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GOV/PGC/SBO(2012)9

Organisation de Coopération et de Développement Économiques
Organisation for Economic Co-operation and Development

16-Oct-2012

English text only

**PUBLIC GOVERNANCE AND TERRITORIAL DEVELOPMENT DIRECTORATE
PUBLIC GOVERNANCE COMMITTEE**

Working Party of Senior Budget Officials

**REVIEW OF SELECTED BUDGETING ISSUES IN CHILE:
PERFORMANCE BUDGETING, MEDIUM TERM BUDGETING, BUDGET FLEXIBILITY**

8th ANNUAL MEETING ON PERFORMANCE AND RESULTS

**OECD Conference Centre
Paris, 26-27 November 2012**

*The mission to Santiago Chile on which this report is based took place 18-27 April, 2011.
The report has subsequently been updated to reflect the latest changes in May 2012.*

The OECD would like to express its gratitude to the Chilean authorities for their gracious collaboration and hospitality.

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JT03328870

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REVIEW OF SELECTED BUDGETING ISSUES IN CHILE: PERFORMANCE BUDGETING, MEDIUM TERM BUDGETING, BUDGET FLEXIBILITY

by

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EXECUTIVE SUMMARY OF RECOMMENDATIONS

1. Performance Budgeting

Overall the Chilean performance budgeting framework is very advanced and is grappling with issues other best practice OECD countries have not presently found clear solutions to. However, there are a number of areas where other OECD countries' good practices may be of interest to Chile. These are discussed below.

A modified Budgetary Program Structure

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

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

- Ensuring that the program structure provides a more detailed classification of expenditure by objective.
- Priority should be given to programs that are managed with particular political goals in mind not to construct program categories for that are purely administrative in nature.
- In case of programs which are not defined as cross-sectoral eliminate the practice whereby the budgets of programs includes money which is in fact not part of the program concerned, but represents transfers to other programs. In this way, establish the principle that program budgets should cover all (direct expenditure) on the program's objectives.
- Reviewing programs to ensure that they are defined as groups of outputs with common outcomes, and not on some other basis.
- Clearer specification of the specific objective (intermediate outcome) of each program,

Implementation Strategy and Timing

- The first step in the revision of the budgetary program classification should be the rapid development of a Methodological Guidelines/Manual which clearly states the principles to be observed in the definition of programs and the linking of programs to strategy. This is important because there are matters which, if not clearly resolved in such guidelines, will cause confusion and lead to conflicting approaches in different ministries or agencies.
- The overhaul of the program structure could initially be piloted in a small number of ministries/agencies (e.g. food inspection, subsidy payment, social program spending, health, education).

- The reform of the program structure should then be extended to all ministries and agencies.

Linking Government-Wide Priorities to the Budget

The modified program structure should be used to explicitly link the budget to government-wide programs. Government-wide strategic objectives should in general relate to "high-level" outcomes such as the strong economic growth. The objectives of programs, by contrast, are in general "intermediate" outcomes which *contribute to the higher-level government-wide outcomes*. Once program-specific outcomes are defined, these will serve as the means of making an explicit link with relevant government-wide priorities.

Introduce Spending Review

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

- The sources of cuts should be (i) efficiency improvements; (ii) programs which are low priority; (iii) programs which are not cost-effective and can't readily be fixed by policy or management changes. The government should, however, avoid the illusion that efficiency improvements alone will be enough to create substantial fiscal space in the short term. If significant fiscal space is to be created, it is essential also to be willing to cut programs.
- There is always the political danger that spending review will be attacked as a "small government" exercise. It is, of course, an essential tool for any government which wishes to reduce the size of the public sector. However, assuming that this is not the government's goal, it should be stressed publicly that the objective is to reallocate rather than reduce aggregate government expenditure. The point should be made that reallocation is an essential way to fund new priorities while maintaining Chile's well-known fiscal discipline.

Institutional Structure of Spending Review:

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

Frequency of Spending Review

Because cuts to existing programs usually create some political resistance, the best time to carry it out spending review in depth may be at the start of each presidential term of office. The best approach to the conduct of spending review may therefore be:

- In-depth spending reviews in the first year of each Presidency, plus
- More limited spending reviews in other years.

Improve Analysis to support Spending Review: Ex Post Evaluation and Efficiency Reviews

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

- While it is tempting for the selection of programs for evaluation to be focused on programs, which look like potential candidate for budget cuts, this has to be balanced against the fact that the evaluations will be met with strong resistance by the ministry concerned. Thus selection should be balanced.
- The scope of the impact evaluations carried out should be tightened considerably to focus exclusively on issues relevant to budget preparation (e.g. by eliminating the standard requirement to review management processes).
- In order to more clearly identify programs or elements of programs which can be cut, the standard terms of reference of Impact evaluations should be revised to require a clear assessment of the practicality of fixing (making effective) programs which, as presently designed, are assessed as ineffective. This includes an assessment of the probable cost of fixing the program. Parallel modifications should be made to the terms of reference of Evaluations of Government Programs.
- Consideration could be given to whether the timelines of impact evaluations might be shortened.
- Consideration should be given to whether the Evaluaciones Comprehensivas de Gasto – which seem to be focused entirely or mainly on policy and management improvement – play a useful role in supporting the budget, and if not whether the Ministry of Finance should cease carrying them out.
- Efficiency reviews – that is, reviews aimed at identifying opportunities for savings by delivering services at lower cost – should be given greater emphasis than at present.
- Efficiency reviews should actively benchmark agencies and public institutions against each other, relevant private sector entities and similar institutions in other countries.

The Assignment of Institutional Responsibilities for Evaluation

It is recommended that *the Evaluation unit of the Ministry of Finance's mandate of the evaluations be reviewed so that it focuses* primarily on evaluation to support budget preparation, and more specifically to provide the information necessary for spending review.

- The role of the new Ministry of Social Development with regards to ex ante evaluations and evaluations of the existing stock of programs needs to be coordinated. The potential for overlap and bureaucratic conflict between the Ministry of Finance and the Ministry of Social Development concerning this area cannot be discounted.

Introduce Productivity Savings Mechanism – Efficiency Dividend

The other useful means of creating fiscal space is the introduction of a *productivity savings* mechanism.

- Under this mechanism, the current baseline budget of each ministry or agency is reduced by a small percentage (typically around 1.5 – 2 percent) each year. The justification is that ministries/agencies should be able to make such savings on a routine basis by improving their efficiency (e.g. from the savings created by information technology).

Strengthen the use of Formula-Based Performance Budgeting

While Chile is at present making use of formula funding in various ways it may be possible to tie funding and outputs closer together in particular fields. It might be beneficial to strengthen MoF budget

department's analysis of the presently used formulas to assess whether they are precise enough and whether they result in good performance. Institutions could be benchmarked against each other and compared to relevant private sector institutions where applicable.

2. Medium Term Budgeting

There are a number of recommendations which the Chilean government could consider in order to improve further the medium-term budgeting framework and strengthen the longer-term budgeting perspective.

Medium-Term Forward Estimates

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

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

MT Budgeting and Resource Certainty for Ministries/Agencies

Spending institutions could be given greater certainty about future funding in order to permit them to plan and manage their expenditure more effectively. This will enable the government to enforce a fiscal consolidation path more easily. Naturally this should be balanced against the need for budgetary flexibility. The following might be helpful:

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

Long term budgeting and fiscal rule

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

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

- a fiscal council
- a stronger mandate for the copper committee and
- transparency efforts in the form of enhanced reporting on liabilities and deviations from the targets

These efforts should be pursued.

- DIPRES should continue to give priority to improved analysis of the long term expenditure trends, particularly in respect to entitlement spending and health spending,
- Consideration should be given to investigating concretely appropriate long-term objectives with a focus on fiscal sustainability which should guide fiscal policy.

3. Flexibility and Efficiency

The Chilean government sector is characterized by high quality civil servants and high quality performance. However, it is possible that further efficiency and effectiveness could be achieved should a number of rules impeding management be modified.

As the programs are quite aggregate and line ministries are allowed to transfer funds within them overall the budget is quite flexible. Compared to some OECD countries, however, a number of budget and management rules seem overly restrictive leading to an overall welfare loss. Examples include the need for Ministry of Finance approval of minor changes in the use of capital expenditure and other minor reallocations. In addition, it is difficult to carry over operating funds leading to potential frantic spending at the end of the year and increased administrative burden for re-appropriating delayed tasks.

- Chile could consider a relaxation of reallocation rules for minor changes and introduce a general carry over rule (2% operating, all capital).

1. CURRENT PERFORMANCE BUDGETING CHALLENGES

1.1. Introduction

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

On the political front, the election in 2010 of a president from the conservative parties after two decades of left-centre government represented a significant change in the landscape. There is the common phenomenon of a new government, suddenly finding itself in charge of the massive ship of state, discovering that it is no easy matter to fully master the controls and move public policies and expenditure in the direction dictated by its priorities. President Piñera has sought energetically to put his stamp on government policy, including through the articulation of a set of high-level government-wide objectives and performance targets (so-called *Objetivos Estratégicos*) – mainly relating to high-level outcomes – broadly on the model of the Public Service Agreement (PSA) targets of the former British Labor Government. The president has personal meetings with each spending ministry throughout the year to discuss advances in the execution of government priorities. There is, however, acknowledgement of the challenge involved of imprinting government priorities onto the budget. As in many OECD countries existing policies represent substantial funding which leaves less room for new initiatives. This then requires increasing focus on how to create fiscal space within the current base line. The issue is that the structure of the budget should link spending to government priorities in a stronger way.

Box 1.1. - "Strategic Objectives" set by the Piñera Government

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

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

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

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

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

As discussed below, Chile's existing performance management system aims, amongst other things, to make budgeting performance-informed. However, the impact of the system on the allocation of resources

in the budget is unclear. Hence the considerable interest in what can be done to strengthen the impact of performance and government priorities on the budget.

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

1.2. Overview of Performance Budgeting¹

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

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

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

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

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

¹ www.oecd.org/gov/budget/database

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

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

1.3. The Chilean Performance Management System

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

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

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

The Strategic Framework

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

- Specifies each institution's mission, strategic objectives, "strategic products" and clients/users/beneficiaries.
- Links institutional strategic objectives to "government priorities" and "government programs".
- Be based on the "logical framework" concepts of outcomes, outputs, processes and inputs.

DIPRES guidelines state that "strategic products" must be the goods or services (i.e. outputs) which serve the institution's strategic objectives. For example, the Interior Ministry's main Sub-secretariat has defined six strategic products, including "public security", "public order" and "human rights". Expressed differently, the strategic products are supposed to be groups of outputs with a common outcome. In

principle, this framework is a sound one. In practice, however, there are certain difficulties associated with it.

The first is that the way in which some institutions have formulated their strategic objectives and strategic products leaves a room for improvement. Rather than being statements of the key outcomes which institutions aim to achieve, the strategic objectives are in too many cases focused more on outputs and processes. Moreover, rather than being succinct and easy to understand, they are often excessively and written in highly bureaucratic language. The specification of the "strategic products" – while generally quite good – could also do with review to remove the processes, support services and inputs which some ministries have mistakenly identified as outputs².

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

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

Performance Indicators and Targets

Performance indicators are developed for each of the "strategic products" in the institution's strategy statement, as a result of which approximately 1200 performance indicators have been defined as part of the strategic framework. Performance targets are set for each of these indicators, and the performance incentive system (discussed later) delivers rewards which are to a large degree based on institutional performance against these performance targets.

Evaluation

The most distinctive feature of the Chilean performance management system is the degree to which it makes use of systematic evaluation, which is quite exceptional by contemporary international standards, at least outside Latin America³. Evaluations are managed by DIPRES, and the topics for evaluation are centrally determined. There are three different types of evaluation in the Chilean performance management system:

- Impact Evaluations – the main focus of which is whether programs have achieved their intended outcomes. Such an evaluation might, for example, examine a labor market program the stated objective of which is the reintegration into the labor market of the long-term unemployed, and examine the track record of participants from the target population to see whether the program had actually succeeded in increasing their level of employment.

² For example, the Ministry of the Interior counts amongst its "strategic outputs" the "strengthening of State management of emergency operations and the management of risks" (which is a process objective rather than an output).

³ Within Latin American, countries such as Mexico and Colombia also strongly emphasize evaluation as the cornerstones of their performance management systems.

- Evaluations of Government Programs (EGP) – while EGPs measure some aspects related to efficiency dependent on available information, the main element of these evaluations is the analysis of what has sometimes been called the "intervention logic" of programs. This means laying bare, and questioning the logic of, the causal chain by which program outputs are supposed to generate specific program outcomes and, through them, higher-level government outcomes. Taking the example of the labor market program, such an evaluation will not indicate whether or not the employment level of the target population has been increased. It will, however, indicate whether or not it is reasonable to expect that the type of assistance being given to the long-term unemployed is likely to increase their employment level. An important point, discussed further below, is that the "programs" which are evaluated are not the same as the programs in the budget.
- Institutional Evaluations – going under the potentially misleading name of "comprehensive expenditure evaluations" (Evaluaciones Comprehensivas de Gasto), these evaluations look at specific institutions or sectoral groups of institutions. They examine a range of issues including the consistency of institutional and sectoral objectives, organizational structures, production and management processes, resource use and service-delivery performance.

The coverage of evaluation has progressively increased over time, with 33 evaluations in 2009 and 39 in 2010. The organization and conduct of the three types of evaluation remains today essentially the same as described in the 2004 OECD budget review of Chile and elsewhere (e.g. Guzmán, 2007). The programs and organizations to be evaluated are selected by a designated inter-ministerial Committee consisting of DIPRES, SEGPRES and MIDEPLAN, in consultation with the Congress. Evaluations are then carried out by external evaluators (consultants or research institutions) contracted by DIPRES, which provide the terms of reference and methodological guidelines. The unit in the Budget Office running the evaluations is not under the budget division (Sub Dirección de Presupuestos), but is located in a separate control pillar, (División de Control de Gestión), answering to the Budget Director. All final evaluation reports are made available to the Congress and public, and their summaries are included in the budget information papers in the form of "Executive Minutes". DIPRES and the relevant ministry discuss the recommendations of the evaluations and agree on the actions which should be taken in response to evaluation recommendations. This then becomes the subject of a formal agreement, the implementation of which is monitored in subsequent years by DIPRES.

New Spending

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

1.4. The Impact of Performance Information on the Budget

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

Despite this, today there is a perception that performance information is not having a sufficient impact on resource allocation. In particular, it appears that while evaluations often do generate program design and management changes, they relatively rarely impact on budget funding of programs. A DIPRES study of evaluations conducted between 2000 and 2009 found that only 7 percent of these evaluations led to the termination or replacement of the program. By contrast, 37 percent led to design or process modifications, 25 percent to "substantial" program redesign, 24 percent led to "minor" changes, and 7 percent to institutional reassignment of the program⁴ (Arenas and Berner, 2010: 69). This impression is reinforced by advice from DIPRES sectoral budget analysts that they do not often discuss evaluation findings with the affected institutions during the negotiations with line ministries, the so called "technical commissions",⁵ It is therefore hardly surprising that many within government consider that the performance *management* system is not functioning sufficiently well as a performance *budgeting* system.

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

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

These are discussed in turn.

Weaknesses in the budgetary Program Structure

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

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

⁴ The study did not provide any estimate of the extent to which evaluations lead over time to budget savings through efficiency enhancements.

⁵ Technical Commissions are the meetings held with institutions during the budget preparation process at which institution's budget requirements are discussed.

- The program structure does not provide a sufficiently detailed classification of expenditure by objective. The programs themselves are generally very high level, and there are no sub-programs. Take the example of the Ministry of Environment. Under a program budgeting system, the program structure of such a ministry would normally contain separate nature conservation and anti-pollution programs. However, in Chile there is no separate anti-pollution program, and it is not at all clear whether the expenditure on fighting pollution is all in one of the other programs, or is split between several.
- The program structure within each ministry pays more attention to organizational criteria than to the objectives of expenditure. Essentially, each agency associated with the ministry has its own program, and the Ministry itself will have one or several programs. This means that where both an associated agency and the Ministry itself are active in a major policy area, the expenditure will be split between two programs rather than showing up in a single program. For example, there is a Superior Education program (within the Ministry of Education) plus a separate program for the Council of Rectors. (Note that there is also, for reasons which are quite unclear, a further Operational Expense of Superior Education program within the Ministry).
- The transparency of the allocation of resources to policy objectives is blurred by the inclusion of large amounts of money in programs which represent transfers which are paid by the organizational unit concerned to other organizational units, for objectives which are covered by other programs. For example, there is a National Health Fund program, eighty percent of the expenditure of which is transfers to other programs such as the Primary Care program (all of the expenditure of which comes from this source). In a program budgeting system, each program should clearly show the full final expenditure of the government on the area concerned.
- There are too many cases of programs which are not defined in terms of outcomes and outputs, but on some other criteria. For example, the Education Ministry has an Educational Infrastructure program, whereas a basic principle of program budgeting is that the same programs should cover both current and capital expenditure.
- The program classification of expenditure in the budget is not accompanied by any statement of the objectives (intended outcomes) or key services (outputs) of the programs; so that readers of the budget papers must in some cases guess at precisely what the program covers.

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

The failure to link the "strategic products" with the budgetary programs has the serious consequence that it separates entity strategic planning and budgeting. In a properly-designed program budgeting system, the strategic framework should be integrated with the budget via the budgetary programs. Concretely, entities are required to specify the objectives (intended outcomes) of every budgetary program, and develop performance indicators for each program. However, in Chile performance indicators are linked to the "strategic products" rather than to budget programs, and the objectives of the budget programs are not specified.

The other disconnect between the budget and performance management system is that the "programs" which are the subject of the evaluations carried out by DIPRES ("*evaluation programs*" for short) are not the same as the programs in the budget and not part of the budget classification. Not surprisingly – given the lack of sub-programs in a budget classification based on very broad programs – the evaluation programs tend to be more narrowly defined than the budgetary programs. However, DIPRES budget

analysts are themselves not always clear to which budgetary program certain evaluation programs correspond. The consequence of all this is that is that DIPRES sometimes has trouble knowing how to give budgetary effect to the evaluations when they conclude that evaluation programs are ineffective or that their intervention logic is dubious. And to those outside DIPRES – including in the presidency and in the Congress – the relationship between evaluation findings and the budget is opaque.

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

Fortunately for Chile, the new financial management information system (SIGFE 2.0) which came on-line in July 2011 is fully capable of handling properly-defined programs, which will permit the reform of the budgetary program classification to be accomplished relatively quickly. SIGFE2.0 began being implemented incrementally in 2011 and will be fully implemented by 2013.

Lack of focus in the evaluation system on budget preparation

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

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

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

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

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

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

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

The broad focus of the DIPRES evaluation system is also reflected in the choice of programs and institutions for evaluation. If evaluation is going to make its maximum potential contribution to resource allocation, the programs (or elements of programs) and topics chosen for evaluation should be those which appear *prima facie* likely to yield budgetary savings. However, at present the DIPRES system does not choose programs for evaluation primarily on the basis of the likelihood of budgetary saving being realized. Rather, selection appears to reflect a goal of evaluating all programs over time, together with a desire to pay greater attention to programs which are seen as potentially needing policy redesign or management improvement. There has also been a deliberate policy of including within the evaluations programs which are seen to be good performers.

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

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

Second, there is at present no mechanism for reviewing transversal efficiency issues – that is, efficiency issues which affect many government agencies, such as the organization of support services, or procurement practices. This contrasts with the strong focus of efficiency reviews in many other countries on government-wide efficiency issues. In New Zealand, for example, there has been in recent years a very strong focus on reviewing the efficiency of support services, underpinned by the development of key process efficiency indicators for cross-agency benchmarking⁶. The UK is another good example: over the last decade, successive governments have carried out a series of transversal efficiency reviews, including the Gershon review of 2004, the Operational Efficiency Review launched in 2008, and the Green efficiency review of procurement which reported in October 2010. In other countries, such as Sweden and Denmark productivity dividend mechanism has been put in place as discussed in box 1.2.

⁶ See, for example, *Administrative and Support Services Benchmarking Report for FY 2008/09 and FY 2009/10* (New Zealand Government, April 2011).

Box 1.2. - Features of automatic productivity cut procedures

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

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

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

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

Source: *OECD Value for Money in Government: The Netherlands 2010*. OECD Publishing: Paris p. 80-81.

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

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

This question may already be in the process of being answered by the plans which the government has underway to build at least one and possibly two evaluation institutions. One of these will be part of the Ministry of Social Development, and is planned to exercise a wide evaluation mandate in respect to "social" programs across a range of ministries.

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

The other part of the solution may be increased efforts to promote the evaluation function *within* spending institutions. External evaluations are undoubtedly an essential part of the system. However, a limitation of external evaluation is that the institution being evaluated may not "own" the evaluation. Rather, it may regard it as an external imposition and as a consequence fail to make full use of its recommendations. The maturation of the Chilean evaluation system should therefore in part involve a significant measure of *decentralization* of evaluation.

Box 1.3. - Ongoing reform: the creation of the Ministry of Social Development

The reform is to provide an institutional framework that can guarantee coordination and coherence and hinder duplication of social development policy in government. This effort is meant to strengthen one of the strategic objectives of the Chilean government – "eradicate extreme poverty by 2014" – by linking spending to government priorities. The law aims at doing this by creating the Ministry of Social Development and abolishing the current Ministry of Planning. Apart from strengthening social policy the reform is also meant to increase fiscal space by eliminating low priority and ineffective programs and to realize efficiency savings.

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

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

The relationships between the new ministry, the ministry of finance's evaluation effort and the ministry of finance's budget department are presently unclear. In addition, the introduction of a spending review process cutting across all ministries would also need to be coordinated with this new effort.

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

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

Lack of Priority Analysis

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

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

To make this observation is not to criticize the system, because priority analysis is very different from evaluation. It is inherently much more political, often requiring judgments influenced by perspectives on the appropriate role of the state and the nature of the key problems facing the society and economy.

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

Lack of a Spending Review mechanism

The analysis to this point has focused on increasing the impact of performance information on the budget by improving the quality of that information – for example, but making evaluation more budget-oriented, strengthening efficiency analysis, and developing priority analysis. However, to maximize the impact of performance information, there is one further step which could usefully be taken – the creation of a spending review process.

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

Spending review – as the term is used here⁷ – involves the creation of a spending review team with the explicit responsibility of assembling and putting forward for consideration by the political leadership during the preparation of the annual budget, options for cuts to baseline expenditure.

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

⁷ There is no standard definition of the term “spending review”, and it is used in different ways in different countries.

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

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

The use of Formula-Based Performance Budgeting

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

Some countries have tried to extend the formula based funding mechanism to outputs and even outcomes in order for public institutions to focus on delivering value. More than 20 countries across the world today fund public hospital on an output basis known as the "Diagnostic Related Group" funding system. Research has clearly demonstrated the success of this system in improving the efficiency of service delivery. Under the DRG funding system, public hospitals in a number of countries are funded principally on the basis of the services they actually deliver, with a different price set for every output type. For example, each treatment of a hip fracture patient is paid for at a certain price. This means that hospitals make a loss (profit) if the actual cost of the service delivered exceeds (is less than) the price they receive. The hospital is only paid for the services it delivers to patients ("payment by results"), so a failure to deliver expected volumes of services results in reduced funding. Assuming appropriately calculated prices, the system creates a strong financial incentive for efficiency.

The DRG Hospital Funding System

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

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

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

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

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

While Chile is at present making use of formula funding in various ways it may be possible to tie funding and outputs closer together in particular fields. It might be beneficial to strengthen MoF budget department's analysis of the presently used formulas to assess whether they are precise enough and whether they result in good performance.

1.5. Suggestions for Reform

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

A modified Budgetary Program Structure

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

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

- Ensuring that the program structure provides a more detailed classification of expenditure by objective by (1) breaking up certain highly aggregate programs into two or more programs and (2) introducing sub-programs.
- Priority should be given to programs that have particular political goals, not to inventing categories for activities to fit into the program structure (i.e. purely administration in departments).
- In the case of programs which are not defined as cross-sectorial eliminate the practice whereby the budgets of programs including money which is in fact not part of the program concerned, but represents transfers to other programs. In this way, establish the principle that program budgets should cover all (direct expenditure) on the program's objectives.
- Reviewing programs to ensure that they are defined as groups of outputs with common outcomes, and not on some other basis.
- Clearer specification of the specific objective (intermediate outcome) of each program,
- Linking of relevant outcome and output indicators to each program and sub-program,

Implementation Strategy and Timing

- The first step in the revision of the budgetary program classification should be the rapid development of a Methodological Guidelines/Manual which clearly states the principles to be observed in the definition of programs and the linking of programs to strategy. This is important because there are matters which, if not clearly resolved in such guidelines, will cause confusion and lead to conflicting approaches in different ministries or agencies, such as:
 - The relationship of budgetary programs to internal organizational units, and
 - The treatment of ministry-wide support services.
- The overhaul of the program structure could initially be piloted in a small number of ministries/agencies (e.g. food inspection, subsidy payment, social program spending, health, education).
- The reform of the program structure should then be extended to all ministries and agencies.

Linking Government-Wide Priorities to the Budget

The modified program structure should be used to explicitly link the budget to government-wide programs. Government-wide strategic objectives should in general relate to "high-level" outcomes such as the strong economic growth. The objectives of programs, by contrast, are in general "intermediate" outcomes which *contribute to the higher-level government-wide outcomes*. Once program-specific outcomes are defined, these will serve as the means of making an explicit link with relevant government-wide priorities.

Implementation Strategy and Timing

At the same time that the program structure is overhauled, it can be linked to the government-wide strategic objectives.

Introduce Spending Review

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

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

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

Institutional Structure of Spending Review:

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

Frequency of Spending Review

Because cuts to existing programs usually create some political resistance, the best time to carry it out spending review in depth may be at the start of each presidential term of office. The best approach to the conduct of spending review may therefore be:

- In-depth spending reviews in the first year of each Presidency, plus
- More limited spending reviews in other years.

Implementation Strategy and Timing

It may be too late to conduct significant spending review for the 2012 budget. If this is the case, the main options are:

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

Improve Analysis to support Spending Review: Ex Post Evaluation and Efficiency Reviews

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

- While it is tempting for the selection of programs for evaluation to be focused on programs, which look like potential candidate for budget cuts, this has to be balanced against the fact that the evaluations will be met with strong resistance by the ministry concerned. Thus selection should be balanced.
- The scope of the impact evaluations carried out should be tightened considerably to focus exclusively on issues relevant to budget preparation (e.g. by eliminating the standard requirement to review management processes).
- In order to more clearly identify programs or elements of programs which can be cut, the standard terms of reference of Impact evaluations should be revised to require a clear assessment of the practicality of fixing (making effective) programs which, as presently designed, are assessed as ineffective. This includes an assessment of the probable cost of fixing the program. Parallel modifications should be made to the terms of reference of Evaluations of Government Programs.
- Consideration could be given to whether the timelines of impact evaluations might be shortened (from the current 18 months to, say, 12 months or less) to make their findings more timely.
- Consideration should be given to whether the Evaluaciones Comprehensivas de Gasto – which seem to be focused entirely or mainly on policy and management improvement – play a useful role in supporting the budget, and if not whether the Ministry of Finance should cease carrying them out.
- Efficiency reviews – that is, reviews aimed at identifying opportunities for savings by delivering services at lower cost – should be given greater emphasis than at present. To ensure their relevance for budget preparation, the terms of reference of these efficiency reviews should require them not only to identify specific areas where efficiency can be improved, but also to quantify the potential efficiency savings involved and the time-frame for their potential realization.
- Efficiency reviews should include reviews of transversal efficiency issues (efficiency issues which affect many government agencies, such as the organization of support services, or procurement practices).
- Efficiency reviews should actively benchmark agencies and public institutions against each other relevant private sector entities and similar institutions in other countries.
- Efficiency review should be carried out by business process experts, and not only by professional evaluators.

The Assignment of Institutional Responsibilities for Evaluation

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

- Whether they should be re-defined to focus primarily on evaluation to support budget preparation, and more specifically to provide the information necessary for spending review.

- Whether the role of evaluation in supporting policy and management improvement of programs and institutions should be re-assigned to other institutions (e.g. the planned new evaluation agency and the Social Development ministry).
- The role of the new Ministry of Social Development with regards to ex ante evaluations and evaluations of the existing stock of programs needs to be coordinated. The potential for overlap and bureaucratic conflict between the Ministry of Finance and the Ministry of Social Development concerning this area cannot be discounted.

Introduce Productivity Savings Mechanism – Efficiency Dividend

The other useful means of creating fiscal space is the introduction of a *productivity savings* mechanism.

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

Implementation Strategy and Timing

- Before introducing the mechanism, it is necessary to carefully define the expenditure to which it will apply. This could be done during 2011.
- Consideration could be given to initially introducing the productivity savings at a quite low rate – say 0.75 percent – so as to make sure that any unforeseen design problems don't cause major problems for ministries. The rate could be kept at this low level for, say, 2 years while the design is perfected. After that, the permanent rate (1.5 – 2 percent) could be safely applied.

Improve Institutional Strategy and Indicators

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

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

Implementation Strategy and Timing

- The methodological guidelines for the revised budgetary programs should include guidance on the reformulation of institutional definiciones estratégicas, linking them to programs and clarifying them.

Strengthen the use of Formula-Based Performance Budgeting

While Chile is at present making use of formula funding in various ways it may be possible to tie funding and outputs closer together in particular fields. It might be beneficial to strengthen MoF budget department's analysis of the presently used formulas to assess whether they are precise enough and whether they result in good performance.

Investigate whether more output based funding mechanisms are appropriate and viable.

- Strengthen the scrutiny of the formulas presently in use in order to assess value for money. Institutions could be benchmarked against each other and compared to relevant private sector institutions where applicable.

Implementation Strategy and Timing

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

2. MEDIUM-TERM BUDGETING

2.1. Introduction

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

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

2.2. Overview of the Use of Medium Term Frameworks in OECD Countries⁸

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

⁸ www.oecd.org/gov/budget/database

Box 2.1. - Core Elements of Medium-Term Budgeting

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

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

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

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

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

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

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

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

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

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

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

2.3. The Current Situation in Chile

Chile has since 2001 had a clear macro fiscal framework featuring a rule with respect to the annual structural budget balance. Prior to the global financial crisis, the rule required a structural surplus of 0.5 percent of GDP (1 percent prior to 2007). During the crisis, the rule was suspended to permit a large fiscal stimulus, equivalent to 2,8 percent of GDP. Following the crisis, the Government has declared its intention to move back to sustainable fiscal settings over the medium term, and to this end has set a medium-term objective of reducing the structural deficit to 1 percent by 2014. It has also mapped out a transition path, setting annual structural budget balance targets for each year till up to 2014, which will gradually move to this medium-term objective. In 2011 the aim is to reduce the budget deficit to 1.8 percent, followed by 1.5 percent in 2012, 1.3 percent in 2013, and finally 1 percent in 2014. The intention is that from 2015 a new structural balance rule will be put in place(see below).

The government has for some years prepared medium-term fiscal projections and presented them to the Parliament together with the budget law. (The table below reproduces those published with the 2011 budget.) The aim of these projections is to show "the fiscal space which exists to expand or create programs, and also to anticipate the need to take action to avoid any possible future disequilibrium". To this end, projections are made of:

- The level of aggregate expenditure permitted by the budget balance rule or (in the present context) target, given projected revenue; and
- The level of committed expenditure ("gasto comprometidos") – by which is meant what is often referred to in other countries as "baseline" expenditure.

The fiscal space is the difference between these.

Consolidated Balance of Central Government⁹ (million pesos in 2011 and % of GDP)				
	2011 Proposed Budget	2012 Projection	2013 Projection	2014 Projection
(1) Total Income	25.769.646	26.540.282	27.386.419	28.406.489
(2) Total Committed Spending	26.693.480	27.134.671	27.353.534	27.145.499
(3) Balance [(1)-(2)]	-923.834	-594.389	32.886	1.260.990
(4) Balance [% of GDP]	-0,8%	-0,5%	0,0%	0,9%
(5) Structural Income	24.660.461	25.798.173	26.809.354	28.037.130
(6) Structural Balance [(5)-(2)]	-2.033.019	-1.336.498	-544.179	891.631
(7) Structural Balance [% of GDP]	-1,8%	-1,1%	-0,4%	0,6%
Convergence to a Structural Deficit of 1% of GDP in 2014				
(8) Structural Deficit Target [% of GDP]	-1,8%	-1,5%	-1,3%	-1,0%
(9) Spending Level Compatible with Target	26.693.480	27.645.225	28.437.838	29.412.873
(10) Spending Difference [(9)-(2)]	-	510.554	1.084.305	2.267.374
(11) Spending Difference [% of GDP]	0,0%	0,4%	0,8%	1,6%
(12) Actual Balance Compatible with Target [(1)-(9)]	-923.834	-1.104.943	-1.051.419	-1.006.384
(13) Actual Balance Compatible with Target [% of GDP]	-0,8%	-0,9%	-0,8%	-0,7%

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

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

⁹ Source : *Informe de Finanzas Públicas Proyecto de Ley de Presupuestos del Sector Público para el año 2011*, p. 62.

Quality of the Forward Estimates

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

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

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

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

What happens at present is that sector budget analysts within DIPRES each year prepare expenditure forward estimates for the ministries which they cover. The principle is firmly established that these forecasts cover only the expenditure required by current law and policy, and exclude possible new expenditure laws. The sector analysts apply common assumptions about the evolution of key macroeconomic variables. They also seek, for example, to adjust their projections to eliminate temporary expenditures which should be coming to an end. Once the sector analysts have prepared the forward estimates for their ministry, these are reviewed and consolidated by the Studies group within DIPRES.

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

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

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

Ministry Expenditure Ceilings

Chile at present has strictly annual budgets. In other words, the budget authorizes spending institution expenditure only for the coming financial year. Annual budgeting is, of course, the predominant

international practice. There are, however, a limited number of advanced countries, such as the United Kingdom, which have multi-annual budgets in the sense that the government gives spending institutions *firm* medium-term spending ceilings covering a large part of their expenditure. There is a school of thought in Chile which would like to see the country move to this type of system. Thus in the first year of every president's term of office, the Chilean Congress could approve a multi-year budget providing institutions with the funding required to carry out a government strategy which was also conceived in terms of medium-term objectives (like the *Objetivos Estratégicos* set out by President Piñera).

This would undoubtedly present a desirable future direction for the Chilean budgeting system. There is, however, an important obstacle to moving to firm multi-year ceilings in the short-term: the quality of the expenditure forward estimates. If firm multi-year ceilings are to be set, DIPRES needs to be able to prepare accurate forward estimates of institution's baseline expenditure requirements not merely for the coming year, but for several years into the future. If DIPRES is not yet able to prepare reasonably accurate medium-term forward expenditure estimates, there will be a high risk that the ceilings set for many institutions in the outer years will be either too low or too high. This is not a problem if the ceilings are only indicative, but it is a major problem if they are firm. If the ceilings are too high, the available fiscal space will be underestimated and the capacity to fund new policy commensurately reduced. But if they are too low, the risk will be that, when the outer years arrive, the unrealism of the supposedly firm institution ceilings will become apparent and the ceilings will end up being modified upwards. Expressed differently, the ability to make firm multi-year ministry ceilings stick depends upon the credibility of those ceilings.

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

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

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

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

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

2.4. The Fiscal Rule and the Long Term

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

- Protecting the competitiveness of the export sector and reducing the volatility of the exchange rate,
- Reinforcing the Chilean government's credibility as a borrower with the capital markets,
- Building public sector savings.

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

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

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

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

The answers provided to these issues and others by the committee include:

- It is proposed to change the term structural balance rule for cyclically adjusted balance rule, but maintaining the methodology that was previously used: budget headings that are affected by deviation of domestic GDP and the price of copper and molybdenum from their trends are adjusted, without considering other sources of deviation of transitory revenue to permanent revenue.
- The committee does not make an explicit recommendation regarding the cyclically adjusted target, leaving it up to the government. However, it is mentioned that in order to define the cyclically adjusted target it is essential to consider future contingent liabilities or deficits, as those presented in

the report on contingent liabilities and deficits made by DIPRES. In addition it is advised to increase the coverage of the Annual Report on Contingent Liabilities.

- It is proposed to move to a target based on the primary balance.
- It is proposed to use an ex-post criterion to adjust expenditure when relevant changes occur to the variables that determine the fiscal rule. When facing important changes in any of the parameters that would affect the cyclically adjusted revenues, partial adjustment mechanisms should be considered by the government to smooth the convergence towards a fiscal equilibrium. As a legal requirement such deviations, and the measures that will be taken to correct them, should be reported by the annual government "Report on Evaluation of Financial Performance of the Public Sector".
- It is recommended to complement the rule with a component that would allow the authority to use ex-ante contra cyclical policy. Such a component would establish a variable target as a function of the estimated GDP threshold. The definition of the parameters that will activate such a component shall be made by the executive authority at the beginning of every administration.
- It is suggested to establish an Independent Fiscal Council with the following functions: 1) Evaluate the methodology of the fiscal rule; 2) Provide the economic assumptions and projections for the adjustment of the cyclical adjustment variables; 3) Evaluate fiscal policy, the application of the rule and sustainability of medium and long term fiscal policy; 4) Produce an assessment on possible changes of principles and accounting methodologies used in the budget; 5) Evaluate the escape clauses and convergence strategy towards the cyclically adjusted balance; 6) Provide an opinion on the contingent liabilities report and the impact of such estimation on policy goals.
- Give official status to the Consultative Committee on the reference copper price.
- Give legal status to the regular delivering of long term actuarial fiscal projections.
- Improve financial information contained in proposed new legislation.

Broaden the annual presentation of financial and fiscal medium term projections, using a higher level of disaggregation in the medium term financial program and providing estimates of the cyclically adjusted balance rule year to year in a similar time horizon. This should include details of the main economic assumptions in order to evaluate the viability of achieving fiscal targets. The Budget Office has recently published a report¹⁰ that includes the main elements of a second generation structural balance rule that incorporates many of the measures proposed by the committee. The most relevant are:

- The term structural balance rule will be changed to the Cyclically Adjusted Balance Rule, to better reflect its purpose. It will only be adjusted for cyclical incomes derived from GDP and the price of copper and molybdenum.
- Other changes in incomes due to one off factors will not be adjusted for.
- No cyclical adjustments will be made on interest gains on government assets. No adjustment will be made to "other incomes"
- The long term price of Molybdenum will be estimated based on a moving average of the actual price for the last seven years.
- The rule will be calculated on the basis of the global balance of the Central Government.
- An ex-post criteria for implementing the rule will be used. A section will be incorporated into the annual 'Report on Evaluation of Financial Performance of the Public Sector' describing the impact of adjustments and deviations from initial projections in the established policy targets. A Fiscal Council is to be created with the following functions: 1) Participate in the GDP Tendencies and the Copper Referential Price Committees; 2) Verify that the mentioned variables are correctly reflected in the rule and its implementation; 3) Provide advice to the Ministry of Finance on specific aspects regarding the cyclically adjusted balance rule; 4) Assess eventual methodological changes to the

¹⁰ Larraín, Felipe et al (2011), "Una regla fiscal de segunda generación para Chile", Dirección de Presupuestos, Estudios de Finanzas Públicas, Octubre.

rule proposed by the authorities; 5) Verify mid – term projections of structural results included in the Public Finances Report.

- The information about the methodology, variables and rationale for calculating the fiscal rule will be made available to the public.

Long term budget projections

As a prerequisite for achieving this, the Ministry of Finance is focusing considerable effort on the preparation of long-term fiscal projections. This is an area to which OECD member countries have paid increasing attention over the past decade or so (see box 2.2). The Ministry of Finance has carefully studied the practice of other countries in this area, including the European Commission’s projections of the fiscal costs of ageing.

Box 2.2. - Long-Term Fiscal Forecasts: Selected International Practice

- Australia: the national government has since 2002 published every five years an *Intergenerational Report* which provides 40-year fiscal projections,
- New Zealand: a report on the Long-Term Fiscal Position with a 40-year time horizon has been prepared every 4 years since 1993,
- United Kingdom: since 2002, the Treasury has produced a *Long-Term Public Finance Report* with 30-year projections,
- United States: the US was one of the first movers in this area, and the Office of Management and Budget (i.e. finance ministry) has published 75-year fiscal projections annually for the past forty years.
- A number of other OECD countries, such as Switzerland and Norway, have recently started producing similar reports.

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

Box 2.3. - Rationale for Swedish Choice of 1 Percent Budget Surplus Rule

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

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

Source: The Swedish Fiscal Policy Framework, Statement by Finance Minister, March 2011.

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

2.5. Suggestions for Reform

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

Medium-Term Forward Estimates

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

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

MT Budgeting and Resource Certainty for Ministries/Agencies

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

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

Long term budgeting and fiscal rule

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

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

- a fiscal council
- a stronger mandate for the copper committee and
- transparency efforts in the form of enhanced reporting on liabilities and deviations from the targets

These efforts should be pursued.

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

3. SERVICES FLEXIBILITY AND EFFICIENCY

3.1. Introduction

Most OECD member countries are placing a larger emphasis on budgeting, management and accountability to take them away from controlling inputs towards achieving results. There is a tendency to relax input controls to give government organisations greater flexibility and autonomy to achieve their objectives efficiently and effectively. The basic assumption is that heads of individual government organisations are best positioned to achieve their policy and programme objectives if enough flexibility in the management of financial and human resources is granted. Flexibility would allow taking into account the differences in priorities and the functions performed by government ministries and agencies. In this context, flexibility can be defined as the extent to which an organisation can adjust budget appropriations and empower and enable public managers to adjust the number and competencies of the public workforce to the business needs of their organisation.

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

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

3.2. Towards More Flexibility in Budget Execution

The situation in Chile

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

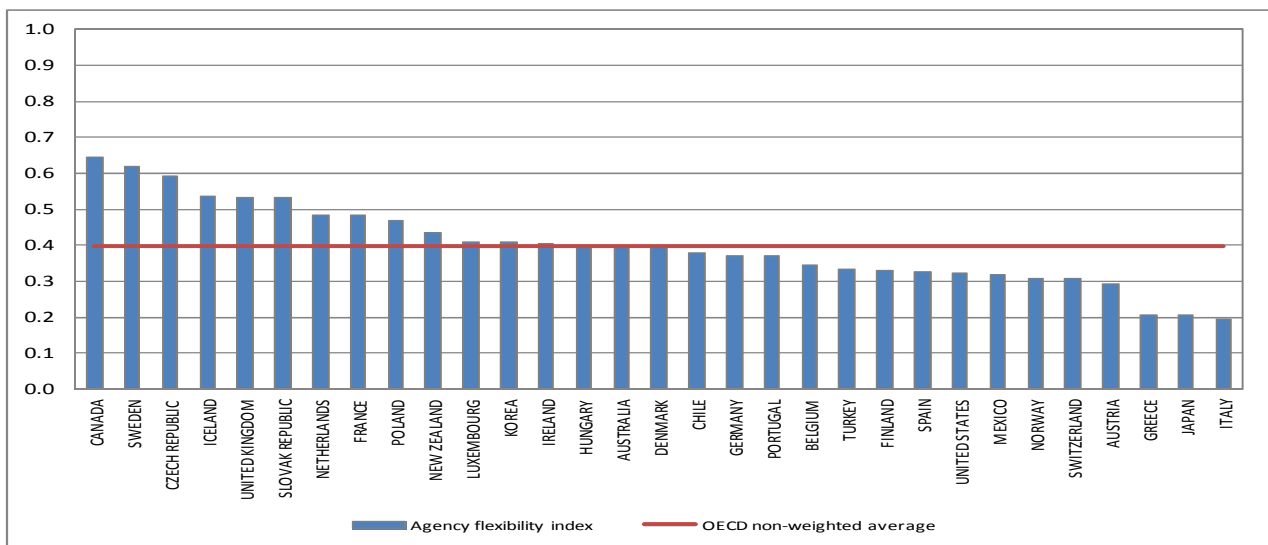
Article 26 of the law 1263 of 1975 regulates the procedures for transfers, increases and decreases of the budget. It is here stated that the rules for changes in appropriations are to be determined in a decree issued in December of the previous year by the Minister of Finance. In the decree 1531 of December 2009, it is specified that carry over and reallocations can take place by a decree issued by the Ministry of Finance. Certain appropriations, however, require a new law to be altered (transfers between ministries, to state enterprises and if global amounts of a given appropriation are to be enlarged). Both carry over and reallocation requires a special authorization from the Ministry of in the form of a decree. While this legally

is the same process, it should be noted that due to the broad program definitions in Chile relatively few reallocation decrees are necessary.

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

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

Figure 1. - Agency Flexibility in Budget Execution



Source: OECD Budgeting practices and procedures in OECD countries.

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

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

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

Suggestions for reform

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

In other OECD countries reallocation rules usually vary according to which kind of expenditure they relate to. Line ministries/agencies are typically allowed to reallocate a percentage (2-5%) of current expenditure appropriations within programs and a smaller percentage between programs. Usually Ministry of Finance and Parliamentary approval is required for larger reallocations or reallocations across ministries. Appropriations for salaries can typically be reallocated to other operational spending but not the other way around. Countries have different regimes regarding capital spending. Since entitlement spending is sanctioned in law other than the budget the amount appropriated is usually a non-binding estimate.¹¹

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

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

A carry-over of appropriations allows government organizations to use a portion or all of an unspent appropriation after the time period for which it was originally granted. By using a carry-over, an organisation may use unspent money in the next fiscal year. As with reallocation rules there is a great variation between OECD countries with regards to the rules governing carry over. In many cases there will be a distinction between the types of expenditure (current, capital, salaries and entitlements). Depending on the country carry-overs are allowed after a qualitative evaluation by the Ministry of Finance and/or based on a quantitative rule. Quantitative rules include: a limit on the amount of carry-forward allowed in any given year (usually 2-5% of the appropriation); a ceiling on the amount of accumulated carry forwards; or limits on the draw-down of accumulated carry-overs. For instance, in Canada, unused funds from operating

¹¹ www.oecd.org/gov/budget/database

and capital budget can be carried forward up to a 5% limit. In Finland, most operating expenditures and investments may be carried over for a maximum of two years. In the United Kingdom, unlimited carry-over of both operating and investment budgets is permitted, but the approval of the Finance Ministry is needed to draw-down the funds.

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

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

Box 3.2. - Preconditions for establishing a carry-over system

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

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

Source: Lienert, I. and G. Ljungman (2009), Carry-over of Budget Authority, Public Financial Management Technical Guidance Note, IMF.

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APPENDIX - CHILE ACTION PLAN OVERVIEW

	2011	2012	2013	2013
Program Classification (assuming a new structure needs to be developed)	<p>Develop methodological guidelines/manual.</p> <p><i>Investigate to whether a new program classification should be developed or whether the existing one can be modified.</i></p> <p>Launch pilots in 5 agencies.</p>	<p>Program budget annex with new for pilots.</p> <p>Pilot extended to all other ministries/agencies.</p>	<p>Program budget annex covering all ministries/agencies.</p>	<p>Budget law based on the new programs.</p>
Institutional Strategic Framework	<p>Revise framework of institutional <i>definiciones estratégicas</i> and link to new program framework.</p>	<p>As programs are developed, clearly specify their intended outcomes and main outputs.</p>	<p>As programs are developed, clearly specify their intended outcomes and main outputs.</p>	
Link to Government-Wide Priorities		<p>Link the new programs explicitly to <i>Objetivos Estratégicos</i> of the government.</p>	<p>Link the new programs explicitly to <i>Objetivos Estratégicos</i> of the government.</p>	
Performance Report to parliament	<p>Develop a new, briefer and more accessible structure for the <i>Antecedentes Complementarios Control de Gestión Pública</i>.</p>			
Performance Indicators	<p>Review performance indicators to improve their relevance</p>	<p>Review performance indicators to improve their relevance.</p>	<p>Review performance indicators to improve their relevance.</p>	
Spending Review	<p>Decide SR mechanism.</p>	<p>Establish first Spending Review.</p>	<p>Second Spending Review.</p>	<p>Major Spending Review.</p>
Performance based budgeting	<p>Initiate studies for the implementation of performance based budgeting in the public hospital and education system.</p> <p>Analyze the current formulas in place with regards to precision and value for money.</p>	<p>Complete studies & develop implementation strategy.</p>		

.../...	2011	2012	2013	2013
Efficiency Review	Create a new efficiency review mechanism.	Carry out first cross-cutting efficiency reviews.		
Evaluation	Redefine the mandate of the DCG, and make appropriate changes to the evaluation instruments.	Implement changes to evaluation system.		
Productivity Savings Mechanism	Define the mode of operation of the productivity savings mechanism.	Apply productivity savings at initially low rate.		Raise the rate to the planned long-term level.
Baseline Expenditure Methodology	Develop methodological guidelines Enhance the fiscal impact assessments of new legislation Enhance the use of long term budgeting.	Complete methodological guidelines.		
Using Baseline in Budget Preparation				Start to use ministry baselines as starting point in preparing the budget As part of this, let ministries/agencies know their baselines.
MT Revenue Projections	Document revenue projection methodology.	Complete documentation of revenue projection methodology.		