Every budget system rations resources by allocating money for some uses and withholding it from others. The effectiveness of government programs depends on these allocations, but governments face numerous impediments to making truly efficient allocations. One of the key tasks of modern public expenditure management is to create the conditions that foster allocative efficiency.

Allocative efficiency refers to the capacity of government to distribute resources on the basis of the effectiveness of public programs in meeting its strategic objectives. It entails the capacity to shift resources from old priorities to new ones, and from less to more effective programs. Allocative efficiency requires that the government establish and prioritize objectives and that it assess the actual or expected contribution of public expenditures to those objectives. To allocate efficiently, government must be strategic and evaluative; it must both look ahead and define what it wants to accomplish and look back to examine the results.

The linkage of strategic planning and program evaluation to ongoing budget procedures has been a perennial issue in public expenditure management. Forging a tight link has been a recurring theme in budget reform during the past half century. Many governments have tried, few have succeeded. The failure rate has been high because striving for allocative efficiency increases informational burdens, transaction costs, and political conflict. Informational needs are higher because of the demand for additional data on program impacts; political conflict escalates because of efforts to redistrib-
ute budgetary resources. The task of contemporary public expenditure management is to improve allocative efficiency without overstraining the capacity of government to process information and cope with conflict. Unless information demands and budgetary conflict are manageable, governments may prefer suboptimal allocations that enable them to muddle through the annual budget exercises.

This chapter considers the conditions (institutional arrangements, including informational flows and behavioral implications) that promote allocative efficiency in the context of efforts to strengthen aggregate fiscal discipline.

The Pursuit of Allocative Efficiency

Ideally, governments should seek allocative efficiency under all fiscal conditions, when the budget is growing and when it is shrinking, when incremental resources are available to finance additional spending and when they are not, in poor countries and in affluent ones, during boom times and when the economy is in distress. In all cases, government should spend its limited resources on programs that yield the greatest social return. In fact, however, financial conditions can make a big difference in whether and how governments seek allocative efficiency through the budget.

In developed countries, during the long postwar expansion, budgeting was oriented to allocating incremental resources. Budget bids were made and reviewed as claims for additional resources, and relatively little attention was paid to the base of previously authorized expenditure. Incremental budgeting enabled the government to respond to fresh demands without taking resources away from existing budget holders. Budgeting was a distributive, not a redistributive process. Intragovernmental conflict was low because explicit tradeoffs generally were avoided; winners gained by claiming incremental resources, not by taking from those who already had shares in the budget. Relative priorities were rearranged by awarding different growth rates to the various parts of the budget. The central budget office accrued power by serving as the hub of this incremental process; by allocating the increments, it influenced the future direction of government.

Budgeting paid lip service to allocative efficiency by insisting that there be a nominal review of all expenditure claims.
each year. Spending departments submitted detailed justifications of all items of expenditure, not just of the increments. Formally the process was highly adversarial; the budget office had authority to review and challenge any items and to seek the cutback or elimination of those it considered unproductive or of lesser value. In fact, however, the process was relatively calm and accommodating. Conflict was mitigated by the tendency to continue most ongoing programs. Although all of the budget was nominally reviewed, almost all escaped serious review. Few changes were made, except those financed by additional resources.

Incremental budgeting suited the times, but it is a flawed means of allocating public money. It encourages allocative inefficiency and the creeping enlargement in the relative size of the public sector. It weakens aggregate fiscal discipline by presuming that spending will be higher next year making the totals accommodate the parts. Spending departments generally have few constraints on proposing program initiatives, but these typically are bids for more money, not trade-offs within fixed budgets.

Incremental behavior calls into question due process assumptions. Classical budgeting seeks allocative efficiency by requiring that the budget be comprehensive and that all claims compete against one another in a global competition for public funds. It assumes that if all claims are standardized as to form and are submitted according to a prescribed schedule, the allocations deriving from the budget competition will be correct. But as budgeting hardened into incremental patterns, structural impediments to the optimal allocation of government money became apparent. One is the “stickiness” of public expenditure; another is the short time frame of annual budgeting; and a third is a lack of adequate information on program effectiveness. Stickiness refers to the difficulty of taking funds from existing programs and agencies. Budgets are sticky because recipients mobilize and logroll to protect their shares and because there is no market mechanism to drive out inefficient performers. Moreover, within the framework of annual budgeting, it often is difficult to make reallocations that unfold over several years or whose program impacts lie in the future. Finally, by allocating inputs conventional budgeting does not sufficiently consider
whether funded programs are achieving governmental objectives.

Recognition that due process in budgeting often produces inefficient outcomes led to a series of abortive efforts to reform government budgeting. One popular vein of reform ideas was centered around PPBS (planning-programming-budgeting systems) and similar arrangements in many developed countries; another was zero-based budgeting (ZBB) and its variations. PPBS sought to give budgeting a longer time horizon and to upgrade its analytic capacity; zero-based budgeting sought to redistribute resources within the base of existing programs and expenditures. Although they differed procedurally, both PPBS and ZBB sought to intensify competition for budget resources, the former by providing information on the cost effectiveness of alternative means of achieving government objectives, the latter by having each spending unit prepare alternative budgets (each with incremental resources and outputs). With the prospect of greater competition, however, came increased informational burdens and conflict, along with often successful political-bureaucratic tactics to disable the new budgetary mechanisms. Variations of both approaches were exported by bands of consultants (often encouraged or financed by international institutions) to many developing countries. The reforms were even less fruitful in poor countries than they had been in rich ones, for they overtaxed the capacity of governments to generate policy analysis and budget alternatives.

This is not the place for reviewing the many reasons why efforts to reform budget allocation systems have failed, but it is important to distinguish contemporary PEM from PPBS and ZBB-type innovations. The earlier reforms were confined to budgeting; they tinkered with the informational content and procedures of the annual budget process. PEM, by contrast, views budgeting as a critical part of the larger institutional environment in which it is embedded. PEM connotes a Copernican shift in the relationship of budgeting and institutions: rather than budgeting being the driver of political and managerial actions, it is the behavior of politicians and managers that drives budgeting. To change budget allocations requires, therefore, changes in the incentives provided those who decide the budget, including the institutional arrangements in which they work and the information supplied to or by them.
The test of the allocative strength of any budget systems lies not in its procedures but in the allocations themselves. Due process in budgeting does not suffice. It is possible to have a well-run budget process that allocates inefficiently because of the stickiness of expenditures and the refusal of politicians and managers to reallocate. Budget stakeholders need incentives to cooperate and the rules that matter the most are that they operate under constraints that impel them to reallocate and that they have a large say in the reallocations that are made. Anything less will blunt allocative efficiency.

Allocating Under Fiscal Constraints

In terms of allocative efficiency, enforcing fiscal discipline can be a mixed blessing. Although it stabilizes the budget totals and makes them congruent with government economic objectives, a fiscal norm that constraints total spending risks freezing old programs into the budget and new ones out. This outcome is highly likely because it is politically safer to continue old programs than to terminate them in order to make room in the budget for spending initiatives. Consequently, a government whose fiscal norms compel incremental budgeting might seek to meet aggregate constraints by eliminating program initiatives rather than by stringently reviewing the effectiveness of existing expenditures. The more austere the spending norm and the longer it is maintained, the greater the risk that budget priorities will rigidify. The risk is greatest when economic growth is weak and fiscal increments are inadequate to finance normal year-to-year increases in spending. In this circumstance, a strong case can be made for reallocative initiatives that transfer resources from current budget holders to new spenders. Paradoxically, however, while striving for allocative improvement is most needed when the budget is tight, this may be the condition under which it is most difficult to achieve. To keep the budget fresh and supple when there is little or no money to expand programs requires that the government have the strategic capacity to reallocate resources in accord with its priorities.

Both rich and poor countries suffer from allocative inefficiency, but the cost may be significantly higher and more apparent in the latter. When they fund ineffective programs, developed countries obtain suboptimal returns on public expenditure. Per capita income is somewhat lower, citizens are deprived of social benefits they might otherwise receive, and government is not sufficiently
responsive to emerging problems. Depending on the pattern of inefficiency, there may be distortions in private investment and consumption as well as in the distribution of income. Poor countries face all of these costs, but relative to the country’s wealth, the price paid may be far higher. When a poor country tolerates serious inefficiencies in the allocation of public resources, it may underspend on critical needs (such as public health and education) and overspend on other areas (such as military forces); facilities and other capital investments acquired through international assistance may fall into disrepair because they are inadequately maintained; money may be wasted on showcase projects that offer meager social returns. When poor countries misallocate resources, development is retarded and poverty persists. It is especially urgent, therefore, that countries striving to lift themselves out of impoverishment improve allocative efficiency in public expenditure.

**The Institutional Framework for Reallocation: Rules, Roles, Information**

The procedural elements of a public expenditure reallocation system are similar to the elements of PPBS and other failed budget reforms. Both PPBS and the public expenditure model seek to enhance allocative efficiency by establishing a multi-year budget framework, generating data on program performance, and allocating resources to more productive uses. One difference is in their fiscal context: PPBS-type reforms were introduced during a period of rising expectations about economic well-being and the affordability of program expansions. The logic of PPBS-type systems was that through multi-year planning and program analysis, governments would be more efficient in allocating the dividends of a growing economy. Although governments gave lip service to reallocation, the prevailing mood was that planning and analysis would lead to improved allocations of new money.

Contemporary public expenditure is being managed in a different environment. Austerity is the order of the day, promoted by efforts to curtail the legacy of past deficits, weaker economic growth than was enjoyed in the past, and taxpayer unwillingness to pay more to finance government programs. In this environment, most program initiatives have to be financed by reallocation, not by new money. The dif-
ference in fiscal condition and government ambitions has affected the institutional context, informational resources, and behavioral patterns in public expenditure management.

**Rationing Public Expenditure**
The key change in rules is that budget allocations are made pursuant to explicit constraints on the amounts that can be spent. These constraints need to be set before departments bid for resources, and they must be centrally set for each sector and portfolio in accord with government objectives. In contrast to conventional bottom-up budgeting which permits open ended bids for resources, PEM requires that department requests be within the resource envelope provided them. Moreover, in contrast to PPBS and other “rational allocation” systems which base budget decisions on net benefit considerations, PEM requires beneficial programs to compete for constrained resources: just because a program yields net benefits does not necessarily mean it will be funded.

Rationing public expenditures mitigates the common resource pool problem of public finance, but can worsen the principal-agent problem. Inasmuch as the amount that can be drawn from the pool is rationed, self-interested spenders cannot opportunistically take more than is permitted. Enforcing this rule requires a vigilant, powerful central office that reviews spending demands and assesses adherence to budget constraints. But no enforcement mechanism is perfect, and wily ministers and managers can maneuver to spend more resources than are in their envelope. As long as the excess is marginal, it will not do much damage to the fiscal constraints; but if spenders succeed in breaking the constraints, preset limits will have little impact on budget outcomes.

**Organizational Roles: The Center Versus Ministers and Managers**
Reallocation is difficult because it stirs up political conflict, spurs those threatened with a loss of resources to take counter-measures to protect their budgets, and requires an enriched flow of information on program objectives and results. Nevertheless, governments can facilitate reallocation by building their capacity to specify strategic objectives and reprioritize programs within medium-term expenditure constraints.

Seen in this light, reallocation is a function of strategic capacity, that is, the ability of a government to antici-
pate and plan for future changes in its environment, to recast its objectives and programs on the basis of planned change, to define future desired outcomes and to reallocate resources to achieve them, to measure progress in achieving the planned outcomes, and to assess the effectiveness of programs. Having all these capabilities promotes use of the budget as an instrument of change, but doing all these places significant demands on the analytic and conflict-resolving capacities of government. Few governments make serious efforts along these lines; those that do generate more reallocation than those that do not.

The strategic capacities set forth above must be concentrated at the center of government where responsibility for national priorities and inter-sectoral allocations is lodged. Moreover, strategic decision-making should be linked to allocative decisions; if they are not, the plans made by government will not be effectively implemented.

Allocating resources is the stock in trade of the central budget organization; reallocating resources may require a more sensitive division of labor in which central budget makers are responsible for strategic decisions and major priorities, while ministers and managers are responsible for sub-allocations in their respective fields of responsibility.

**Top-down Versus Bottom-up Budgeting**

In classical budgeting, the production of information proceeds in a bottom-up sequence, while decisions flow in a top-down sequence. Spending agencies are permitted to ask for as much as they want, with little or no guidance from the center. In bidding for resources, agencies submit vast amounts of information on their activities and expenditures. This information and the associated bids are reviewed by central authorities who decide the amounts provided to each agency or activity in the government budget. Invariably, the total demanded by agencies exceeds available resources. The fact that not all demands can be satisfied gives the central budget office the lead role in allocating budget resources. The greater the excess of bids over resources, the greater the center’s influence in dictating where the money goes.

This arrangement puts spending agencies and central budget makers on a collision course. Much of the increase sought by agencies is denied
by budget guardians. But friction typically is eased by weak aggregate fiscal discipline (the total can be raised as spending pressures intensify), the inclination of central officials to give agencies at least as much as they were allocated for the previous year, the availability of spending increments, and avoidance of explicit reallocation. When austerity removes these favorable conditions, central controllers no longer regard bottom-up, open-ended requests as useful. Such requests enable spenders to avoid hard priority choices and explicit reallocation. When central controllers want significant reallocation, they cannot rely on spending departments to voluntarily surrender resources in the normal course of compiling their budgets. Central controllers have to intervene early and effectively by providing substantive guidance on the government’s preferences and strategic interests.

**Changing Government Priorities**

What does the center do when it is bent on reallocating resources? The short answer is that it changes government priorities. Reallocation entails changing what government does with public money. In contrast to allocation which is driven by the opportunity to obtain a bigger budget, reallocation depends on government decisions that certain objectives should be accorded priority in the competition for public funds. Reprioritizing can be an explicit decision that A is more important than B, or an implicit choice that is revealed only by the outcome—A gets more money and B gets less. Either way, reallocation requires capacity at the center of government to change. In contrast to allocation which often proceeds in a fragmented manner, reallocation requires a high degree of central coordination. Not much reprogramming of public funds occurs when spending departments logroll to divide the budget among themselves.

There is no standard process for reconsidering and changing government objectives and priorities. Some governments are guided by party platforms, others by the views of strong leaders. In some multi-party governments, coalition agreements map out the policy initiatives that will be taken, including changes in the use of public funds. In some countries, the Cabinet meets months before the annual budget is prepared to specify medium-term priorities and to decide the fiscal envelope for each sector or department. In recent years, a few countries have
announced the strategic areas that are to be favored in budget allocations. In these countries, ministers and managers must demonstrate that the resources they are bidding for would contribute to the government’s strategic objectives.

All of these processes can be used to reallocate, but they are more likely to be used for allocative purposes, that is, to claim larger budgets. Strategic planning potentially is oriented to reallocation, though it is not always applied to this end. In business, strategic planning is used to decide which markets to enter or exit; in government, it typically is used to decide which programs to expand. When used to its full capacity, strategic planning questions the role and objectives of government entities and considers how they might be transformed by terminating some activities and starting others.

The common element in the various approaches is that they provide an opportunity for the government to rethink its strategic goals and to shift resources to new or underfunded priorities. Governments operating in a constrained environment are likely to find that they can respond to new priorities only when they cut funding on some existing activities.

**Medium-term Expenditure Constraints**

Because strategic changes typically unfold over an extended period and have greater impact on future budgets than on the one immediately ahead, a second element of reallocative capacity is for the government to set medium-term fiscal targets, including the margin (if any) available for spending initiatives or the net savings required to meet the preset targets. The margins and savings usually are calculated on a net basis: new spending minus savings from program cutbacks. Net budgeting encourages reallocation by protecting spenders against a loss of resources when they shift funds in response to changes in the government’s strategic priorities.

The medium-term constraints should be consistent with the government’s fiscal objectives, and they should not be so accommodating as to enable the government to avoid reallocation. It is also the case, however, that (as discussed in the previous chapter) the constraints have to be attainable. If they aren’t, the government might be impelled to resort to accounting maneuvers that understate the true amount of public expenditure.

Medium-term spending constraints are not self-enforcing. In fact,
the drive to reallocate can open the door to efforts by spending departments to substitute more expensive programs for the ones they are replacing. A familiar ploy is to overstate the savings from program cutbacks and to understate the spending on new programs. To forestall these tactics, it is important that the government maintain a baseline that projects the spending impacts of authorized programs over the next 3-5 years, and enables it to estimate the future budgetary impact of proposed policy changes. As will be discussed below, scorekeeping is one of the important functions of the central budget office.

**Inter-sectoral Decisions**

Reallocations across sectors are not likely to emerge from bottom-up bids by departments for resources. Decisions to take money from one sector and assign it to another must be made at the top, or they will not be made at all. Accordingly, reallocation requires that the government specify a resource envelope for each sector or major spending unit before ministers and departments compile their budget estimates. In the course of setting these envelopes, the government may decide that some sectors should be permitted increases above the baseline and that others should have decreases. In parliamentary regimes, these decisions usually are made by the Cabinet, often pursuant to recommendations from the Prime Minister or the Finance Minister. In a presidential system, the chief executive usually sets the constraints.

Reallocation can be made at any stage of budgeting, but there is a clear advantage to doing it early, before spenders stake their claims for resources. If the government were to defer these decisions to the give-and-take of budget formulation, the outcome might be very little reallocation and pressure to accommodate spending demands by raising the totals. Moreover, when sectoral decisions are a byproduct of unguided departmental bids for resources followed by bilateral negotiations between them and the Finance Ministry, there is a good chance that the budget will not be aligned with the government’s objectives and priorities.

**Intra-sectoral Spending Decisions**

The contemporary drive for fiscal discipline may tempt the government to maintain a tight grip by making detailed budget allocations within sectors or departments. Central control of
spending details might seem to be a logical response to the current budget situation in many countries. If spenders are reluctant to trade off within their areas of responsibility, it may make sense for central authorities to do the job for them. There are a number of strong reasons for centralizing intra-sectoral allocations in the Cabinet or Ministry of Finance: (1) The center can reallocate more broadly than can a line minister or department; (2) The central organs have a more comprehensive and strategic view of the government’s interests and priorities than a single department which is beholden to sectoral pressures and perspectives; (3) Central authorities can promote reallocation based on evidence of program effectiveness, evaluative findings, and objective analysis; (4) Central involvement is essential for establishing rules and procedures that enforce fiscal discipline and ensure that the cost of program proposals is accurately reflected in the budget; (5) Without strong pressure from the center, departments may protect existing programs rather than reallocate resources; (6) Departments have incentives to launch programs at low cost and to underestimate the full impact on future budgets. If not countered by the center, this behavior would undermine both aggregate fiscal discipline and the government’s capacity to establish program priorities. In sum, if spending agencies will not (or cannot be trusted to) make the tradeoffs, central budget authorities should do the job for them. But despite these arguments for centralized intra-sectoral reallocation, the current condition of government finance in many countries—fiscal constraints, inadequate increments, and pressure to make room in the budget for program initiatives—may justify a decentralized approach for budgeting within sectors and departments. Arguably, more reallocation will occur if spending ministers and managers have an active role in generating policy changes. Trying to do the job centrally may result in much conflict and little reallocation. The threat of losing resources and coveted programs may impel departments to resist the tradeoffs and savings demanded of them. Although they are not at the center of power, departments have formidable weapons at their disposal. They can withhold information needed to make cost-effective tradeoffs; they can enter into logrolling coalitions with other spenders to protect their budgets.
against cutbacks and reallocations; they can mobilize support among affected interests and within government. Judging from the past, it is by no means assured that central authorities will win the battle for reallocation; instead, they may end up with status quo budgets.

Central organs operate at a disadvantage vis-à-vis spending departments when they aggressively seek to reallocate resources. They may lack sufficient information on program and political impacts of proposed policy changes, and (despite their central perch) sufficient political support to accomplish the task. Departments know a lot more about their programs—what works and what does not—than do the ministry of Finance, Cabinet and other central authorities. They may also have a better appreciation of the political risks of changing policies and programs. This asymmetry is due to the high cost of obtaining program and political information, as well as to the understandable reluctance of departments to provide information that may cast their programs in an unfavorable light or lead to loss of resources. In other words, central organs are beholden to (or captured by) spending departments for much of the information needed to make effective reallocations. Central authorities can seek to develop independent sources of information by installing a performance measurement system or by developing a comprehensive evaluation capability. But even if they take these steps, central allocators inevitably depend on spending departments for much of the raw data that goes into evaluation and measurement.

To gain the cooperation of spending departments, it may be sensible to give them a prominent voice in the reallocation process. A devolved arrangement would free up the Cabinet (or other central decision-making organs) to focus on major policy changes rather than on the details of expenditure. When the government dictates the myriad spending items, its attention to the details often drives out consideration of strategic issues.

When intra-sectoral matters are entrusted to ministers and their departments, the government allocates a spending margin or savings target to each sector minister in accord with its budget priorities. In Australia, for example, the forward estimates (described in Box 3.1) give each minister an approved spending baseline for his/her portfolio. The forward estimates may be set at a
level that accommodates spending increases, in which case the minister would be able to propose program expansions consistent with the government’s priorities; or they may be set at a level that requires cutbacks, in which case the minister would have to propose savings. These targets serve both as constraints on spending requests and as the starting point for compiling and reviewing the budget. Within the assigned target, a minister may propose increased spending on some activities to be financed by savings derived from other activities in the same sector or portfolio. In this devolved institutional arrangement, ministers would have authority to approve relatively minor spending changes below a preset threshold on their own; proposed reallocations above the threshold would be reviewed by the government to ascertain whether the policy change would contribute to its priorities and to estimate the impact on future budgets. Australia has a AUS$5 million threshold below which departments can act unilaterally. This threshold clears the government’s agenda for major policy issues.

Shifting much of the initiative and responsibility for intra-sectoral allocations downward to the affected spending entities entails a fundamental reorientation in the role of central budgeting organs and their relationship with spending departments. In seeking allocative efficiency, they would act more as referees of the reallocation system than as close reviewers of department budgets. They are likely to have a lead role (shared with the Cabinet or some other policy coordinating organ) in managing the trade-off system and in ensuring that program changes and budget reallocations are consistent with the government’s fiscal norms and policy objectives. In this arrangement, the budget office would be responsible for guidelines and procedures for proposing and implementing program changes. It would maintain baselines and data bases for assessing the budgetary impact of program initiatives and reallocations; it advises ministers and the Cabinet on the financial and program impacts of proposals; and it conducts or promotes the ongoing evaluation of programs and reporting on performance. As it emphasizes these allocative tasks, the budget office would likely withdraw from (or curtail its involvement in) some traditional controls. It would no longer decide or monitor detailed items of expenditure; if it continued to do so, spending departments
would have little incentive to cooperate in reallocation schemes. Instead, departments would be permitted to manage their operating budgets within guidelines and financial limits set by the government. This devolution would free the central budget process to concentrate on strategic objectives and policy decisions (and contribute to operational efficiency—to be discussed in the next chapter).

A devolved reallocation scheme may require more political support and earlier involvement of politicians than one in which central authorities try to shift resources. In conventional budgeting, reallocation decisions are made late in the process, if at all. The process generally revolves around bilateral negotiations between the finance ministry and the affected spending departments. These “bilaterals” begin with middle managers who strive to resolve issues in their competence, then move to senior managerial levels. Ministerial discussions take place at the end of the process and consider only those matters not resolved at official level. After bilaterals between the finance minister and the affected spending minister, remaining issues may be taken to Cabinet. In a public expenditure system bent on significant reallocation, however, ministers must get involved earlier to set the “fiscal envelope” within which sectoral decisions are made and to establish baselines and/or reallocation targets for the various ministers or portfolios. If politicians do not play these roles, the central budget office will lack sufficient leverage to compel departments to reallocate.

The institutional rearrangements discussed here aim to make spending departments allies in reallocating public resources. But even when a cooperative relationship is established, the interests of spending departments may not perfectly align with those of central authorities. Reallocation engenders tension and conflict between those who want to hold on to or increase their resources and those who want to shift money to other uses. Decentralizing some decisions and giving departments a greater say in budget outcomes can diminish friction, but it cannot ensure that the allocations will be optimal and free of conflict.

To promote more effective reallocation, it would be appropriate for the government to insist that ministers first look to their own portfolios for savings before approaching it for additional resources.
Allocative efficiency depends not only on institutional arrangements that facilitate reallocation, but also on information concerning the effectiveness of programs. The drive to reallocate can add significantly to information demands on spending departments. In addition to detailed operating data, they have to supply information on multi-year impacts and program results. In seeking broader reallocation, budgeting risks information overload, as occurred when PPBS and other reforms were introduced. Overload is common because departments have limited capacity to produce the demanded data and central authorities have limited time to review the material within the confines of annual budget routines.

Decentralizing the reallocation process and entrusting spending departments with most operational decisions can ease the informational burden by reducing the volume of operational detail produced by departments for central review, and by delegating much of the analysis and evaluation to spending units. But these informational savings are offset by the vast increase in program evaluation and performance data. It is costly to produce these data, especially when, as is often the case, the program’s outcomes are outside the direct control of the affected department. In a reallocative budget process, departments have to make special efforts to build evaluations into their work. They must design appropriate methodologies, gather and interpret the data, and apply the findings in allocating resources.

The cost of evaluation is not only in the money expended in searching for and analyzing data, but also in the threat to departments that covered programs will be found wanting. Departments undertake programs because they “know” the activity is worthwhile, and because they know this, they want to continue ongoing activities. Turning an evaluation spotlight onto a program calls it into question. It is the rare program that passes every major evaluation test and is therefore judged worthy of being continued without change. Not surprisingly, therefore, departments often protect their program interests by giving little more than nominal support to the idea of evaluation. Where evaluation is conducted, it is typically on a hit or miss basis, as is the application of evaluative findings to resource decisions.
Developing a systematic approach to evaluation requires a substantial commitment of money and political support. To influence the allocation of public funds, this commitment must be strong and continuing, and it must be manifested in the use of evaluative findings in allocating resources and making other program decisions. Without follow through to allocation, evaluation withers.

In establishing an evaluation process, the government must strike a balance between leaving the task to line departments and entrusting it to a central agency. If the finance ministry or some other central unit conducts the evaluations, spending departments may be unwilling to act on the results. When departments lack a vested interest in the evaluation, they can refuse to cooperate with evaluators, withhold data, or refrain from using the findings in making budget and program decisions. But turning responsibility over to the departments, without strong central guidance and commitment, will likely mean that little genuine evaluation is done. Yet, as important as it is for departments to have a say in the process, most have a quite limited capacity for self-evaluation. To undertake thorough and objective assessments of programs, it is necessary for government to prod departments to take the process seriously.

The government also has to strike a balance between organizing program evaluation as a free-standing process without any formal tie-in to the budget cycle, or feeding it directly into resource decisions. A tight linkage might discourage departments from cooperating, for fear that the data they produce will be used against them at budget time; but without a formal link-up, there is a strong possibility that data on performance will not be used in allocating resources. There is no perfect or permanent solution to this problem, but a sensible middle ground might be to establish evaluation as an independent process, while prodding departments to apply the findings in reallocating resources.

Australia’s ambitious evaluation strategy has been designed to influence budget allocations. Each portfolio must publish evaluation plans that describe the studies to be conducted over the next three years. In addition to the periodic review of ongoing programs, Cabinet rules require that each program proposal submitted to it indicate how the initiative will be evaluated if it is approved. The Department
of Finance monitors the evaluation process, participates on many of the working groups that oversee the studies, advises on appropriate methodologies and best practices, reviews portfolio evaluation plans, and maintains a roster of completed evaluations. It also reports on the extent to which evaluations are used in allocating resources. Despite this substantial investment, many budget allocations are made without regard to the evaluations. In Australia, as in other countries, there often is a big gap between doing and using evaluation.

Australia and a few over governments have sought to link evaluation and allocation through performance measurement systems that report on program results and social outcomes. In their most advanced forms, these systems seek to feed data derived from ex post evaluations and other research into annual budget decisions. Systematic reporting on performance can influence budget allocations in several ways: (1) performance trends can be tracked over an extended period and related to program and spending trends; (2) performance results can be compared to ex ante targets and variances can be analyzed; and (3) increments in resources can be explicitly linked to increments in performance at the time budget decisions are made.

Despite these seeming advantages, no government has yet devised a performance-oriented budget system that directly links program outcomes and budget allocations, though several (Australia, New Zealand, Sweden, and others) have made significant progress. One reason for this difficulty is that outcome measures are costly to develop and difficult to apply. In contrast to evaluation which probes deeply into program operations and results, outcome measures express key aspects of a program’s contribution to public objectives in relatively few (usually quantitative) indicators. It is rarely easy to distill a complex program with multiple and sometimes conflicting objectives into a few measures, or to devise measures that fairly account for the various factors (some of which may be beyond the government’s control) that contribute to the observed outcomes.

In countries that emphasize outcome measures, departments that start down this path often end up with output measures instead. The tighter the formal linkage of performance measures and budget allocations, the greater the likelihood that the data will pertain to outputs, and the greater the incentive
for spending units to select easy rather than challenging performance targets. When budgeting and performance reporting are tightly linked, so that measurable results become the basis for allocating marginal resources affected departments may have little choice but to report on outputs because only these can be directly correlated with the level of expenditure. Inasmuch as outcome data are much more relevant to allocative efficiency, it may be sensible for the government to loosen the connection between performance measures and budget decisions.

Even when circumstances are favorable, measuring and reporting on outcomes is difficult and costly. It takes special effort to gather appropriate outcome data. Major outcomes typically result from a confluence of factors, including government policy, private behavior, and social conditions. Attributing outcomes to specific budget allocations does not enhance allocative efficiency when the cause-effect nexus is problematic. Nevertheless, policy makers must be mindful of outcomes when they make budget and program decisions. After all, the objective of government actions and expenditures is to improve the condition of those affected by its programs. It would be logical to regard outcome measures as directional signals, as stimulants to policy review and change. When used properly, they should spur policy makers to review existing programs and explore opportunities to do better. They indicate whether conditions are getting better or worse, whether the government is closer to achieving stated objectives or further away, whether existing programs should be continued or retargeted. Even when particular programs do not by themselves cause the measured social conditions, ministers and officials should be mindful of whether established policies are working.

These considerations dictate a loose coupling of outcome measures and budget choices. Government should use outcome data in establishing strategic priorities and in evaluating results. But strategic planning and program evaluation need not be conducted solely within the prescribed routines of the annual budget process. To promote allocative efficiency, budgeting should be viewed as only one of the government’s policy tools. If it is the only one, there may be less reallocation, not more.
Summing Up: The Path to Allocative Efficiency

The incentive to reallocate is inherently weak in public organizations. In contrast to markets which are non-stop reallocation mechanisms, in which resources are continuously rearranged in response to changing consumer preferences and other signals, the public sector faces strong pressure to maintain the status quo. Program evaluation and performance information can prod departments to adjust their program mix, but there is no self-enforcing mechanism to ensure that resources are shifted to more effective use.

In reallocation, the behavioral objective is to turn potential adversaries into active allies. This is not easy to do because the interests of those at the center of government are not the same as those of ministers and managers in departments. At the least, however, it is essential that politicians and officials not be penalized for reallocating resources; they should not be any worse off than they would be if they had refused to cooperate. As much as ministers and managers may want to do public good, they will not aggressively seek to reallocate if in proposing to shift resources their budgets are cut.

This reasoning justifies a division of labor in reallocation, in which central authorities establish national objectives and strategic priorities and manage the budget process but the affected departments or portfolios have considerable latitude in proposing and implementing program changes within their respective sectors. There is a risk that entrusting so much power to those who would be most affected by change will lead to little or no reallocation. Yet central authorities need not be helpless when faced with departmental intransigence. Their job is to push for reallocations by giving strategic direction to government, demanding that departments adhere to the strategy, insisting on robust evaluations and performance reports, and adjusting the baseline to encourage cooperation.

The logic of this division of labor in reallocation is that the center cannot do the job by itself, but neither can it leave the task solely to the affected departments. The center must manipulate incentives to promote cooperation, even though it will not always get the cooperation it seeks. If it doesn’t, stronger direction from the center may be necessary, but the first choice should be to induce cooperation, not to compel it.
Basic elements of a public expenditure system oriented to reallocation include the following:

- The government establishes strategic objectives and priorities before departments bid for budget resources. These can be global objectives (for society or the public sector) or sectoral (for particular areas of government activity).
- The government establishes medium-term (3–5 years) fiscal objectives, including the margin (if any) for spending initiatives or the net savings required to meet the fiscal target. The margin and savings usually are calculated on a net basis: new spending minus savings from program cutbacks. The net margin is the amount of unallocated money (incremental resources plus savings from existing programs) available for new spending in a sector or portfolio; net savings are the amount by which spending in a sector or portfolio must be reduced to meet the government's expenditure target.
- Spending margins or savings targets are allocated among ministries in accord with the government’s strategic priorities. Within a target, a minister may increase the resources available for program enhancements by taking resources from other programs within his/her portfolio. The extent to which ministers can reallocate on their own without obtaining approval from government will depend on the size of the reallocation and the structure of government. The scope for reallocation is greater when there are relatively few portfolios.
- The government maintains a baseline for projecting future budget conditions, establishing targets, and measuring the fiscal impact of policy changes. The baseline covers three or more years and is rolled forward with each annual budget.
- The government encourages reallocations that promote program effectiveness by requiring departments to systematically evaluate their activities and expenditures and to report on outcomes and performance.
- Cabinet review of the budget concentrates on policy changes,
not on discrete items of expenditure. Authorized policy changes (both expansions and cutbacks) are incorporated into the baseline which becomes the starting point for the next round of budget allocations.

As Box 3.1 indicates, most of the elements of a strategic reallocation process have been implemented by Australia since the mid-1980s. Annual budget decisions are made in reference to medium-term forward estimates which project spending (and other fiscal aggregates) for the budget year and the three following years. The forward estimates specify the amounts that will be provided in future budgets unless policy changes are made or underlying economic or program conditions (such as prices or program participation rates) are reestimated. By definition, a policy change is a revision to the forward estimates. Proposed policy changes are considered in a prescribed sequence that includes identification of options; consideration of policy proposals by the Cabinet’s Expenditure Review Committee; Cabinet decision on allocations to portfolios; the costing of policy changes proposed by portfolio ministers; trilateral negotiations between the Treasurer, Minister for Finance, and the relevant portfolio minister; and preparation of the budget. Moreover, resource allocations are supported by an ambitious evaluation strategy that requires ministers to systematically review ongoing programs and approved policy initiatives. ✷