. **We therefore propose pursuant to the introduction of programme budgeting within a budget chapter to allow the transfer of unused funds allocated to a programme into the following year. This possibility should apply to all funds within a programme.** The possibility to transfer funds must, of course, be tied to the condition that the implementing agency must first use them to cover all its liabilities from the previous fiscal year.

Knowing the actual financial situation of the state and its individual parts is of key importance for the management of public finances. We continue here our proposal from part 3. The primary instrument for collecting information in this area is accounting. The present system **does not take into account depreciation and payables and receivables that have not been settled either due to insolvency or because they are due in the future. It therefore does not allow the gathering of information on total expenditure.** This requires the use of accounting where the emphasis shifts from the tracking of financial flows to the tracking of costs and revenues and their timing. Such accounting systems are referred to as accrual accounting. We propose that the budgetary sector in Slovakia adopt an appropriate form of accrual accounting along with introducing depreciation write-offs and time-stamping of costs and benefits and use profit and loss statements as the basic reporting statements for public finances.

In connection with amortisation write-offs, we should point out that at present, decisions on the renewal and development of capital assets in the public sector are made centrally and arbitrarily through capital spending. This means that public finances do not have to come to terms with the question to what degree tangible and intangible assets in the public sector can be maintained on a **sustainable** basis. The introduction of depreciation write-offs would bring to light the degree of obsolescence of assets in the budgetary sector and express explicitly the until now hidden part of the public sector deficit arising from the fact that capital assets are not renewed. The introduction of depreciation write-offs could also be used to decentralise decision-making on the allocation of funds to budgetary organisation for the renewal of their capital stock. This could be implemented either by allowing the updating of property from current expenditure at a level corresponding with the write-offs or by allocating capital expenditure for asset renewal at a level corresponding with the write-offs (capital expenditure on development would continue to be allocated as before). If there are not sufficient funds for these purposes (as is the case now), at least the role of revealing the hidden debt would apply.

In part 6 we deal with recommendations in the area of institutional background for the reform of public expenditure budgeting and management. At present, in our view, reform of public finances lacks a unified vision. In practice, the concept, methodology and software are prepared and implemented "on the move" and managers at central organs of state administration and within implementing agencies are not prepared for the implementation of reforms. There is no systematic feedback on reforms from users or their own strategies that would be taken into account. Part 6 contains several specific recommendations, which should alleviate these problems in the implementation of the reform.

2. Medium-term and long-term management of public finances

This chapter deals with the issue of medium-term and long-term management of public finances. In terms of the possibilities of reforms in the next four years we focus on the medium-term and in the end we mention some recommendations concerning the long-term horizon.

The medium-term horizon of public finance management and system of medium-term management of public finances serve different aims in different countries. Like in other areas of public finance management, there is no single "best" system, which must be implemented here. Solutions depend on objectives we want to accomplish and problems we want to address. We stress this fact repeatedly because we often witness discussions on solutions not preceded by a discussion of the problems.

We therefore see as appropriate starting with objectives and problems, which are in our view most serious for Slovakia.

Already in the beginning of this vision we hinted at what we consider the most basic problems of the current method of public finance management. From the perspective of medium-term management of public finances, the main areas are:

- **The fact that the current public obligations and programmes are unsustainable in the long-term, inefficient and politically risky.**

The Slovak Republic inherited from the past or created after 1993 various legal, conceptual and other commitments for public finances from the construction of highways to the pension system. These commitments differ in character illustrated by the following examples:

- Obligations in the pension system stemming from the rules for revaluation of pensions and the growing number of pensioners
- Social benefits guaranteed to the defined extent to all who meet certain criteria
- Claims on financing for infrastructure construction on the basis of approved government concepts particularly in the area of highway and railway network construction
- The extent of guaranteed healthcare based on a number of regulations, particularly the law on medical treatment
- Guaranteed wage, social premium and operating funds for the educational system stemming from the law on the financing of primary and secondary schools and school facilities and normative algorithms contained therein
- Expenditure on defence stemming from official commitments to NATO
- Expenditure on the environment stemming from our approved negotiating position in European Union accession negotiations

The current level of taxes does not allow the financing of these and other existing commitments in the current system on a sustainable basis. According to 2001 MoF estimates, tax revenues in the medium-term will represent less than 30 % of GDP[7].

[7] The figure follows the GFS 1986 methodology (see part 3). The difference between tax revenues and liabilities remains huge even with the use of other methodologies.

There has not yet been an attempt to quantify the costs of meeting all public commitments on a sustainable basis, but on the basis of available data we can estimate that they are higher than the expected revenues by about 10 - 20 % of GDP. Commitments are increasing constantly - Box 2.1 contains selected concepts with significant financial consequences adopted by the government in the years 2000 to 2002 alone.

Box 2.1 Selected conceptions approved by the Slovak government in the years 2001 and 2002

- Millennium - The National Programme of Upbringing and Education in the Slovak Republic for the Next 15 to 20 Years assumes an increase on public expenditure on education from less than 4 % of GDP at present to 5 % in 2006 and over 6 % in 2010, meaning an annual increase of several billion Sk, depending on nominal GDP growth
- Conception of Housing Construction: year 2003 - 11 billion Sk, 2004 - 11.3 billion Sk, 2005 - 8.5 billion Sk, 2006 - 9.2 billion Sk, further figures are only stated for 2010 - 15.4 billion Sk
- Conception of Water Policy Until the Year 2005 - 63.4 billion Sk, the Ministry of Agriculture is unable to quantify what portion of this amount has to be paid by the state
- Conception of Agrarian Policy - 110 billion Sk in the years 2001 - 2005
- Conception of Development of Combined Transport - 2.9 billion Sk until 2010
- Conception of Highway Construction - 2002 - 10.8 billion Sk, 2003 - 13.3 billion Sk, 2004 - 13.5 billion, 2005 - 15.8 billion, 2006 - 16.7 billion
- Armed Forces Development - 2 % of GDP annually (from 23 billion in 2003 to 44.2 billion in 2010)
- Integrated Approximation Strategy in the chapter Environment - Investment expenditure on harmonisation with EU legislation in the years 2003 - 2010 - 67 billion Sk, public budgets are to cover only a lesser portion, but it is unclear what steps the government will take if expectations of foreign and private resources are not met

Source: Office of the Government of the Slovak Republic

The discrepancy between available resources and the sum of commitments leads to deficits and debts of different kinds:

- The formal, openly declared public finance deficit
- Formal debts of various parts of the public sector - the healthcare system and to certain extent the educational system
- Financing of public expenditure from unsustainable sources - auctions of licences for mobile networks, etc.
- No renewal or low levels of updating of capital assets - public buildings, especially schools
- Non-compliance with various commitments and obligations based on laws - for example, legal deadlines for entry into the cadastre - or quality standards
- Non-compliance with formal obligations of the government not based on laws, i.e., insufficient financing of various programmes at the level to which the government is formally bound on the basis of domestic or international documents

The consequences of this situation are in particular:

- obsolescence or even collapse of some systems of public services
- inefficient decisions arising from the high level of uncertainty and the inability to plan strategically

- frustration on the part of the public, public sector employees and politicians from living in an environment of permanent decay

This relates closely to another serious problem - that of absence of a real medium-term view of possibilities and claims on public finances. Despite certain attempts, to which we may return later, today the minister of finance and the government do not have at their disposal a realistic overview of the amount of funds at the public sector's disposal in the next 3 - 4 years and especially, they are completely missing an overview of de facto or de iure medium-term obligations of the government. This results in the following concrete problem areas:

- **The non-existence of real strategic government priorities and the absence of their link to concrete decision-making in the area of public finances**

If there does not exist an analysis showing the amount of public funds we will have at our disposal and particularly, how much we need to cover existing programmes, it is not possible to strategically manage the public sector or to have priorities. The government's strategic priorities are, with few exceptions, closely tied to finances. Without a realistic overview of total future needs and obligations it is impossible to make any real medium-term decisions on concrete programmes and areas.

- **The absence of a link between the system of management of public finances and conceptual government documents (e.g., highways, railways…) and external obligations (EU, NATO, etc.)**

The consequence of the situation described in the previous points is that there exists no link between public finances and their medium-term possibilities on one hand and all official commitments on the other hand.

Strategic and conceptual documents adopted by the government, at least in the area of financing, turn into "half empty" promises - pledges of financing, which all participants know are unrealistic but are nonetheless a useful, albeit debased, currency in budget negotiations one, two or three years down the road. However, the value in terms of financial coverage of approved documents and of domestic and international obligations based on them is subsequently very low. Since adequate financing is a necessary, although not a sufficient, condition for the success of the vast majority of major government programmes, the overall value of these documents is questionable.

This situation causes not only the above-mentioned domestic problems (obsolescence or collapse of systems, inefficient decision-making, frustration on the part of the public, public sector employees and politicians) but, if not resolved, could become an obstacle for Slovakia's accession to the European Monetary Union.

This analysis implies **the objectives, which we propose for the reform of the medium-term horizon of public finance management** and which it is very difficult to deal with in the short-term. Such a reform should:

- Demonstrate that current commitments are unsustainable
- Lead to a political and public debate on the possibilities of public finances

- ❍ Introduce mechanisms exerting pressure on ensuring the sustainability of public finances and helping a government determined to make reforms in this direction
- ❍ Enable the public sector and its constituent parts to plan strategically.

If successful, the result should be a graduate shift of public finances and their constituent parts towards sustainability, aggregate and sectoral stabilisation and predictability of public finances and successful preparation of Slovakia for EMU accession.

The problems described here are neither coincidental nor specific to Slovakia. They have internal logic and it is not possible to propose realistic solutions without comprehending this logic. Many countries have found themselves in a situation where **the structure of public expenditure established claims on public finances, which increased faster than tax revenues.** The following areas present the most frequent examples:

- ❍ Pensions as a consequence of demographic changes
- ❍ Healthcare as a consequence of growing costs arising from scientific and technological progress, as well as from demographic changes
- ❍ Various social payments and transfers as a consequence of sharp growth in the number of beneficiaries
- ❍ Slow growth of tax revenues as a consequence of medium-term slowdown of the economy in comparison with recent years

This **situation creates the need decision, which are politically very costly.** To stop the continual rise of the public finance deficit, politicians must either increase taxes or limit the scope of public services - without any evident compensation for voters. To limit may simply mean to cut but also to implement other cost-cutting measures (increasing patient co-financing, abolition of schools or shorter entitlement to parental support). It is usually very difficult to "sell" these measures to voters or even to members of one's own political party, because they imply **obvious, present pain in the name of preventing future problems, currently invisible to the "naked eye".** Besides, individual ministers and interest groups feel that there is enough "padding" or inefficiency in other parts of the budget and that these problems could be resolved at their expense. **The debate on changes often lacks a clear point where all the issues cut across** and either changes are made forcedly when the budgets for the nearest year are prepared or the uncovered or hidden deficit of public finances increases as described above.

Our proposal introduces a mechanism, which serves the following functions for governing politicians and other participants in discussions on obligations and possibilities of the public finances:

- gives them a shared framework uniting all the partial discussions into a single debate on the overall possibilities of public finances
- forces them to identify the overall extent of the "budgetary gap" and distribute it between the individual departments/programs
- allows the setting of medium-term priorities, as well as areas, in which reforms reducing the claims on public finances can be implemented
- by looking several years ahead, it provides an opportunity to prepare real and deep changes in systems

Based on our proposals, the Ministry of Finance would in cooperation with other departments and other major actors in the budgetary process and particularly on the basis of political decisions of the government prepare as the medium-term budget a document with three parts:

A. "commitment budget"
B. "expected budget"
C. proposal for addressing the difference between A. and B.

A. The commitment budget would contain an aggregate projection of public expenditure developments based on

- The current regulatory[8] or conceptual[9] state of affairs
- Forecast of developments in other variables while maintaining the current or law-mandated standards of quality.

This aggregate projection would comprise a sum of concrete projections for important programmes and an estimate of the development of further expenditure claims. It would therefore be an expert analysis. An example is provided in Box 2.2.

Box 2.2 Example of Commitment Budget and Expenditure Budget in the area of railroad infrastructure and rolling stock renewal

In compiling the commitment and expected budgets the individually analysed components would probably include railroad infrastructure and rolling stock renewal.

The commitment part of the budget would reflect Government Resolution no. 544/1999 on the proposal of Economic Stabilisation and Transformation of Slovak Railways, which stipulates that state investment subsidies on infrastructure and rolling stock renewal are supposed to reach 4 billion Sk every year.

The expected part of the budget would state how much the government can actually realistically allocate for this area in the next four years within the existing budget constraint (in 2000 the state budget provided an investment subsidy for railway transport in the amount of 275.6 million Sk and for combined transport in the amount of 60 million Sk).

Source: Ministry of Transport, Posts and Telecommunications

B. The expected budget would contain an overall projection of the actual expected expenditure development based on the government's political objectives.[10] This aggregate projection would subsequently be divided into concrete projections, on important programmes and an estimate of development of further expenditure claims. This would be a political decision based on expert analysis.

C. Proposal for resolving the differences between A. and B., which would represent a political decision of the government based on expert input

[8] The regulatory state of affairs refers to the framework created by the legislation, other binding rules and other regulatory decisions.
[9] The conceptual state of affairs represents obligations contained in conceptual documents approved by the government and/or the parliament.
[10] Level of taxation and redistribution, forecasts of future economic developments

This medium-term budget would cover a four-year horizon - the following fiscal year and three further years. It would be compiled on a rolling basis - continually updated and amended with changes in macroeconomic developments and changes in government decisions.

To function, it would require **the following requisite components:**

- Short-term model of economic development[11]
- Medium-term model of economic development[12]
- Forecasts of expenditure required to sustain the main public programmes in the medium-term while maintaining the status quo and based on this, a forecast of overall potential public finance expenditure in the medium-term
- Scenarios of development of revenues given various tax rates (status quo, reduction, increase) and scenarios of development of public finance deficits and based on them, a forecast of actually possible total public finance expenditure in the medium-term
- Division of actually possible public finance expenditure on main programmes in the medium-term
- Proposals of measures resolving the difference between possible and necessary expenditure in individual programmes

There also exists a link between the expected medium-term budget and the official budget for the following year. **The expected budget for the year t+1 will in the year t, following the inclusion of changes in macroeconomic forecasts, become the basis for the preparation of the current annual budget for the year t+1** (see also part 3).

It is, however, very important to point out that with this approach, **the Ministry of Finance would have to take on a much more active role in the preparation of the medium-term budget, particularly with respect to analyzing government obligations.** In other words, analysts at the MoF or its subordinated organisations would calculate the costs of existing government commitments. If this task were left to the individual departments, the commitment budget would, instead of reflecting the government's commitments, turn into an arena for their further inflation, despite the fact that the commitment budget does not establish a claim for negotiations on increasing a budgetary "allocation". A high level of **MoF involvement in estimating costs of individual programmes in not as unrealistic** as it may seem, because **the task of a medium-term budget proposed in this manner is not to cover all aspects of public finances, but only the most important ones, which constitute a significant majority of public expenditure.** In other words, for smaller programmes and departments, it would be possible to adopt the convention of a common coefficient of growth. The medium-term budget is merely an instrument to achieve the above-mentioned goals and for these purposes, it does not have to be completely accurate.

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[11] We recommend that the current situation when the MoF uses its own forecast, National Bank of Slovakia and INFOSTAT forecasts be amended with the average of forecasts of analysts at commercial banks.

[12] A medium-term model and forecast do not really exist, since the credibility of existing forecasts is extremely low. The National Bank of Slovakia is preparing to develop its own model, which could serve as the basis for MoF projections. Another option is to cooperate with analysts in the commercial sector.

This combination would allow the fulfilment of the goals stated above. **The expected budget would represent the foundation for the medium-term financing of individual departments/programs. It would therefore provide a fundamental degree of predictability and stability for the individual resorts/programs, while allowing the government to indicate its fiscal plans with a longer horizon.** The actual process of its preparation should be based on the methodology described in the following part for the preparation of the annual public budget, projecting it into subsequent years.

The commitment budget would have no influence on the actually allocated public funding. **The role of the commitment budget would be to present a combined depiction of the existing main commitments of the public sector on a sustainable basis. The total difference between the commitment budget and the expected budget would represent the deficit between commitments and possibilities of public finances.** The difference between the commitment budget and the expected budget in individual departments/programmes would show this deficit in specific areas and demonstrate the existing discrepancy between the government's commitments and its ability/willingness to finance them.[13]

The requirement to present a proposal to resolve the differences between obligations and possibilities would create pressure to present proposals of changes that would in the medium-term address the deficits between obligations and possibilities in specific areas.

With respect to this proposal, it is necessary to stress that like any other framework systems of public finance management, the system in and of itself does not guarantee results if used by a government without the will to reform public finances towards sustainability. As we have stated already, there are several reasons why the government can for political reasons feel this need. On the other hand, **this proposal provides such a government with an instrument to reduce the political costs of reform measures.** By concentrating the discussions on reforms on the medium-term budget, the government would partly make visible the above-mentioned "invisible" future costs of not implementing reforms and by uniting all fiscal obligations in the commitment budget, it would unify all the partial discussions into a single one. **The proposal creates a powerful framework tool for a minister of finance willing to reform the public finances, which he can use to exert pressure for sectoral reforms and on other ministers.**

In addition, it is necessary to warn that the methodology of calculating commitments is neither trivial, nor unambiguous. Commitments can be divided into several groups.

- Conceptual documents or laws quantifying obligations approved by the government/National Council. This represents the simplest case when these obligations can be taken directly. It concerns particularly the area of infrastructure, science and technology, environment and agriculture.
- Conceptual documents or laws allowing the estimation of future obligations approved by the government/National Council. This concerns areas where it is possible on the basis of the current situation or historical data to extrapolate future developments, if the approved framework does not change. It concerns particularly the area of social expenditure.

[13] This allocation of the overall deficit in individual areas would be a matter of political decision.

- Areas, where the amount of funds is not limited. This concerns areas such as support for small and medium-size enterprises or other transfers to the enterprise sector, where it is in principle possible to allocate an unlimited amount of funds. In this case we recommend budgeting as an obligation the current amount multiplied by the overall coefficient of expenditure growth.
- The so-called "insatiable systems" - i.e., systems where the value of obligations is difficult to estimate either because wage costs are a key element in costs (see below) or because quantitative and qualitative standards are imprecisely defined - for example in healthcare. In such cases, we recommend the use of a gross estimate of funds required to at least maintain a fundamental balance in the existing system.
- Public sector wages. Where there exists an explicit government obligation (for instance in the document Millennium, with respect to the desirable level of teachers' salaries) or law (the introduction of the 13th and 14th salary in the years 2003 - 2006), these would serve as the source. Otherwise, they would be budgeted according to the average expected nominal GDP growth.
- Capital expenditure - asset updating would be included in the commitment budget on the basis of write-offs of existing capital assets or on the basis of estimates of investment needs in the case of property that has been written-off but has not been renewed.

As we have already mentioned, **Finance Minister B. Schmögnerova tried to introduce several measures based on a similar philosophy.** The current situation may be interpreted as a gradual shift for the better, particularly in the area of short-term economic forecasting. Although a medium-term forecast of economic development, medium-term financial planning and scenarios of tax revenues and the tax burden formally exist, they do not represent an authoritative and accepted input into actual decision-making.

In conclusion we would like to draw attention to the issue of the so-called **long-term management of public finances.** In the 80s and 90s, many countries began to formally investigate the expected long-term developments in their public budgets, with a 5 - 30 year horizon. In such a horizon it is of course infeasible to meaningfully investigate macroeconomic developments or developments in individual programmes. Long-term budgeting can, however, serve as a simulation of effects of predictable changes, which at present include particularly demographic changes and population aging in developed countries. It is important to investigate the effect of these changes on:

- The pension system
- Healthcare
- Education

The long-term budget attempts to integrate various scenarios of development in areas sensitive for example to demographic changes and thus become a point triggering discussions on necessary reforms and a rallying point for these discussions.

Slovakia, like other OECD member states, faces the problem of aging population and with the exception of pension reform has made little progress in discussing the consequences for public services and the public sector. We can therefore recommend the preparation of a long-term budget, again in the form of a pragmatic document with a clear objective. On the other hand, as the saying goes, **if we want to run we must first be able to walk.** Therefore the attention in the next few years should focus on building a strong institutional capacity dealing with the medium-term horizon, particularly since our country must address quite rapidly many problems anticipated by other countries in the long-term.

For this reason we would recommend to attempt the preparation of a long-term budget only several years down the road and then to prepare this study with a 3 - 4 year frequency as a stimulus for public and political discussion.

3. Preparation and implementation of yearly public budgets at the highest level

3.1 Current problems

The preparation and implementation of the overall public budget in the horizon of the respective fiscal year is the basic and unavoidable part of public finance management. In the past few years we have witnessed some reforms in this area. Although we in general view their overall direction as positive, it is necessary to point out the persisting problems of the present system of design and implementation of the public budget at the highest level - within the triangle formed by the MoF, the government and the National Council of the Slovak Republic, where both power and responsibility to decide on public budgets as a whole rest. This chapter is thus devoted to the issue of the management of public finances at the highest level with a yearly horizon.

In our view, the government's most important decision in the annual preparation of public budgets is the determination of the total expenditure ceiling and especially its distribution among the individual budget chapter administrators. Most other discussions on public finances unfold from the manner in which this decision in made. With a single party government or a government with a dominant coalition partner, this decision is usually significantly influenced by this party's political decisions and those of its key representative - the minister of finance. In this case, a formally elaborate system of determination of distribution of expenditure ceilings among the various actors is not required.

The philosophy of our approach to this issue (as well as of the current approach of the Slovak government) **derives from the existence of coalition governments without a significantly dominant party and the consequent need for formal rules for the determination of expenditure ceilings.** Without such a rule (algorithm), agreed in advance by the individual parties and their representatives in government, the preparation of the budget every year turns into a drama, in which every minister has the incentive to advance his own interests at any cost regardless of anything. The discussion is unstructured and a system for reaching an agreement is lacking. Since a coalition government of several parties lacks party discipline, the preparation of the budget turns into a permanent drama leading up to the government's collapse or deficits in public finances higher than the parties themselves would consider appropriate.

For this reason, almost every government has an official or at least de facto rule for the determination of the total expenditure ceiling and its distribution among the individual administrators. A simple and commonly used algorithm is the indexing method, where expenditure ceilings of individual chapters are basically multiplied by a coefficient based on the year-on-year change in public expenditure warranted by revenue possibilities. The main disadvantage of such a system is that it does not allow strategic management of public finances and does not take into account the fact that expenditure growth in some chapters is given by demands based in laws and can be higher than the overall index. On the other hand, the need for resources in other chapter rises more slowly. In other words, the indexing method is simple, comprehensible and unambiguous, but significantly inefficient and makes running the state more difficult.

Before 2001 Slovakia essentially used the indexing method combined with estimates of some major requirements. **In 2001 the MoF introduced the breakdown of expenditure into facultative and obligatory, as an attempt to change the way of thinking in public finances. In our view, however, in spite of certain progress, this system gives chapter administrators the wrong incentives and goes against the philosophy of several changes in public governance.**

Obligatory expenditure has been defined as funds required for the functioning of the public sector. According to the MoF, this "approach provides information on the manoeuvring space available to the government or to budget chapter administrators in decisions on directing expenditure… That certain expenditures are obligatory in character does not imply that their budgeting is unalterable. Change in the amount, however, mostly requires the adoption of a law… The Ministry of Finance, however, included among obligatory expenditure the spending on energy, water and communications. Albeit their use is not conditional on a law, they are required for the functioning of organisations and given the increase in prices of these services, it is unreasonable to expect significant possibilities for savings and thus for variability in budgeting."[14]

Obligatory expenditure in the preparation of the 2002 budget included particularly:

- Wages in budgetary organisations of the state
- Insurance premiums on employees of budgetary organisations of the state
- Social security benefits and social benefits
- Energy, water and communications expenses of budgetary organisations of the state
- Contributions to the social fund
- Subsidies for scheduled public bus transport
- Contracts on operations in the public interest in transport
- Current transfers abroad
- Expenditure in the chapter State debt
- State payments into health insurance agencies and the Social Insurance Agency
- State bonuses on construction savings
- Pre-accession funds
- Current transfer for secondary vocational schools, Centres for Vocational Training and school production facilities
- Mandatory insurance of motor vehicles
- Expenditure on uniforms
- Expenditure on substitute civic service
- Economic mobilisation
- Stipends of university students and graduate students
- Wages and insurance of clerics

Such a categorisation is only appropriate for very short-term thinking when it is necessary to cut spending **within** a fiscal year. Already from the perspective of budget preparation it poses negative incentives, which appear more and more strongly with a several-year horizon of employment of this system, particularly if the process of public sector reform is taking place at the same time.

[14] 2002 State Budget, proposal for a session of the Government of the Slovak Republic, MoF, July 2001.

It is because the system lacks a clear philosophy of what is understood as obligatory expenditure. This mixes real law-mandated claims on transfers with funds required to maintain the current number of employees in budgetary organisations of the state and buildings maintained by budgetary organisations, further mixing in arbitrarily determined funds for transfers into healthcare and funds for financing those parts of the education system, which represent contributory organisations. This fact has several practical negative consequences:

- An unclear philosophy and the mixing of various types of expenditure create room to include in the future as much expenditure as possible within obligatory expenditure. The fact that the allocations of funds for obligatory expenditure is "guaranteed" motivates budget chapter administrators to act in this way
- Unclear rules for determining the value of certain obligatory expenditure items provide room for strategic games on the part of budget chapter administrators
- The inclusion of wage, insurance and energy costs of budgetary organisations in obligatory expenditure means that administrators of budget chapters are motivated to preserve budgetary organisations, transform contributory organisations into budgetary organisations, not privatise or otherwise get rid of existing organisations and perform new activities primarily through their own budgetary organisations
- This approach does not give incentives to reduce the number of employees or basic operational expenditure in budgetary organisations, because such a mea sure would result in the allocation of less funding to the chapter in the subsequent year
- The answer to the question of budgeting expenditure on areas not serviced by budgetary organisations of the state or where there does not exist a normative for quantifying claims (many decentralised areas, higher education) is missing

In addition, the present method of exerting pressure on the reduction of public spending has proved ineffective. In recent years the government would approve some programmes without sufficient financial coverage with the proviso that the budget chapter administrator should enact reforms in the course of the fiscal year to leading to reductions in expenditure. Without a hard budget constraint and thus without real pressure for savings measures in the process of budget approval, this approach could not be and was not successful.

A further problem is that in the current system the government does not really know what it is deciding on and therefore to a large extent it does not really decide. The absence of the programme approach means that individual ministers do not know what they are deciding on with respect to other chapters. Where the programme approach has already been implemented, due to unclear methodology and philosophy, the government makes decisions on too many programmes of different size (see part 4). In preparing the budget it therefore often devotes the same amount of attention to deciding on an expenditure item in the amount of several tens of millions of crowns as on an item in the amount of billions of crowns. Furthermore, no government **can effectively judge the distribution of expenditure at a more detailed level than the budget of a chapter or basic programmes it is implementing, which the current system of budgeting does not take into account.**

A key question affecting the later **implementation** of the budget lies in the weaknesses of its **design,** particularly in the fact that **the pressure for accurate budgeting of**

claims on public finance resources is insufficient. The current way of budgeting allows several budget chapter administrators to undervalue or even keep secret certain claims, knowing that the government will have to deal with the problem of insufficient funding in the future anyway. Budget chapter administrators do not feel real pressure to adhere to certain types of expenditure approved in the budget. In the course of the fiscal year they are able to de facto "blackmail" the MoF with arguments that if it does not authorise additional finances, the expenditure programme will collapse and/or hidden debts (unpaid invoices, etc.) will rise. Social benefits have exceeded planned expenditure by 3 to 3.5 billion Sk every year since 2000. In addition, in the course of the fiscal year budget chapter administrators put forward requests for expenditure, which they intentionally kept secret when the budget was prepared. A good illustration of this practice is provided by the expenditure on textbooks for primary and secondary schools covered by the Ministry of Education. These costs recur annually and the ministry is aware of them. Despite this, it did not include them in the state budget proposal it had prepared for 2001 on the basis of the approved expenditure ceiling. In the early months of 2002 the ministry then initiated pressure on the government through the media to approve additional funding for the Ministry of Education chapter for textbooks. The approved limits of public budgets (with the exception of the overall limit) consequently are of value only on paper.

This is also caused by the fact that expenditure limits in public budgets are not sufficiently binding. In the case of the state budget, at least its deficit cannot be exceeded; other sections of public finances (Social Insurance Agency, healthcare insurance agencies…) are not even bound by this limit. For example, health insurers are required by law to compile balanced budgets. In practice, they have not yet succeeded in adhering to this requirement in a single fiscal year. Their budgets are therefore merely declared to be balanced. The law on the state budget also permits considerable expenditure freedom (15 percent in 2002).

The result is that in recent years, the actual spending from the state budget and public budget exceeded the approved budget by tens of billions of crowns. In 2000 actual expenditure exceeded the approved state budget by 4.5 % of GDP, in 2001 by 3.3 % of GDP. The credibility of the approved budget is therefore very low. The ability to exceed expenditure limits or introduce new programmes in the course of the fiscal year gives budget chapter administrators the wrong incentives and does not create pressure for efficiency.

Major distortions in the government's impact on budgets of public institutions, for whose solvency it is responsible, relate to the topic outlined here. Not all components of public finances with their own budgets are governed by equally strict budget rules. Meanwhile, the government or the state budget guarantees their solvency. The key problems include the fact that **the state budget guarantees the solvency of budgets of the so-called public law institutions (Social Insurance Agency, National Labour Bureau, General Health Insurance Agency),** but has only limited and inefficient tools available to manage and affect the fulfilment and compliance with these budgets in the course of the fiscal year. Other components of the public sector outside of the state budget are governed by softer budgetary restrictions than the central government budget. Their budgets, approved by parliament, are only informative by nature and there is practically no binding limit for them - neither the deficit nor an expenditure ceiling.

For instance, health insurers are required by law to compile a balanced budget, but there is no obligation to adhere to it. Thanks to the tripartite system of management in health insurance agencies and the National Labour Bureau, the government's management powers are also limited.

All of the measures outlined above only make sense if the data used reflect the actual situation in public finances. At present, the general management of public finances and the micro-level in the budgetary sector use accounting methods, which focus primarily on the flow of finances - on revenue and expenditure and thus on cash-flow statements. We can speak of accounting based on cash flows (cash accounting). This approach does not take into account payables and receivables that have not been settled whether due to insolvency or because they are due at a future date. Nor does it account for write-offs.

The final topic is the high number of budget chapters. The state budget for 2002 divided funds into 46 chapters. Dividing up funds into too many autonomous chapters reduces efficiency of the whole process. To prepare the budget, the government must allocate resources into a large number of separate budget units. Meanwhile, the amount of funds in individual chapters varies significantly. For instance, the budget chapter of TASR (The Press Agency of the Slovak Republic) received approximately 78 million Sk, while the chapter Ministry of Labour, Social Affairs and Family received 25 billion Sk.

3.2. Changes in the preparation of the budget

In the process of creating the public budget[15] the government as a whole, and individual budget chapter administrators, make a number of key decisions. We propose that they proceed in this decision-making process according to the following four steps:

- The government's decision on the **overall** expenditure ceiling of the budget
- The government's decision on **expenditure ceilings** for individual budget chapters based on differentiation between mandatory, priority and other expenditure quotas
- Autonomous **preparation of a concrete budget proposal for individual chapters by their administrators** within the limits given by prior government decisions
- Decision of the government as a whole on corrections in budgets put forward by individual budget chapter administrators and approval of the budget as a whole

This process roughly corresponds to the preparation of the budget implemented since 2001 (the preparation of the 2002 budget). Differences, on which we focus in this part, could, in our view, significantly affect the decision-making process and the incentives of its participants.

The government's decision on the overall expenditure ceiling of the budget

The foundation for decisions on next-year's budget should be provided by a qualified

[15] The proposed measures can be applied independently of integration of public budgets in the preparation of the State Budget.

estimate of revenues of public budgets from the MoF supported by comparisons with forecasts of other authorities (particularly the National Bank of Slovakia, possibly also averaged forecasts of analysts at commercial banks). It is necessary to emphasise this point, because the practice in the past, when the finance ministry intentionally undervalued expected revenues, also contributed to reducing the credibility of the approved budget. The estimate should contain a scenario forecast of revenues with changes of tax rates/other measures, particularly if the government indicates willingness to consider such measures. The second step is the political decision of the government on the maximum acceptable deficit/minimum acceptable surplus of public finances. **The overall expenditure ceiling (E)** is a sum of expected public revenues and the acceptable deficit of public finances (or the difference between expected public revenues and the minimum surplus).

The algorithm for the government's decision on expenditure ceilings for individual budget chapters

It is necessary to stress early on that **at this stage only the overall expenditure ceiling for the budget chapter is being determined, NOT the individual types of expenditure** within it. **Expenditure items used at this stage represent only variables in the algorithm for the determination of the expenditure ceiling** of the chapter. Actual expenditure on specific areas will be determined at the next stage. This distinction is very important.

The proposed algorithm works with three kinds of expenditure:

- Expected required mandatory (obligatory) expenditure within the chapter
- Political decision of the government on the extent of priority expenditure on individual chapters
- Residual (remaining) sum of expenditure for individual chapters - the so-called standard expenditure

The expenditure limit for the budget chapter administrator, which he can distribute between its programmes[16], will be determined by the government as the sum of mandatory, priority and standard types of expenditure within the chapter: $\mathbf{E_k = M_k + P_k + R_k}$

The expected needs for mandatory expenditure (M) consist of law-mandated transfers to third persons (social assistance payments, social benefits, interest payments on state debt and exercised state guarantees, contributions of the Slovak government for membership in international organisations and in the future also Slovak payments into the common budget of the European Union). This group of expenditure items must be defined clearly, since it will be significantly isolated from other public expenditure. It is necessary to emphasise **that mandatory expenditure includes expenditure provided by the budget on the basis of obligations to third persons. These are either entitled to them by law or not meeting these commitments would lead to sovereign**

[16] This procedure is also possible before the budget moves to the programme approach. In that case, administrators will distribute expenditure according to classifications currently in force.

default or violate an international agreement. This implies that if budget revenues are not met, savings in these expenditure items cannot be made by rationalisation or increased efficiency of the public sector without a change in entitlements. At the same time, the payment of these expenditure items cannot be stopped without legislative changes if the approved limit is insufficient.

Mk denotes **the expected need for mandatory expenditure,** which the chapter administers on the basis of legal responsibility and which can be estimated using the technical expertise of the MoF and the individual budget chapter administrators. In this context it must be said that if the MoF holds a dominant position in the budgetary process, it must have its own capacities capable of forecasting mandatory expenditure under various macroeconomic and other scenarios.[17]

The amount of mandatory expenditure in 2002 would consist, for example, of expenditure items budgeted for:

- Payments of interest on state debt: 40.3 billion Sk
- Social assistance payments: 13.9 billion Sk
- Social benefits: 15.9 billion Sk

As we can see, mandatory expenditure would dominate particularly in the chapter State debt, in the chapter of the Ministry of Labour, Social Affairs and Family, but significant amounts would also appear in other departments, such as the department of finance (mortgage loan interest subsidies and construction saving) or education (several types of scholarships).

Relations with self-governing regions and municipalities within the decentralisation of competences represent a separate issue. The law on budgetary rules assumes the so-called decentralisation subsidy to regions and municipalities, which will be calculated on the basis of normative formulas determined by ministries in individual areas. In the area of education there exists the law on the financing of primary and secondary schools and school facilities, which serves as the basis for normative formulas in this area. If on the basis of these normative formulas we can clearly calculate the amounts to be transferred in the given area to regions and municipalities, this amount should be included among mandatory expenditure items. If the specific normative does not allow the determination of a specific amount or the normative does not exist, these expenditure items should be included among standard, other expenditure,

Another important category is represented by the share of the budget chapter on priority expenditure - Pk. After analyzing mandatory expenditure, the government will allocate the overall sum of priority expenditure **(P)** from the overall public finance expenditure ceiling set for the strategic management of public finances, i.e., to give the government explicit manoeuvring room within which it can increase spending on specific areas. P will be distributed among the individual chapters in a way that primarily reflects the government's political decision on areas, on which it wishes to be more generous, since it considers them to be a priority. We cannot therefore speak of

[17] Following the integration in the public budget, mandatory expenditure would include expenditure on pensions paid by public institutions and unemployment support or the deficits of own resources of institutions, which pay them.

a technical/expert model of determination of **Pk.** In spite of this we can recommend the use of the programme approach to public finance management for the government to bind the distribution of priority expenditure in practice to specific programme commitments of ministers - quantitative and qualitative obligations in specific programmes.

The sum of other - standard - expenditure (R) should serve as an instrument of stability for a large part of public finances. This would not be a small amount, but the amount "left over" from the overall expenditure ceiling after allowing for mandatory and priority quotas. The sum of standard expenditure would be distributed among individual chapters according to the historical principle, based on a comparison of last year's mandatory expenditure **(R** and **P)** and the sum of other expenditure available in this year (R). The comparison of these two yields the coefficient of annual growth. R would really represent the basis for the expenditure ceiling for example in the area of education, defence, interior and justice, culture and environment, where the share of mandatory expenditure is not high.

But the proposed system does not function automatically - it requires an early warning system. With low growth/decline of revenues, sharp rise of mandatory expenditure or the allocation of a large amount for priorities, this approach could lead to a sharp nominal decline of inter-year expenditure ceilings in many chapters dominated by standard expenditure (R) or to other situations, which can not be addressed through decisions on savings at the level of budget chapter administrators. After budget approval, such a situation would not lead to credible pressure on changes in expenditure programmes. In other words, the proposed system represents an algorithm for the allocation of budget ceilings for the individual actors in the budgetary process, which functions smoothly given a standard combination of stability and strategic management of public finances. If a non-standard degree of internal tension exists in public finances, no such system will resolve it by itself. The tension can be reduced only in conjunction with short-term or medium-term decisions on changes in specific programmes, policies or laws. If during the preparation of the yearly budget the MoF comes to the conclusion that given the expected revenues, mandatory expenditure and government-determined priorities cannot be financed in the upcoming year without collapse in many other areas, it will have to warn the government of this. (In reality, various scenarios will form a part of the state budget foundations presented to the government by the MoF in April or May of the preceding year.)

The government will have to prepare measures to increase revenues, or decide collectively on reducing the amount of priority expenditure. Should it be unable to reach acceptable results in this way, it will have to change mandatory expenditure. But in this case, the following rule should again apply: if a budget chapter administrator wishes to or, per government's orders, has to cut spending on mandatory purposes, he will have to propose the necessary legislative changes to be approved by the government together with the proposal of the law on the public budget. It is thus not enough to reduce the ceiling without changes in the policy that leads to the expenditure.

Autonomous preparation of proposed budgets of individual chapters by their administrators and approval of the budget as a whole

Within the preceding phase, only an overall expenditure ceiling for the individual chapters was determined, but without distributing this limit to individual programmes.

On the basis of this ceiling, individual administrators will prepare their budget proposals. In preparing the budget proposals, chapter administrators will have to distinguish between mandatory expenditure and other expenditure.

- The sum and division of mandatory expenditure $\mathbf{M}_k$ will be proposed by budget chapter administrators in accordance with estimates carried out in the preceding phase. Administrators will be able to propose lower mandatory expenditure than estimated in the preceding phase only if they also present a legislative proposal allowing such a reduction. In such cases they will be able to use the funds saved for other budgeted expenditure.
- Budget chapter administrators will be able to independently propose the division of the sum of $\mathbf{P}_k$ and $\mathbf{R}_k$ between the individual areas so as to preserve the incentive to save where the administrator is able to do so and shift these funds into other areas he views as priorities. On the other hand, the question arises on the use of the amount allocated within priority expenditure. The answer will come from the way in which the government will allocate priority expenditure. If it will be allocated for specific purposes (for example, increased construction of rental flats), the purpose will be binding for the administrator. The government has final say here through the process of overall budget approval.
- Proposals put forward in this way will be summarised by the MoF in the budget proposal presented at a government session. Before approval the government will be able to carry out collective corrections (for example, if a minister proposes to use allocated funds in violation of the government's overall priorities, in contradiction with a fundamental priority of one of the parties, etc.)

The proposed system has (like any other system) its shortcomings and reserves, but it will avoid some of the distortions of the present system:

- **It will introduce a clear methodology for determining expenditure items, which "automatically" receive funding** through the criterion of entitlement to transfers for third persons. This will eliminate the room for placing as many expenditure items as possible among mandatory expenditure in the future, as well as ambiguities in their determination
- **Together with other measures it will create pressure for truthful budgeting of mandatory expenditure already at the beginning of the budgetary process**
- The proposed definition of mandatory expenditure **will eliminate incentives for budget chapter administrators to give preference to a certain form of provision of public services** (through budgetary organisations) without losing incentives to reduce the numbers of employees or basic operating costs of an organisation
- **It will allow the government** through setting the inter-year coefficient on standard expenditure (R) **to fine-tune the pressure to save in areas with lower priority, while managing them strategically through priority expenditure** (P)
- It will, however, give budget chapter administrators the autonomy to propose transfers between individual expenditure programmes within the set expenditure ceiling

An apparent drawback of the proposed system is that, at the first glance, it does not force systemic reforms of social benefits and other mandatory expenditure, since it "guarantees" the allocation of funds for mandatory types of expenditure. This objection is justified to some degree, but in our view, this problem must be addressed mainly within the medium-term budget, which will show the sustainability of public finances. Another antidote lies in the fact that with tight public finances, there will be a danger of budgetary collapse without changes in mandatory expenditure. The proposed system will demonstrate this clearly already in the course of determining expenditure ceilings, unlike at present, when undervalued amounts are simply budgeted instead. This approach will create more real pressure for reforms of mandatory programmes.

Finally, it is also necessary to discuss in greater detail the relationship between the proposed system and the medium-term budget. The proposal for budgeting in the yearly horizon is formulated so as to add value even without simultaneously applying the medium-term approach - so that it can function independently. If the medium-term approach is applied, this methodology will be used not only for the formulation of the official yearly budget for the nearest year (e.g., 2003) but also for the preparation of **expected** budgets for three more years (e.g., 2004 - 2006). For this very reason, part 2 **did not discuss** in greater detail the process of preparation of a specific **expected** budget for a four-year period. In other words, the proposed methodology for the formulation of the yearly budget can be applied to subsequent years, thus linking the short-term and medium-term horizons.

3.3 Budget compliance and changes in the course of the fiscal year

The credibility of the approved public budgets is reduced by the fact that their expenditure limits are not sufficiently binding. This introduces major distractions into the system of public finance management, particularly the fact that **the approved limits of public budgets (other than the overall deficit) only carry value on paper.**

We propose that **in addition to the public budget deficit, public expenditure should represent an equally binding indicator,** both at the level of the overall expenditure limit and the limits at the budget chapter level. The introduction of the expenditure limit would bring about higher responsibility of the budget chapter administrator in using the allocated funds, while also increasing demands in the budget preparation phase. The strengthening of independence of chapters in budget preparation must be connected with increased pressure for financial discipline. Budgetary rules would not allow the Ministry of Finance to satisfy the demands of chapter administrators to release additional funds without significant administrative barriers.

The introduction of the expenditure limit, however, cannot have absolute validity, particularly because many expenditure items cannot be planned exactly during the budget approval. It is therefore desirable to **strengthen the role of the government reserve.** The reserve should address the discrepancy between approved expenditure and actual developments. We emphasise that the government reserve should serve the role of a real macroeconomic reserve and should thus reach several billion crowns, specifically 2 - 3 % of expected expenditure. It should serve as an insurance against unforeseeable events, which will require the use of public funds, exchange rate changes and so on. The government would collectively decide on using the reserve.

After the exhaustion of the government reserve, the expenditure limit of a chapter could be exceeded only with parliamentary approval at the government's proposal, through an amendment to the law on the public budget.[18] Should there be a threat that the expenditure limit will be exceeded by a significant margin as a consequence of incorrect budgeting, the political punishment for non-compliance with the budget through the need to negotiate with the finance ministry/government on the release of additional funds is insufficient. To the contrary, as we have stated, departments knowingly use this method of raising funds, most often using the threat of a collapse of an under funded programme as their argument. The need to amend the law on the public budget in the National Council of the Slovak Republic would make increasing the expenditure limit administratively and politically more difficult. The adoption of a new programme with a financial impact on the present fiscal year would also have to be accompanied by an amendment to the law on the public budget. At present, the adoption of new programmes requires disclosure of their impacts on the state budget, but it is only declarative by nature and for the above-mentioned reasons, not binding in any way.

The necessity of the proposed political punishment for exceeding expenditure derives also from the fact that any system of public finance management and audit can assure that the chapter does not exceed its expenditure limit, but cannot prevent the formation of real obligations exceeding the available funds.

We propose to increase the functionality of this system by connecting it with the introduction of a system of mandatory expenditure and their binding to a specific purpose.[19] Mandatory expenditure will be demanding in budget preparation with respect to precise ex ante estimates. If they are undervalued, it will not be possible to cover them from other sources without administrative and political barriers. At the same time, the administrator of such expenditure will not be able to rely on using overvalued mandatory expenditure for other purposes. The risk of a sharp distinction of mandatory expenditure can lie in efforts of chapter administrators to gradually shift their expenditure into this category. But the government should be aware of these risks when adopting legislation, which raises financial requirements or introduces new mandatory expenditure. The limit should create hard pressure for correct estimates. The government has for several years approved expenditure on social benefits with the knowledge that the budget in this area is undervalued.

3.4 Integration of public budgets

The present system of public finances in Slovakia displays a significant imbalance between the government's responsibility and its powers. Not all parts of the public finances, which have their own budgets outside of the state budget, are governed by

[18] With the exception of delimitations

[19] Binding to a specific purpose should be implemented by having mandatory expenditure usually represent one or several separate programmes or subprogrammes within the chapter, applying binding of funds to the level of subprogrammes. This approach may not be appropriate in some cases and could lead to significant distortions in programme budgeting. In such cases we recommend the "traditional" purpose binding.

equally strict budgetary rules. At the same time, the government or the state budget guarantees their solvency but has only limited means at its disposal to manage and influence the implementation of and compliance with these budgets in the course of the fiscal year.

The problem of integration of public budgets cannot be addressed solely by reform of the management of public finances. It is not the aim of this publication to propose reforms in individual programmes financed by the public sector. Many of them depend on the government's political decisions (public vs. private healthcare, pension system reform, etc.). We will therefore limit ourselves to a few essential recommendations, which are important for more efficient management of public budgets.

There is an essential distinction between different parts of public finances, depending on whether or not they are financially independent and self-sufficient. In other words, the question is: is there a systemic risk that the organisation will be unable to cover its expenditure with its revenues; i.e., is there an automatic and functioning mechanism guaranteeing a balanced budget? In that case, is it the state who guarantees its solvency or the provision of its services?

If the answer to both questions is in the affirmative, the budget of this organisation should be subject to different rules than if the answer in negative.

In our view, institutions, which are presently not financially independent include:

- Social Insurance Agency
- National Labour Bureau
- health insurance agencies

On the other hand, we can view as financially independent the following:

- Slovak Land Fund
- Municipalities
- self-governing regions
- National Property Fund

The following institutions are ambiguous:

- Slovak Television
- Slovak Radio

In the preparation and implementation of the overall public budget, the budgets of financially independent institutions should mainly have reporting obligations towards the MoF. The current system, stipulated by the law on budgetary rules, is essentially suitable.

Budgets of institutions that are not financially independent should be included in the law on the public budget. This is a minimum condition for the burden of compliance with approved limits of public budgets (expenditure ceiling, deficit) not to rest only on state budget chapter administrators, as is the case at present. The state should introduce strict budgetary limits for them equivalent to the limits in the state budget - the requirement to comply with the approved budget deficit and expenditure limit. For instance, the expenditures of the Social Insurance Agency and the National Labour Bureau are mandatory in character. If the government can according to our proposal press on a state budget chapter administrator to precisely estimate mandatory expenditure and abide by strict budgetary limits, there is no reason why insurance funds administrators should not abide by the same rules. In the special case of health insurers it is necessary to adjust expenditure to income (or the other way around) for the health insurers to comply with limits approved in the budget. The specific shape depends on reform measures in the healthcare sector.

Pursuant to concrete reforms in the individual areas, the government should in the next electoral term opt for one of the two alternatives for every institution that is not financially independent:

- A reform leading to a fundamental degree of financial independence and self-sufficiency and consequent budgetary autonomy.
- If the government does not wish to take this step and wishes to preserve a tighter level of integration of these institutions in public finances, it should consider whether the character of their programmes is sufficiently specific, unique and different from state budget programmes to keep them separate from it. The formation of independent public insurance institutions in Slovakia was supposed to trigger reforms in programmes financed by them. This has occurred only to a limited extent. The so-called insurance system, on the basis of which health insurers, the Social Insurance Agency or the National Labour Bureau finance their pro grammes, does not practically differ from pay as you go financing from taxes and contributions, which bears no resemblance to insurance. We propose the abolition of these institutions. However, if the government decides not to make them financially independent, they should become budget chapters in the state budget.

The decision on the status of a specific part of public finances is a matter of political persuasion and individual specifics. No part of the public finances should, however, in our view "fall between" the two options with all the negative consequences we recall from the 90s.

3.5 Accuracy and informative value of public budgets

Knowing the actual financial situation of the state and its individual components is of key importance for managing public finances. The primary instrument for obtaining information in this area is accounting. Accounting encompasses three basic statements:

- Balance sheet (balance of assets and liabilities)
- Profit and loss statement (balance of costs and revenues)
- Cash-flow statement (balance of income and expenditure)

The difference between the profit and loss statement and the cash-flow statement lies in the fact that the profit and loss statement accounts for the timing of costs and revenues while the cash-flow statement focuses on recording financial flows - income and expenditure. In terms of thinking about a reform of public finance management, this simply means that **the cash-flow statement does not take into account payables and receivables that have not yet been settled, either due to insolvency or because they are due at a future date, and write-offs.**

At present, **the overall management of public finances as well as the micro-level in the budgetary sector still use accounting focused primarily on the flow of finances - on income and expenditure or on cash-flow.** We refer to this as cash accounting. From the viewpoint of international standards this model is based on a methodology of the International Monetary Fund **Government Finance Statistics (GFS) from 1986.**

On the other hand, the European ESA95 methodology based on the system of national accounts, as well as the innovated IMF methodology from 2001 (GFS 2001) are based on the notion of capturing income and expenditure rather than cash-flow, but focusing at the moment when they are incurred. Specifically, we can observe the following differences between GFS 1986 and ESA95:

- The GFS 1986 method used by the MoF records operations on the basis of cash-flow (when cash is received or paid), while ESA95 uses accrual principles (when a claim or value arises). This leads to significant differences in the case of accumulation of payment arrears for both income and expenditure
- According to GFS, privatisation revenues in cases when sales are a result of economic policy (conducted for policy purposes) are included in the item **loans provided less repayments,** thus reducing the deficit. ESA considers these as financial operations without an effect on the budget balance.
- Expenditure on insurance contributions of state and public administration are under GFS subject to consolidation, while ESA includes them in wage expenditure (in the case of the state budget) or insurance funds income (Social Insurance Agency, health insurers, National Labour Bureau)
- GFS does not include interest costs for bank restructuring, while ESA views them as current expenditure

In Slovakia's case, this leads to significant differences in reported public finances, as depicted in the following table:

Table 3.1: Public Finances in the Slovak Republic - differences between GFS 1986 and ESA95 (in % of GDP)

	GFS				ESA			
	1999	**2000**	**2001**	**2002**	**1999**	**2000**	**2001**	**2002**
Revenues	39.0	36.8	32.9	32.7	47.6	46.1	46.4	45.8
Of that taxes and insurance contributions	31.8	32.4	28.4	29.0	34.4	33.7	33.8	33.5
Expenditure	39.6	41.8	41.0	37.0	54.2	52.2	52.9	52.2
Of that social transfers and subsidies	22.3	22.9	24.6	21.1	26.5	26.3	26.1	25.2
Loans provided less repayments	3.1	-3.1	-4.2	-0.8	-	-	-	-
Deficit/Surplus	-3.6	-2.0	-3.9	-3.5	-6.6	-6.1	-6.4	-6.3

Source: OECD

Note: Years 2001 and 2002 - budget figures, other years - actual figures

At the level of overall public finances, the biggest problem in this respect is posed by state guarantees and the use of privatisation revenues.

Expenditure on exercised state loan guarantees represents a typical example of the current distortions. Despite the fact that they require several billion crowns every year, from the viewpoint of budget statements it is as if they did not exist. In recent years, in preparing the budget the government has included them under the so-called memorandum items financed from privatisation revenues. Changes adopted in the legislative treatment of loan guarantees led to a situation when an exercised state guarantee is considered repayable financial aid, which the debtor is required to pay back. But the repayment rate of this aid only reaches a few percent of the value of exercised guarantees.

In practice this means that at the time of provision of a state guarantee on a loan it is not yet considered current expenditure (it is a "sub-balance-sheet" liability) while at the time it is exercised, the state includes it in the category of "past debts" which may be financed from privatisation revenues without increasing state budget expenditure (and its deficit).

A similar situation exists in the repayment of debts for instance in the healthcare sector or with the so-called operations in the public interest (railways). The government covers debts of health-care facilities for unpaid invoices for goods and services with privatisation revenues. Similarly, the government agreed with the railways on gradual repayments for operations in the public interest, which actually represents a subsidy from public funds for the railways to keep prices below costs. The government did not include this expenditure (or liabilities) in the budget balance at the time when they accrued or at the time when they were repaid, because at that time they are included in the category of "past debts" financed from privatisation. Thus they are not counted in public expenditure (or deficit) of the public finances.

We propose that Slovakia should switch as soon as possible to the ESA95 methodology, which is binding with respect to EU accession and the Maastricht criteria and also provides a more accurate picture of public finance developments. This would mean that privatisation revenues would not reduce the deficit of public finances and a portion of state guarantees would be included in the public finance deficit. We deal with implications of these changes at the level of a budgetary unit in chapter 5.

3.6 Addressing the reduction of the number of budget chapters

The 2002 state budget distributed funds in 46 chapters. The distribution of funds into too many autonomous chapters reduces efficiency of the whole process. Programmes carried out by individual chapters differ significantly in size. We therefore recommend considering whether the existence of a budget chapter managing a relatively small amount of funds is justified. This reform would be of particular importance in connection with the move to programme budgeting.

In determining expenditure limits, the government should distribute funds into groups of approximately equal size. The basic criterion for deciding on folding a separate chapter into a larger whole could be an analysis of whether the budget of this chapter can at least be considered a separate programme. In addition, the government should consider whether a chapter needs to be independent if its budget only covers a single programme. It may be efficient to include such a chapter as a programme or sub-programme in another chapter.

This would lead to a situation where only 20-25 budgetary chapter would exist, which could be further meaningfully divided into programmes, particularly in the larger chapters. This would improve the functionality of strategic management of public finances on the part of the government.

This approach could, under some circumstances, have negative consequences on the independence of regulatory and auditing agencies, the hottest potential candidates for inclusion in another budget chapter. The administrator of such a joint chapter could also face the wrong incentives. In preparing the budget, he may suppress the demands of these agencies made at the expense of his "own", original expenditure. We therefore propose that the budget of independent organs be bound to a specific purpose through the programmes/sub-programmes they carry out. In preparing the budget, the government would guarantee to them a standard year-on-year change in expenditure at the level of the coefficient of increase/decrease of other expenditure (R), or the overall year-on-year change of expenditure. In addition, the government as a collective organ has the ability to influence the budget through priority expenditure.

4. Public finance management and the programme way of thinking[20]

4.1 Programme way of thinking as a shared principle of the vision

A shared element, which in our view, concerns all levels of management of public finances, is the so-called programme way of thinking on public finances. Its principles and application to Slovakia are presented in this chapter.

As mentioned in the introduction (see part 1), the presented material distinguishes between four levels of the system of budgeting and management of public expenditure, from the top level of the government, National Council and Ministry of Finance to the level or organisational units of implementing agencies.[21]

Any system of public finance management with an ambition to contribute to efficient and transparent use of public funds must provide answers to the following questions:

- Is there a clear "owner" of funds at every level of public finances responsible for their use?
- Is a higher level able to determine the **purpose** for which it is allocating funds to a lower level and enforce their usage for the set purpose?
- Is there possibility for meaningful oversight and discussion on allocated and spent public funds within decision-making and audit organs, as well as on the part of the public?

Every system of management of public finances, which does not merely represent masked chaos, answers "yes" to each of the questions posed here. The precise meaning of this answer, however, depends on what we understand under the term **purpose.**

In traditional approaches to budgeting based on economic classification of expenditure one must determine **what portion of funds allocated to budget chapters is allocated to wages, mandatory social contributions, goods and services and transfers.** There is also a distinction between current and capital expenditure. The government therefore knows from the data on a budget chapter how much money it is allocating to individual ministers and budget chapter administrators. It knows, for example, that the Ministry of Transport, Posts and Telecommunications (MTPT) can spend in 2002 directly or through "its" organisations 1.19 billion Sk on wages, transfer 3.92 billion Sk for current expenditure to other organisations or individuals and has a ceiling of 12.41 billion Sk for capital expenditure.[22] Within its detailed budget, the MTPT then knows the same data on the organisations and individuals to which it further distributes these funds.

[20] We will use as illustration for our ideas examples from the education department, since its budget chapter moved to full programme budgeting in 2002 as the first chapter managed by a ministry. Other chapters that moved to full programme budgeting in 2002 were the chapters of the Slovak Academy of Sciences, Constitutional Court and Supreme Court.

[21] In some cases, an intermediary level between levels 2 and 3 can appear, which we will characterise as level 2a. This includes for example District Offices and at the time when the previous law on universities was in force also universities, since their faculties usually served as their implementing agencies.

[22] According to the approved 2002 State Budget

Under normal circumstances, however, the government would not know from these data how much money will be spent on highway construction and how much on their maintenance. This is one of the reasons why highway construction was one of the first larger programmes really introduced in Slovakia.

This approach allows for transparent preparation and oversight of the budget both at the lowest organisational levels and at the higher, more aggregated levels. Its drawback is that it does not derive primarily from the content of activities to which funds are allocated or from the efficiency of spending and the accomplishment of objectives in this area.

The drawbacks of the above-described traditional approach for budget preparation are eliminated by the programme approach.[23] The term programme is the focal point of the approach. Within public finances, a programme is understood as a set of activities aimed at achieving a common purpose with specifically determined objectives and measurable indicators of achievement. Activities within a programme are usually divided into groups, each of which is aimed at achieving a certain part of the purpose and objectives of the programme. If needed, these are subdivided further. Objectives and indicators are set for every part of the programme structure. Programmes can be viewed as means, through which the government realises its more general objectives or intentions.

The programme way of thinking in public finances therefore contains:

- **Allocation of funds for a purpose,** which is defined in a certain area of activity
- **Linking the allocation of funds with the achievement of objectives** determined in advance

The programme way of thinking allows for a broad scale of approaches not only to budget preparation but also to planning, programme design and the design of budget for programme implementation and the evaluation of achievement of plans and programmes. Various approaches based on the programme way of thinking in public finance management share certain key characteristics but differ in the emphasis they place on various specific features. Foreign and domestic consultants working in Slovakia therefore have different opinions on the content of programme budgeting and if a clear concept of programme budgeting is absent, its implementation may be accompanied by serious problems.

The programme approach to public finance management does not only cover the issue of financing. As an example, we can point to the PBBS system (Planning, Programming and Budgeting System) implemented by the US government in 1965. PBBS was proposed as an instrument for allocation of funds to individual programmes. Planning includes analysis focused on the setting of goals and corresponding solutions to achieve them, programming refers to the choice of the method to achieve goals using cost and benefit analysis. In the budgeting phase, programming becomes reflected in the budget. The programme approach can be employed in Slovakia specifically in the area of planning, budgeting and financial policy.

[23] The programme approach does not necessarily mean programme budgeting - a partial substitute in terms of specificity may be the purpose binding or the existence of state funds.

For the area of planning, the programme approach provides instruments for the formulation of intentions and goals. Its deployment would support and facilitate the design of a government strategy in individual areas of government activity, which has so far been conspicuously missing.[24] Instruments of programme budgeting can also be used in the formulation of financial policy. Here it concerns particularly

- The support for achieving specified goals with economic instruments[25]
- The setting of binding indicators affecting the behaviour of the subjects receiving funding.

With respect to the setting of binding indicators using instruments of programme budgeting, this primarily concerns the degree to which expenditure is binding for individual programmes. This implies for instance a ban on the use of funds allotted for universities' main activities - education and research and development - for its other activities such as student social support and vice versa. But within the programme approach, there is also the possibility of formulating much finer financial instruments: for instance, you can stipulate that within the normative formula-based financing of universities for the subprogramme of Operating Expenses, savings can be used within the subprogramme Development of Higher Education. At the same time, you can set a restriction that funds earmarked for the subprogramme Development of Higher Education may not be used to finance operating expenses (cannot be "consumed").

The programme way of thinking therefore does not only concern the top level of the public sector - government and parliament. It can be applied at every level. The key is to understand programmes as a contract between a subordinated and superior level to use funds in the given area and achieve the programme's goals.

The present form of programme budgeting implemented in Slovakia has the ambition to represent mainly a contract between ministers and other budget chapter administrators and the government - it represents a relationship between levels 1 and 2. Subprogrammes and their further subdivisions, as well as contracts between central organs of state administration and their budgetary and contributory organisation introduced within the Audit of Central State Administration represent an attempt to transfer this way of thinking to relations between chapter administrators (level 2) and implementing agencies (level 3). So far, there does not exist a universal system that would attempt to introduce the programme way of thinking into internal management of organisations (i.e., into relations between levels 3 and 4).[26]

[24] As an example we can mention the area of higher education, whose conception of further development approved by the government in August 2000 and the new legislation based on it has been closely linked to the programme structure used in the budget proposal for universities in 2002 and its implementation.

[25] As an example supporting the achievement of specific goals with economic instruments we can mention the assignment of special financial bonuses for university development for concrete results in the area of improvement of qualification structure of young university lecturers or of efficiency of post-graduate study.

[26] Although it is necessary to mention that some state organisations - for example, the Slovak Hydro-Meteorological Bureau, Datacentrum - took advantage of the introduction of contracts to launch internal management reforms towards the programme approach.

In the concluding part of this section, it is necessary to say that experiences with deployment and use of systems based on programme budgeting in different countries differ. They can be briefly summarised as follows:

- **Implementation of programme approaches to budgeting made the most sense where there was a clear and realistic objective for its introduction**
- **Another key factor is to implement the principles of the programme approach rather than a mechanically created or copied system of programme budgeting**
- **Thirdly, the importance of pragmatism must be emphasised - meaning the willingness to implement the approach in a way and to an extent which will bring results**

Proposal, which we put forward in the following section, are based on an effort to apply these experiences in Slovakia.

4.2 The current state of the programme approach to the management of public finances in Slovakia and its problems

Partial implementation of the programme approach within the management of public finances began in 1999 through programme budgeting. In 2002, the budget of four chapters is implemented in complete programme structure and budgets of several other chapters are implemented with a partial application of the programme structure (hereinafter, we refer to the implementation of programme budgeting in the 2002 State Budget as "2002 implementation"). It is expected that in the 2003 budget, six further chapters will be composed in complete programme structure with overall amount of expenditure budgeted through programmes at about 100 billion Sk. The 2004 state budget should be implemented entirely with the programme structure. In preparation for the 2002 budget, budget chapter administrators presented to government sessions some 100 programmes. In total, some 60 billion Sk were allocated for financing programme expenditure in the 2002 budget.

In our view the programme approach to the management of public finances in Slovakia should be implemented so as to contribute to the following goals:

- Allow the government to strategically manage public finances, as well as to allow a better-qualified discussion on government priorities
- Create pressure on budget chapters to formulate departmental strategies
- At the level of budget chapter, to allow components of the ministry responsible for individual areas of its authority ("content sections") to gain "ownership" of a clearly delineated budget package and positively shape their incentives to act
- Allow greater pressure at all levels for a close connection between results and funding provided to achieve them

The 2002 implementation stresses particularly the budgetary role of the programme approach to administering public finances. It does not address its use in the area of planning. In the area of expenditure management it only emphasises that funding allocated to a programme should be earmarked for a specific purpose. In the 2002 implementation, we can identify certain problems with respect to our aims, which make reaching these goals more difficult.[27]

The first problem is the varied degree of resolution (granularity) of proposed programmes both at the level of whole programmes and the level of their internal structure. The 2002 implementation contains programmes with funding ranging from 1.2 **million** Sk (the National Programme for Health Support in the chapter of the Ministry of Healthcare) to 10.6 **billion** Sk (Development of Highways and Speedways until 2006 in the chapter of the Ministry of Transport, Posts and Telecommunications). With respect to the internal structure, the government in 2002 approved, on one hand, programmes which had no internal structure and on the other hand, programmes with tens of subprogrammes and elements, some of which only carried allocations of several thousand crowns. **Programmes at levels 1 and 2 were mixed together with level 3 programmes.** This represents a major systemic issue - if the government[28] decides on a high number of programmes (the magnitude of hundreds or thousands) and if these programmes differ by orders of magnitude in their size (hundred to thousand times), the government cannot really discuss priorities or strategically manage public finances and the purpose of programme budgeting is lost at the level of the government.

The 2002 implementation assumes that intents are defined solely at the level of programmes, while programmes had been put forward, which completely lacked intents or their intents were only of formal nature. In our view it is important that the three characteristic elements - intent, goals, and measurable indicators - be defined at every level of the programme structure. **The intent is what unites the programme's, subprogramme's or element's activities - it is the raison d'etre of the given programme part.** If it is not possible to formulate an intent for the given group, it does not make sense to join the elements into a group and create programme structures. **Every intent is fulfilled through goals and a goal is a goal if we can decide, whether we have met it or come closer to meeting - i.e., when we can measure its fulfilment.** However, we realise that the relationship between a programme's intent and its goals is a dynamic one, and particularly with programmes with a medium-term or long-term intent characteristic for the government level the fulfilment of the intent cannot be characterised by a group of easily measurable goals in an exhaustive and unambiguous way. In such cases, goals are set for the nearest year or for several years and these are evaluated along the way and updated so that their fulfilment reflects the meeting of the intent. **Without the thorough application of principles, programme budgeting turns into the allocation of finances for a certain area without an obligation to "produce" an outcome and the key incentive element of the programme approach is therefore lost.**

The internal structure of several programmes in the 2002 implementation copies the organisational structure, while the constituent parts of this programme structure do not differ in any characteristic features from the perspective of programme budgeting. This

[27] We will base the text on the document Proposal of expenditure of budget chapters for 2002 realised in the form of programme budgeting put forward by the government to a National Council session.
[28] The same applies to decision-making at lower levels.

appears to be a consequence of a rule used in the 2002 implementation, according to which an element has to be implemented by a single organisation so that the responsibility for its implementation is clear. If programme budgeting is to be an application of the programme approach to the management of public finances, one must not place an equal sign between programmes and organisations. We do not rule out the case that activities of some organisation may constitute a subprogramme or element, but in creating the programme structure, efforts at such organisation cannot serve as an argument for such identification. Individual parts of the programme structure are characterised by their intent, goals and corresponding measurable indicators. This implies that the programme structure should be subdivided only if groups of activities differ in these aspects.

In the 2002 implementation, it is recommended to take into account in creating the programme structure the activities according to their functional classification with the aim of assigning a single third level of functional classification (class) to the individual lowest parts of the programme structure wherever possible. The programme structure and programme expenditure classification derived from it (within which every expenditure item is assigned as one of its attributes the programme from which it is financed) and the functional classification, however, represent separate classifications, which serve different purposes. **The programme classification of an expenditure item characterises the source of its financing while the functional classification characterises the area, where the expenditure item is targeted. An effort to tie these two classification together by rules such as "expenditure on a programme/subprogramme must belong in a single division/group/class/subclass of the functional classification" restrict the possibilities of programme budgeting and we are therefore not in favour of them.** In systems based on programme budgeting, both above-mentioned classifications of expenditure serve an irreplaceable role. The programme classification is necessary from the viewpoint of evaluating the fulfilment of programmes and the functional classification is a statistical tool for the long-term tracking of expenditure according to areas and their comparison between years or internationally. The functional classification is therefore based on a stable scheme (in Slovakia, the functional classification in force is based on the COFOG system created by the UN), while the structure of programmes and the programme classification derived from it can adjust to current needs and is assumed to be more dynamic in connection with government changes or changes in political priorities.

4.3 Proposals for adjustment of the application of the programme approach to the management of public finances in Slovakia

In the preceding parts we introduced the possibilities provided by the programme approach in the area of public finance management, as well as the state and problems of its current implementation in Slovakia. In this part we wish to briefly present proposals for further steps in this area.

As stated above, the programme approach can be used at all levels of the system of public finance management. **According to our proposal, the key to applying the programme approach should be in creating an integrated system of programme**

financing relationships between levels 1, 2 and 3 - between the government and budget chapters and between budget chapters and implementing agencies. The formation of an integrated system of programme financing relationships should exploit the possibilities of the programme approach in the area of planning/strategic management, budgeting and financial policy.

A system of programmes at the government level implementing its strategy in individual areas should become a unifying element of the proposed integrated system. The number of programmes at this level should be restricted so as to enable the government to discuss the system of programmes as a whole (we recommend 60 - 80). The system of programmes should be created on the basis of the government programme as a result of centrally coordinated work of individual departments. **The minimum size of a programme in terms of the allocated funds would be determined, which along with reduction of the number of budget chapters to 20 - 25 would facilitate strategic management of public finances** (small budget chapters would contain a single programme or would be abolished - see also part 3). The government would set binding indicators at the level of programmes; in individual cases it would have the ability to selectively set binding indicators at the level of subprogrammes or specially earmark purpose-bound expenditure.

Individual ministries and other central organs would be responsible for programme completion. The authority of every ministry would be divided into the main areas, each of which would be covered by one or several programs. A three-level programme structure would be used with the levels of programme, subprogramme and element.[29] The programme structure within a budget chapter should in principle be independent from the organisational structure. The classification of expenditure based on the programme structure is independent from other types of classification (functional, economic). In parallel with the successful implementation of the programme structure, it would be possible to liberalise certain restrictions, particularly with respect to binding economic classification (see part 5).

In other words, departments with significant amounts of funding (Ministry of Labour, Social Affairs and Family, Ministry of Defence, Ministry of Transport, Posts

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[29] Practical experience from the 2002 budget preparation shows that in some areas, the level of subprogrammes was sufficient, for instance in Programme 023 - Social Support of University Students, but in other cases we required the use of the level of elements - for example in the area of university science and technology, which constitutes Subprogramme 022 02 - University Science and Technology of Programme 022 - University Education and Science, where it was necessary to structure Subprogramme 022 02 into five elements to group similar activities appropriately (science and technology infrastructure operation and development, projects within the internal VEGA grant agency, KEGA, applied research projects and internal science and technology cooperation projects). Each of these groups in the end follows the intent of Subprogramme 022 02 - to develop research at universities as a necessary condition of provision of quality university education and sustainable social development, but each contributes to this intent in its specific way. The VEGA agency focuses on basic research, applied research projects are covered by initiatives of research teams at universities in cooperation with client applying their results, KEGA focuses on specific research issues for education development and projects of international cooperation support vital international activities of universities in the area of science and technology cooperation. Finally the Element 022 02 01 - University Science and Technology Infrastructure Operation and Development focuses on improving research and development infrastructure at universities to create a supportive environment for all research and development activities at these institutions.

and Telecommunications, Ministry of Construction and Regional Development, Ministry of Interior, Ministry of Agriculture, Ministry of Education, Ministry of Healthcare) would probably administer several programmes each and the effects of programme budgeting would appear mainly in the preparation and implementation of budgets of these chapters.

We consider it important that the system of programmes should in addition to departmental programmes also contain programmes above departmental level or programmes across departments in cross-cutting areas. An often criticised shortcoming of the management of public finances is the so-called issue of resortism. Logically, budget chapters care about being allocated as much funding as possible for their own programmes. The issue of how efficient and generally beneficial they are often becomes less important when the budget is being prepared and conflicts over available resources take place. Many programmes carried out by several chapters also overlap, serve a related purpose, but are uncoordinated due to power conflicts.[30] The possibility to evaluate which programme is more efficient and should be strengthened or vice versa, is limited. With excessive fragmentation of programmes with similar intents, synergic effects, which the government could achieve through coordination or closer cooperation in these programmes, are lost. We therefore propose **the introduction of cross-departmental programmes with a common intent and coordinator in selected areas.** The coordinator would also distribute funding to other budget chapter administrators participating in the programme. To prevent power-struggles between departments, it would be useful to appoint the MoF or the Office of the Government as the coordinator (deputy prime ministers). If elaborated appropriately, cross departmental programmes would allow the introduction of an element of competition between chapter administrators, not only to compete for funding for their own programmes but to compete for a most effective solution for the common programme. We must, however, warn that this approach cannot dominate in the area of public finances; rather, it should serve as a complementary approach. The alternative is to focus responsibility in a specific ministry (for example, it is possible to concentrate all instruments in the area of housing construction at the Ministry of Construction and Regional Affairs). But this alternative is not realistic with respect to issues, which are truly cross-cutting in nature, such as drugs or the Roma minority.

The system of programmes at government level would directly address the management of public finances at level 1 (government) and 2 (budget chapters). The actual implementation of programmes would be coordinated by budget chapter administrators and carried out by implementing agencies (levels 3 and 4). At their level, they would also employ the programme approach, which would also include

[30] The support for housing serves as a good example. The Ministry of Construction and Regional Development implements support for housing construction through subsidy programmes and the State Fund of Housing Development, but the awarding of construction savings bonuses and mortgage loan subsidies is guarded by the Ministry of Finance.

a system of contracts in relationships with implementing agencies.[31] The process should include the introduction of the programme approach within those implementing agencies that are a part of the state administration (state budgetary and contributory organisations) using their own system of programmes based on the programmes at government level. It would also be appropriate to help and encourage other implementing agencies in internal application of the programme approach (public organisations, territorial self-governments, public universities, etc.).

An integrated system of programme financing relations constituted in this manner would represent a universal tool of strategic management of public finances available to the government and the finance ministry, as well as to individual budget chapter administrators. Given the varied nature of implementing agencies, the application of the programme approach inside these organisations will vary (it will be different for state administration, territorial self-government, public organisations, private organisations). For this reason, our vision does not address it in greater detail.

In conclusion, it must be stressed that the elaboration of an appropriate methodology with a special emphasis on eliminating the problems mentioned above is a necessary measure in the further use of the programme approach in public finance management in Slovakia.

[31] To put it simply, programme budgeting at the level of budget chapters means that chapter administrators allocate funding to implementing agencies' programmes so as to ensure the fulfilment of objectives and goals of programmes, for which they are responsible. Programme budgeting does not distinguish between organisations "owned" by the department (budgetary/contributory organisations) and other organisations (public universities, private organisations, etc.) or individuals. With these organisations it usually makes binding agreements/contracts specifying in greater detail the obligations of both parties and required outputs and financing.

5. Budgeting and management of public finances at the level of budget chapter administrators and implementing agencies

The vision presented here focuses on the possibilities of reforms in the system so as to give all participants including chapter administrators and implementing agencies appropriate incentives and create a suitable framework for their actions. We therefore do not generally focus on proposals for budget chapter administrators, but on systemic changes affecting budget chapter administrators and implementing agencies.

5.1 Binding indicators and allocation of funds

Budgeting and management of public expenditure makes decisions not only on the overall volume of funds allocated by the government to the budget chapter administrator and by the budget chapter administrator to the implementing agency, but also on the internal structure of this funding in accordance with further criteria. The question of whether and to what extent the internal structure of allocated finances should be determined has significant practical effects on the efficiency of public spending,

A binding internal structure may be built in an arbitrary fashion or could be based on one of the four budgetary classifications:

- **Organisational (who can use the funds)**
- **Economic (what kind of expenditure can the funds be used for - wages, insurance contributions, goods and services, transfers)**
- **Programmatic (from which programme and for what purpose)**
- **Functional (for which function of the public sector)**

In addition, there is of course also a distinction between current and capital expenditure, but this issue is addressed in a separate section.

Arbitrary binding is an exceptional tool used in the form of expenditure bound to a specific purpose. The frequency of use of this instrument declines with the introduction of programme budgeting, because in many cases it can be integrated within it.

Functional classification is primarily a statistical instrument for the long-term tracking of expenditure according to areas and is not used for the purposes of setting binding indicators (with the exception of science and technology expenditure).

Traditionally, organisational and economic classifications have been used as binding (or partially binding). The government divides expenditure between budget chapters and restricts their use to certain types of expenditure according to economic classification. The budget chapter administrator does the same with respect to implementing agencies. Organisational classification is a necessary foundation - funds must be allocated to someone who will be responsible for their use.

A system of binding indicators based on economic classification serves well the requirements of expenditure oversight at the lowest level, as well as at the aggregate level. It is a simple and transparent system. One of its main goals is usually to prevent transfers between personnel expenditure and other items. Critique of this approach focuses on its inflexibility, as well as on the fact that with this approach, attention does not focus on policy goals and the budget is not sufficiently linked to these goals (see part 4). **In other words, this system does not orientate the implementing agency towards what it is supposed to do and achieve, but towards how it can spend the allocated funds. The implementation of the programme approach to public finance management represents an effort to address this problem.** An additional problem, however, arises: the administrative complexity of combining a system of binding economic and organisational indicators with binding programme indicators and occasionally even functional indicators.

In connection with the introduction of programme approaches and programme classification, a reduction in the degree to which the economic classification is binding or even its complete elimination is being considered. Within the so-called block grants, the recipient receives the given amount of funds without a binding internal structuring or only with a very loose determination. The loosening of restrictions formulated using elements of the economic classification is being compensated by the setting of goals, which are supposed to be achieved with the use of the allocated funds.

From the perspective of public finances as a whole, already the present system can be considered quite liberalised, since with the exception of state budgetary organisations, other implementing agencies are funded through current transfers without an internal structure based on economic classification. In other words, from the MoF's perspective and the budget as a whole, the financing of public services provision by institutions other than budgetary organisations could and should take place through block grants. However, several budget chapter administrators go beyond this limit in financing contributory organisations and structure the allotted funds in greater detail in terms of economic classification. This approach is understandable particularly in an environment where there is a need to control potential commitments of the state towards organisations and where a clear philosophy of the state's relations with such organisations is lacking. On the other hand, without a clear decision on where it is used, useless and inefficient restrictions are placed on implementing agencies.

We therefore propose that along with the other changes in public finance management presented particularly in parts 3 and 4 attention be paid to the issue of binding indicators. In addition to the measures already discussed arising from the implementation of the programme approach to the management of public finances, including the integration of the existing system of contracts, we propose:

- To apply in Slovakia the approach, according to which **contributory organisations and public institutions such as public universities should also include in the public budget not only the contribution in the form of a transfer (the so-called net transfer) but their total revenues and expenditure (the so-called gross transfer)**
- **To consider reducing the degree, to which the economic classification is binding for budgetary organisations following the effective introduction of programme budgeting** within the budgetary chapter, as long as the MoF considers it truly objective-oriented
- **To create pressure on budget chapter administrators following the introduction of programme budgeting to consider to what degree and especially in what way they wish to bindingly structure unstructured of their own will for contributory organisations and other implementing**

agencies. We particularly recommend the application of programme budgeting instruments[32] for this binding structuring

- **To eliminate the anomaly of binding indicators based on functional classification for science and technology expenditure** and thus achieve a situation when functional classification exclusively serves a statistical function

5.2 Transfer of budget funds into the subsequent year

One of the general characteristics of the budgeting used until now is the ban on transferring unused budgetary funds into next calendar year. The rational core of this measure is not to increase the burden on next year's state budget in an environment of permanent shortages of budgetary funds. We can also speak of a "clean slate" and financial savings of funds, which implementing agencies did not have time to spend.

The negative consequence of this rule is the so-called "December madness", used to refer to the phenomenon when implementing units do not want to let funds "expire" and try to use them at any cost even on things, on which they would not normally spend them.

For these reasons, the possibility of limited transfer of funds into the following year has gradually gained foothold in the management of public finances. The creation of state funds in the 90s in Slovakia was partly motivated also by the need of this measure, especially for certain activities. The introduction of programme budgeting brought into public finance management the systemic option of transfer of unused funds allocated to a programme into next year's budget. Subsequently, an amendment to law no. 303/1995 on budgetary rules significantly reduced this possibility.[33]

We therefore propose pursuant to the introduction of programme budgeting within a budget chapter to allow the transfer of unused funds allocated to a programme into the following year. This possibility should affect all funds within a programme. The possibility to transfer funds must, of course, be tied to the condition that the implementing agency must first use them to cover all its liabilities from the previous fiscal year.

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[32] Even after a move to block grants and programme budgeting there remains the possibility of using items of the economic budgetary classification to define certain binding indicators. A binding indicator can also be formulated as a ceiling. For instance, one of the binding indicators in a contract between the Ministry of Education and a public university for its 2002 activities is defined as follows: The total amount of funds from subsidies spent in 2002 on wages and insurance contributions may not exceed 80 % of funds provided in 2002 to the public university for current expenditure.

[33] The right to transfer funds into the subsequent year is set in the new law on universities, which stipulates that the remainder from subsidies on accredited programmes of study, research, development and artistic activity and university development not spent at the end of the calendar year can be used by the university in the subsequent calendar year if it had adhered to conditions stipulated by the subsidy contract. This remainder has no effect on the allocation of subsidies in the subsequent year.

5.3 Complete costs, write-offs and capital expenditure

The management of public finances stands and falls with the knowledge of the actual situation in state finances and their constituent parts based on public budget accounting and accounting of organisations connected to the public budget. In part 3.5 we discussed the need to switch from cash accounting to accrual accounting based on the ESA95 methodology.

Accounting systems focused on cash-flows are simple and their outputs are easy to compare with data on available funds. However, they do not provide a complete picture on the organisation's economic situation, because they do not capture the timing of its costs and revenues - their allocation into the time period to which they relate. In addition, the budgetary sector does not implement asset write-offs.[34]

If we focus exclusively on tracking revenues and expenditure of an organisation, we cannot establish the so-called full costs of its operation in the given period. Their calculation requires an account of expenditure (other than capital expenditure), as well as write-offs, changes in payables and receivables and inventory changes related to the given period. The missing information on full costs does not allow efficiency comparisons of various methods of public service provision, because cost comparisons cannot be carried out through comparing revenues and expenditure or comparing partial costs.[35]

Since full costs reflect economic reality in a more relevant way, they can be used in budgeting and future cost estimates, performance measurements and programme evaluation, setting of fees and compensations, as well as comparing prices of goods and services provided by state organisations with prices in the private sector on an equal footing.

To obtain information on full costs, one requires the use of accounting where the emphasis shifts from the tracking of cash flows to the tracking of expenses and income and their timing. Such accounting systems are referred to as accrual accounting. A standard part of such accounting is the recording of write-offs. Although the principles of accrual accounting are familiar to the private sector, they are also becoming a tool in the fight against **hidden debts** and **subsidies** in the area of public finances. Full accrual accounting requires detailed cost analysis and its implementation poses a highly demanding task. In practice, several modifications of accrual accounting leading to its partial simplification are therefore used.

We propose that the budgetary sector in Slovakia adopt an appropriate form of accrual accounting along with introducing depreciation write-offs and time-stamping of costs and benefits and use profit and loss statements as the basic reporting statements for public finances in accordance with the ESA95 methodology (we are therefore touching upon proposals from part 3.5 at the micro level).

With respect to write-offs, let us first point out that at present, capital expenditure for acquisition and renewal of investment assets is allocated to budget chapters as

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[34] When speaking about write-offs, naturally we mean accounting write-offs.

[35] Not to mention that a comparison of costs can only be carried out with equal quality, a fact often neglected in Slovakia.

a binding indicator (the objective of this measure is to on one hand prevent the "consumption" of all funds and on the other hand, to prevent excessive production of new capital assets accompanied by higher maintenance requirements). **Budget chapter administrators centrally distribute capital expenditure among implementing agencies (mostly budgetary organisations). This means that decisions on renewal and development of capital assets of these organisations are made centrally and arbitrarily.** It implies that public finances do not have to come to terms with the question to what degree it is possible to administer tangible and intangible investment assets of the public sector on a sustainable basis. In part 2 we pointed out that one of the ways in which the public finances come to terms with the conflict between commitments and possibilities is through not renewing capital assets or a low level of renewal, in particular public buildings, and other assets.

If we follow the law on accounting, which stipulates that write-offs should be carried out in a manner reflecting the depreciation of assets corresponding to the usual conditions of their usage, then **the general introduction of write-offs would make evident the degree of wear of assets in the budgetary sector stemming from the non-renewal of capital assets.**

The introduction of depreciation write-offs could also be used to decentralise decision-making on the allocation of funds to budgetary organisation for the updating of their capital stock. This could be implemented either by allowing the updating of property from current expenditure at a level corresponding with the write-offs or by allocating capital expenditure for asset renewal at a level corresponding with the write-offs (capital expenditure on development would continue to be allocated as before). If there are not sufficient funds for these purposes (as is the case now), at least the role of revealing the hidden debt would apply.

6. Institutional background of reform

The previous parts of this vision attempted to respond to the question of **what** has to be done to better manage public finances in Slovakia. The final part focuses on another topic - **how** to provide the organisational and institutional background for the reform of the management of public finances.

We see as the most serious problems accompanying the implementation of public finance management reform in Slovakia until now:

- Absence of a common vision and philosophy of changes in the area of public finances
- Concept, methodology and software are prepared and implemented "on the move"
- Managers at central organs of state administration and within implementing agencies are not prepared for the implementation of reforms
- There is no systematically based feedback on reforms from users or their own strategies that would be taken into account either ex ante or ex post
- There do not exist clear strategies of functioning and development of individual departments, on which public finance reforms could build

The result is insufficient methodological and personnel background for reforms and their disconnectedness from other events in the public sector. Achieving the goals of the reform requires a deep and fundamental change in thinking. Positive effects cannot materialise if the changes remain on the surface - new groups of expenditure are introduced, new budget dimensions or new lines in forms for budget preparation without sufficient communication, information and feedback. People must receive a credible and sensible methodology of how to implement changes at their level. Without such support these changes will be perceived simply as one of many "reporting" activities, which do not make sense to them although they can not say so openly.

In general we can say that the implementation of any major reform in the area of public finances contains at least the following elements:

- Formulation of reform proposals from strategic documents to their concrete implementation, which requires expert work and abilities in the area of economics, finance, accounting, management and legislation.
- Coordination within the Ministry of Finance (with individual sections of the ministry, Datacentrum and others).
- Coordination with other central organs of state administration as the administrators of budget chapters. This coordination is not only required with financing and economics sections of ministries, but also with content sections which make public policy, particularly in the areas most important to the budget. This key group is one of those most often omitted from budget reform preparations.
- Coordination and discussion with representatives of implementing agencies. Without representatives of legal entities, which in the end implement public expenditure, a qualified discussion on the principles and especially on practical implementation of reforms, is not feasible.
- Coordination with other governance reforms. The management of public finances is an important component of overall public sector management and public

administration. It is therefore necessary to interface directly with other groups/departments in charge of such reforms. Specifics depend on the government's implemented priorities - in some periods it may be decentralisation, at other times privatisation or efforts at more efficient use of available public resources.

❍ Coordination with politicians. In the introduction we emphasised that the proposed (and other) reforms of public finance management cannot force the government to make good decisions against its will but can represent a powerful instrument for the government and specifically for the minister of finance to move towards these decisions. It is therefore necessary to realise that the most important client of reforms is the minister of finance and other key politicians in the executive (prime minister, deputy prime minister for the economy, ministers of highest-spending departments).

❍ Communication with the media and the public. Reform of budgeting and management of public finances does not represent an innately appealing issue to raise interest of the media and the public. In spite of this, several of the proposed measures carry the possibility of attracting public support, particularly in the area of quantifying medium-term obligations and possibilities, as well as programme budgeting in general. The support from the media and the relevant expert public can act as an important tool to carry out proposals, which would otherwise fail due to partial resistance.

The fulfilment of these elements would mean that:

- ❍ There exists a common vision of further steps, which, however, should be flexible and subject to change without violating the basic philosophy,
- ❍ At least some individuals at every level of public finance management feel "ownership" of this vision,
- ❍ The vision is really being implemented.

We view the institutional structure containing all of the elements mentioned, from the formulation of reform proposals to coordination with politicians, as a necessary condition for successful implementation. Such a structure can take on various forms; the proposal that follows takes into account the content of our proposals.

In our view, the basic condition for successful reform is the creation of a lean unit for public finance reform at the level of a section, consisting of civil servants temporarily transferred from individual sections of the MoF, budget chapters, budgetary organisations, as well as external experts. Its head would be at the level of general director of a section/advisor to the minister. This unit would be responsible for all components of public finance management reform mentioned here. Specifically, he would provide for the formulation of reforms, monitoring and management of their implementation, education and information dissemination on reforms and feedback. Foreign experts aiding in the formulation and implementation of reforms would also report to him.

Another alternative would be that this unit would be headed directly by the deputy minister of finance if Slovakia returns to the system of deputy ministers. Subordination to a deputy minister can be recommended only if the deputy minister is selected by the minister of finance and the reform will constitute his main responsibility.

Aside from the finance minister's support, the key to this unit's success lies in having a functional structure for communication with users at all levels. We propose two alternatives for its provision:

ALTERNATIVE I:

Within this alternative, a communication and coordination group would be set up with representation of all clients at the non-political level, specifically representatives of other sections of the MoF, budget chapters and implementing agencies, as well as outside experts.

The work of this group would be complemented by the regular use of two permanent coordination mechanisms:

– regular information and discussion within the MoF management council to ensure the provision of information to and the support of both political and non-political management of the department (heads of sections, directors of key departmental organisations)
– regular information and discussion within the Council of Economic Ministers to ensure coordination with politicians within the executive

ALTERNATIVE II:

Within this alternative, a steering committee would be set up to oversee the work of the unit. In addition to the minister and the political and non-political leadership of the MoF, the committee would include some other key politicians from the executive (from fiscally significant departments).

In addition to the steering committee, communication with non-political clients would be carried out through a system of ad hoc consultations with users.

We can also consider a combination of the two alternatives in the form of the existence of both the steering committee and the communication and coordination group. This alternative is advisable only if these reforms represent a top priority for the minister of finance. Otherwise, these organs will turn into time "guzzlers" for a number of high-ranking politicians.

In connection with the selection of members for any of these bodies, as well as the selection of temporary employees of the unit, we must stress the issue of representation and abilities. Representativeness, the representation of all important types of clients, is important for obvious reasons. In a small country with human resources varied in quality, the quality and personal dedication of specific individual also matters. We therefore recommend the creation of systemic mechanisms for general and broad access to information on reform developments and the institutionalisation of free feedback (for instance through the Internet or meeting with directors of implementing agencies). This way it will be possible to find and include in the design and implementation of reforms many individuals, who will be able and willing to offer their practical experience.

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Slovak Governance Institute (SGI) is a non-profit, non-governmental organization, which is not connected to any ideology or political party. SGI's mission is to search for solutions for improving the process of allocation of public resources for the provision of quality, accessible, transparent and efficient public services for the citizens of Slovakia.

SGI was created in October 2001 with the support of INEKO Central European Institute for Economic and Social Reforms, to concentrate and extend its activities focused on public governance reforms.

The current state of public finances represents one of the key economic issues. Addressing public finance problems requires a reform of the system of budgeting and management of public expenditure. The current system of management of public finances (along with other problems) does not allow the government to really manage the state in the horizon of the whole electoral term and turns its activity into a combination of many half-empty words and patching up the most pressing problems. The beginning of a new electoral term provides a unique opportunity to introduce reforms, which will, in the course of the four-year term, bring political effects.

The publication **„Budgeting and Management of Public Expenditure A realistic vision of reforms for the next four years"** therefore contains not only an analysis of the current problems, but also a coherent and integrated system of concrete recommendations for the new minister of finance and the government, relating for example to the sustainability of public finances, changes in the system of budget preparation, increasing government control over public institutions and introducing the method of complete costs and write-offs.

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