OECD Review of Budgeting in Portugal

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Foreword

The review of budgeting in Portugal was carried out at the request of the Portuguese authorities and concentrates on the national government only. This review was conducted as part of the work programme of the OECD Working Party of Senior Budget Officials (SBO). The objective of OECD budgeting peer reviews is to provide a comprehensive overview of the budget process in the country under examination, to evaluate national experiences in the light of international best practice, and to provide specific policy recommendations. Following a common methodology and conceptual framework, reviews promote the sharing of experience among countries and the formulation and diffusion of policy recommendations.

The report is divided into five chapters. Chapter 1 discusses Portugal's recent economic and fiscal performance. Chapter 2 focuses on the budget formulation process. Chapter 3 discusses the role of Parliament and the Court of Audit in the budget process. Chapter 4 examines the budget execution process, and Chapter 5 examines efforts to introduce performance budgeting and accountability for results.

An OECD mission consisting of Dr. Teresa Curristine (head), Mr. Chung-Keun Park, (OECD Secretariat) and Mr. Richard Emery (an independent consultant) visited Lisbon in January 2008 to prepare this review. During its visit, the mission met with senior officials from the various parts of the Ministry of Finance and Public Administration, including the Budget General Directorate, and from the Prime Minister's Office, as well as from several spending ministries and agencies. The mission also met with senior members and representatives of the Portuguese Parliament; the Portuguese Court of Audit, the General Inspectorate of Finance and the Committee for Programme Budgeting. In addition, the mission met with representatives of the Central Bank and with academic experts.

The mission would like to express its gratitude and appreciation to Mr. Luis Filipe Sarmento, Director-General of the Budget, Ms. Marta Abreu, Subdirector-General of the Budget, and Mr. Joaquim Sarmento, Economist, Ministry of Finance and Public Administration, for the generous time they shared with the mission during its stay in Lisbon and for their invaluable assistance during the mission and throughout the preparation of this report. The mission would especially like to thank Mr. Joaquim Sarmento for organising the mission's visit and for his help throughout the visit. The warm and cordial reception by the Portuguese authorities is very gratefully acknowledged.

A draft of this report was presented and discussed at the OECD Peer Review Meeting of Budgeting in Portugal in Lisbon organised by OECD and the Portuguese Budget General Directorate on 26 June 2008. Four OECD countries – Finland, the Netherlands, Spain and the United Kingdom –were invited to be peer reviewers and to participate in this meeting. The mission would like to thank Ms. Annika Klimenko and Ms. Taina Eckstein**,** Financial Secretary from the Budget Department, Ministry of Finance**,** Finland; Mr. Mark Roscam Abbing**,** Head of the Budget Policy Section, Ministry of Finance, the Netherlands; Mr. Jesus Gomez, Cabinet of the Ministry of Finance, Spain; and and Ms. Heather Miller, Head of Spending Control Capacity, The Treasury, the United Kingdom, for their participation in the meeting.

This report was prepared by Dr. Teresa Curristine, Senior Economist, with Mr. Chung-Keun Park, (then) Project Manager in the Budgeting and Public Expenditures Division, Public Governance and Territorial Development Directorate, OECD, and Mr. Richard Emery, an independent consultant and the former Assistant Director for Budget in the United States Office of Management and Budget.

The views contained in this report are those of the OECD Secretariat and should not be attributed to governments of OECD member countries, or to any organisation or individual consulted for this report.

The review was completed in July 2008.

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Acronyms

COP: Committee for Programme Budgeting (*Comissão para a Orçamentação por Programas)*

DGO: Budget General Directorate (*Direcção Geral do Orçamento*)

GOP: Government Plan (*Grandes Opções do Plano*)

GPEARI: Office of Planning, Strategy, Assessment and International Relations (*Gabinete de Planeamento, Estratégia, Avaliação e Relações Internacionais*)

GTIPOP: Programme Budgeting Task Force (*Grupo de Trabalho para a Implementação Piloto da Orçamentação por Programas*)

IGF: General Inspectorate of Finance (*Inspecção Geral de Finanças*)

LFL: Local Finance Law (*Lei das Finanças Locais*)

LFR: Regional Finance Law (*Lei das Finanças Regionais*)

MFAP: Ministry of Finance and Public Administration (*Ministério das Finanças e da Administração Pública*)

MTEF: Medium-term expenditure framework

PEC: Stability and Growth Programme (*Programa de Estabilidade e Crescimento*)

PIDDAC: Central Government Development Expenditure and Investment Programme (*Programa de Investimentos e Despesas de Desenvolvimento da Administração Central*)

PNACE: National Reform Programme (*Programa Nacional de Acção para o Crescimento e o Emprego*)

PRACE: Restructuring Programme for the State's Central Administration (*Programa de Reestruturação da Administração Central do Estado*)

QREN: National Strategic Reference Framework, 2007-13 (*Quadro de Referência Estratégico Nacional, 2007-13*)

RIGORE: Public Accrual Accounting Implementation Plan (*Rede Integrada de Gestão Orçamental e dos Recursos do Estado*)

RODEP: Public Expenditure Steering Report (*Relatório de Orientação da Despesa Pública*)

ROPO: Budgetary Policy Steering Report (*Relatório de Orientação da Política Orçamental*)

SACC: Service Assessment Co-ordinator Council

SIADAP: Integrated System for Management and Performance Assessment of the Public Administration (*Sistema Integrado de Gestão e Avaliação do Desempenho na Administração Pública*)

SIMPLEX: Administrative and Legislative Simplification Programme

SOE: State-owned enterprise

UTAO: Parliamentary budget technical unit (*Unidade Técnica de Apoio Orçamental*)

Executive Summary and Recommendations

For almost a decade, from the late 1990s to the mid 2000s, Portugal experienced structural budget deficits and problems of unsustainable growth of primary current expenditure. Since the adoption of the euro in 1999, the country was declared in excessive deficit by the EU Council twice, in 2002 and 2005. The government elected in mid 2005 took decisive action to correct these persistent fiscal imbalances. Portugal has successfully reduced its budget deficit from 6.1% of GDP in 2005 to 2.6% of GDP in 2007.

To achieve this improvement, the government undertook comprehensive structural reforms of the public sector including reorganisation and streamlining of government departments and agencies, restructuring the civil service to make it more flexible and responsive, and pension reform to enhance the long-term sustainability of public finances.

In parallel with these important changes, the Portuguese budget system is undergoing significant reform in order to further improve fiscal discipline and the efficiency and effectiveness of public spending. It is seeking to evolve from a traditional legalist and highly input-oriented system, which concentrates on controlling expenditure through very detailed oversight of budget execution, towards a more streamlined performance-oriented system.

Over the past three years, a number of improvements to the budget process have already been introduced, notably in terms of the quality, availability and timeliness of the public accounts. There have been significant improvements in the coverage and timeliness of the budget execution data published in the DGO monthly bulletin; financial controllers have been established in individual ministries; and the cash management system has been modernised. The RIGORE project – a plan to implement accrual accounting across government – was launched. The framework for assessing public-private partnerships (PPPs) within the central administration has been strengthened. In addition, a technical unit called UTAO has been set up to assist Parliament in budget matters. In 2007, to foster discipline at a sub-national level, a new fiscal rule on financing of local and regional governments was introduced.

The reform process is ongoing. Future changes are under consideration by the Committee for Programme Budgeting (COP) including an expenditure rule, a medium-term expenditure framework (MTEF) and the details of the performance budgeting framework.

If the government is to achieve its fiscal goals, it is vital that the Portuguese budget process continues to reform. These reforms should take place within the overall framework of the programme budgeting initiative.

Fiscal discipline would be improved by adopting a medium-term expenditure framework combined with more accurate and cautious economic assumptions. The credibility of the assumptions would be significantly enhanced if these were reviewed by an independent panel. To achieve the government's medium-term target, hard budget constraints and a high degree of transparency are necessary. These can be achieved by adopting a comprehensive expenditure rule and/or a medium-term expenditure framework equipped with appropriate enforcement mechanisms.

The current overly detailed and inefficient financial planning and control processes need to be streamlined. The Budget General Directorate (DGO) currently exerts direct control over more than 500 spending units, which makes it rather difficult to develop an overall view of individual ministries and/or major spending areas. This situation calls for a comprehensive review of the financial management processes.

To promote these changes and those envisaged by the programme budgeting initiative, it is essential that the DGO role shifts from detailed control of budget execution to more global oversight and analysis. This will require a gradual recomposition of the current human resources of the DGO, with significant increases in average qualifications.

The streamlining of financial management, the shift to programme budgeting and changes in the role of the DGO pave the way for delegating responsibilities to line ministries, who should take primary responsibility for programme management and budget execution. Before this occurs, it is important for ministries to have the necessary capacities and accountability structures in place. Each ministry should have its own budget office, responsible for overall budget execution and financial oversight on programme budgeting within the ministry, to serve as the DGO counterpart in that line ministry. The DGO should work with the ministries to establish clear lines of accountability. Ministries should implement the current accrual accounting requirements to support this accountability. Within the context of a medium-term expenditure framework, each line minister should be primarily responsible for any spending overruns within his/her own ministry.

The adoption of a more performance-oriented approach to budgeting and management is very important for Portugal. However, a more staged and appropriately sequenced approach needs to be adopted for implementing this reform:

- The first stage is the development of a programme budget and a medium-term expenditure framework.
- The second stage involves the development of meaningful performance information for programmes and ministries, and the design and implementation of the necessary information systems.
- The third stage is the gradual integration of performance information into budgetary decision-making processes.

Across OECD countries, the implementation of this reform is a long-term process. Generating realistic expectations about the timeline and the challenges helps to manage it.

It is important to acknowledge Portugal’s achievements to date and the major steps that have been taken in the right direction. However, it is essential that these reforms continue – in the wider public sector and in budgeting – and are fully implemented in practice. This is especially important given the current less favourable economic climate. Continued political support for these reforms is vital: standing still is no longer an option for Portugal.

The key recommendations of this report, which address the continuing efforts to modernise the budget system, are summarised below and discussed in more detail in the subsequent chapters.

Improving budget formulation

A comprehensive medium-term expenditure framework (MTEF) is needed to lend stability and credibility to the government’s fiscal objectives. The Portuguese budget process needs a comprehensive medium-term expenditure framework that establishes detailed multi-year estimates for all ministries and programmes for the baseline year plus three years out. Generating more comprehensive estimates is the first step towards creating an improved framework.

Newly elected governments should set a medium-term fiscal target for their period in office and establish hard budget constraints with appropriate enforcement devices. The type of MTEF should be consistent with the decision on whether to adopt an expenditure rule.

An expenditure rule would promote stronger fiscal discipline. If the government accepts the recommendation of the Committee for Programme Budgeting to adopt this rule, careful consideration should be given to the expenditures to be included or excluded under the rule. To be effective, it is important that the rule be as simple and as comprehensive as possible. To increase pressure for compliance, it is essential that the general public understand the rule.

Macroeconomic assumptions should be reviewed by an independent panel. In the past, macroeconomic assumptions have at times been overly optimistic. Improving the government's economic assumptions and forecasts is necessary to generate a comprehensive MTEF. Having an independent panel of experts review the government's assumptions would promote improvement and increase credibility. The members of the panel should be recognised experts in fiscal policy.

Changes are needed to enhance the transparency of the budget. The proposal to shift to a programme budget will improve transparency. Focusing on programmes rather than on 5 000 detailed sets of budget data will help to improve public understanding of what the government is achieving with its money. Removing this extensive detail in budget documentation does not mean that budget control would be reduced. Instead, a programme budget will make it easier to understand the budget, talk about budget proposals, and build support for budget policy.

The investment budget, PIDDAC, should be integrated with the operating budget by programme. Summary information on investments should include approved levels and remaining commitments. Summary information on public-private partnerships (PPPs) should show risk analyses for all PPPs over the long term. Public investment in state-owned enterprises could be included in the programme budget.

The role of the Budget General Directorate (DGO) in budget formulation needs to shift from detailed budget execution to a stronger emphasis on more global oversight and an analytical review of the overall budget. The DGO has an important role to play in the implementation of the MTEF, programme review, the development of baselines and the implementation of accrual accounting, as well as generally helping to collect information for the government.

A programme review staff should be established within the DGO. In order for the DGO to take the appropriate leadership role in programme budgeting (and to ensure that programme budgeting is not consumed by the day-to-day demands of detailed budget execution), the DGO should establish a programme review staff of economists, programme analysts or other personnel with analytical training. Their initial functions would be to:

- support the Programme Budgeting Task Force (GTIPOP);
- support the DGO programme delegations;
- perform central overview of programme effectiveness;
- provide training for programme budgeting functions;
- develop and maintain a budget baseline.

Enhancing the role of Parliament in the budget process

The amount of time allotted for debating the budget should be extended to at least three months to ensure sufficient time for parliamentary review and action. This change would be in line with OECD guidelines on budget transparency.

The parliamentary Budget Committee should adopt a more top-down approach, focusing on approving the total aggregates. In light of the introduction of programme budgeting and the development of a medium-term expenditure framework, consideration should be given to how parliamentary committees operate in the budget process. One proposal would be for the Budget Committee to approve the budget aggregates and then the sectoral committees would be given a large role in examining the proposed budget and the goals, performance indicators and results of individual programmes.

The Portuguese Parliament should consider increasing the number of staff in the technical support unit (UTAO) and increasing the duration of its mandate while ensuring the unit's independence. An increase in staff is important to provide sufficient support for Parliament under the current budgetary regime, and to help prepare for the upcoming programme budgeting. The introduction of programme budgeting will require this unit to conduct additional analysis of the budget proposals. More experts will be necessary to review the performance information provided by the government. The mandate of the unit should be extended, and an independent head would help to further increase the unit's credibility.

Parliament needs to be engaged and consulted in the development of the new programme budget. This can be done by having an *ad hoc* group or a subgroup of the Budget Committee to obtain the opinion of MPs, in advance, on the presentational details of the new budget. In addition, it would be helpful to have seminars to inform MPs and the Budget Committee of the details of programme budgeting and how their own roles will be affected.

Improving budget execution and government management

Streamline budget execution and financial control processes. Shifting to a results-oriented programme budget will require the delegation of budget responsibility to programme managers and/or ministries. Decreasing the number of budget line items should reduce the need for detailed DGO oversight and increase the flexibility of programme managers. Ministries, and particularly agencies, should have primary responsibility for programme management and for budget execution. Detailed review of budget adjustments should be substantially reduced, as programme managers assume responsibility for spending and as appropriations are shifted to programme categories. There should be a comprehensive review of financial management processes.

Transfer primary responsibility for budget execution to spending units. The DGO should provide clear guidance to the agencies on budget execution requirements and deadlines for budget reports. It should organise training for ministry/spending unit staff on delegated budget responsibilities. Funds could be apportioned or distributions approved on a programme basis, with the distribution of funds on an automatic quarterly basis, unless specific programme requirements warrant an alternative distribution. Distribution of the funds should be contingent upon programme requirements, such as submission of implementation plans or evaluation structures. The DGO could shift its focus from detailed monitoring of transactions to analysis of budget execution anomalies and reviews of programme financial performance.

Strengthen accountability of ministries. Ministries need to be held accountable for how they fulfill their new delegated responsibilities. Before delegation occurs, it is important for ministries to have the necessary capacities and accountability structures in place. Each ministry should have a budget and finance office, which could take responsibility for budget execution and provide oversight on programme budgeting within the ministry. This office should be under the supervision of the financial controller who should report directly to the minister. In addition, all ministries need to ensure that they have an Office of Planning, Strategy, Assessment and International Relations (GPEARI) with the function of strategic planning and management; this is necessary to implement the programme budgeting initiative.

Implement accrual accounting. The ministries need to implement the current requirements to introduce accrual accounting. Progress to date in implementing this initiative has been slow. Completing the accounting reform should be a higher priority.

Expand PPP review to state-owned enterprises and local government. PPP control procedures for the central government seem to be organised in an appropriate manner. Similar controls should be applied to PPP contracts undertaken by the state-owned enterprises and by local governments. PPPs have the potential of creating future liabilities for the government. PPP contracts should be carefully reviewed to ensure that they meet efficiency tests and that they do not accept inappropriate risks. In addition, before a decision is taken on the launch of a PPP, the public sector comparator could be discussed by Parliament. While the process for the preparation of a PPP in the central administration is adequate, there need to be improvements in the recording of the associated liabilities.

To improve transparency in relation to state-owned enterprises, it is important to have clear public accounting rules about whether or not public entities are part of the government sector, based on their degree of autonomy and the nature of their activities. Furthermore, there should be greater clarity and consistency in the rules applied to state-owned enterprises in terms of their borrowing capacity, level of indebtedness and PPP arrangements.

Accountability for results: performance budgeting and management

Generate realistic expectations about the timeline and the challenges involved in creating a programme budget, to help manage the process. Introducing programme budgeting by 2010, as initially envisaged in the 2006 budget, is not realistic. It would be challenging even for a country with extensive experience of developing performance information, which is not the case for Portugal. The experience of other OECD countries shows that it takes at least three to five years for performance initiatives to develop meaningful performance information. Given this collective experience, it is important to see this reform as the first step in a long-term process which involves learning by doing.

The implementation of the performance budgeting initiative should be in stages. The first stage is the development of a programme budget and a medium-term expenditure framework; the second stage involves the development of meaningful performance information for programmes and ministries and the design and implementation of the necessary information systems; the third stage is the integration of performance information into budgetary decision-making processes.

Co-ordinate reform efforts. The programme budgeting initiative should be closely linked with the Integrated System for Management and Performance Assessment of the Public Administration (SIADAP) reform. This will reinforce efforts to improve performance, avoid overlaps or conflicts between reform efforts, and reduce excessive paperwork for the line ministries.

The co-ordinating group for programme budgeting should include representatives from the DGO, the GPEARI and pilot agencies. It is important that the DGO be a partner in this effort, to ensure that it is not a one-time exercise implemented outside the budget framework. The GPEARI in the Ministry of Finance and Public Administration (MFAP) should also be involved, to foster co-ordination with the Integrated System for Management and Performance Assessment of the Public Administration (SIADAP). The pilot agencies should contribute by sharing their experience in helping to structure the future programme budget. The co-ordinating group should be responsible for setting central guidelines, disseminating best practices and reviewing the information produced. In addition, it could ensure consistency in standards across ministries and create pressure to implement the reforms. The Programme Budgeting Task Force (GTIPOP) should continue to exist for a number of years to advise and support the implementation of the reforms.

The unit responsible for implementing these reforms should report to the finance minister or a high-level designee. In OECD countries, this role is played by either the Ministry of Finance or the Prime Minister’s Office. The role could be performed by the director general of the DGO, but only if the necessary structural changes take place and if the appropriate programme review staff are hired.

Add an independent element in the review of performance indicators and results. OECD experience highlights that it is important to have an independent review or audit of performance information to ensure quality and credibility. This is especially the case for Portugal, since the SIADAP proposes to link performance results to pay. While this linkage creates incentives to achieve targets, it would also generate incentives to manipulate information and might encourage gaming. An independent role could be performed by the General Inspectorate of Finance (IGF), which is already active in this area and has a technical committee on evaluations. In addition, an independent commission or the external audit body could have a role in reviewing the overall system.

Develop different types of performance information and measures. It is important to develop both evaluations and performance measures. The current proposal for programme budgeting concentrates primarily on developing outcome measures. In practice, outcomes are more difficult to measure than inputs or outputs. Most OECD countries begin with outputs and then move on to outcomes, eventually ending up with some combination of both. It is important to develop outputs and not just concentrate solely on outcomes. In the initial stages, it would be appropriate to concentrate on indicators rather than targets; this will help focus on developing meaningful information rather than focusing on achieving targets "at all costs".

It is vital to gain the support and buy-in of line ministries and of those who deliver the programme. Support could be created through a mixture of soft and hard incentives. It is important to engage line ministries throughout the process of designing and developing the system. The information generated has to be useful for managers themselves. Relevant staff can be asked to participate in training, workshops and seminars. Best practices and the experiences of lead performers could be disseminated through the co-ordinating group. To complement this effort, formal and informal networks could be created for exchanging ideas. Other incentives include generating competition among agencies by publishing and comparing results. Political pressure can help to motivate agencies to implement reform by having programme co-ordinators report to the relevant ministers on their progress. Hard incentives are also possible by rewarding better performance with reduced regulations and greater flexibilities. In addition, linking SIADAP with programme budgeting would also generate financial incentives.

Establish a performance dialogue as part of the budget process. It needs to be clear how the performance information will be used in the budget preparation process. In the health sector, progress has been made with the application of direct/formula performance budgeting, but this is not recommended on a government-wide level. Instead, it is recommended that there be performance-informed budgeting. In this case, a dialogue occurs on proposed funding and performance. The dialogue could take place at several levels in the budget process, for example between the spending ministries and their units or agencies, between the DGO and the spending ministries, or as part of the discussions between ministers and the Prime Minister and Cabinet.

Engage politicians in the reform process and in the performance dialogue. OECD country experiences highlight the important role politicians play in creating pressure for change. Politicians could be engaged at a basic level by having the co-ordinating group and/or the institution responsible for implementing the initiative report on progress regularly to the Minister of Finance or the Prime Minister. In addition, programme co-ordinators could also report to their relevant minister. In some OECD countries, individual ministers are held accountable for the performance of their programmes either to the Cabinet, the Prime Minister, and/or Parliament. It is also possible to create interministerial performance committees or Cabinet committees which address performance achievements.

OECD Review of
Budgeting in Portugal

Chapter 1

Portugal’s Economic and Fiscal Performance

Over many years, Portugal has struggled to implement a sound budget policy. In 2005, the newly elected government undertook an ambitious reform agenda to modernise its public sector and to establish a sound footing for its public finances. In this context, changes are being proposed for the budget system in Portugal. The environment for reform is positive, because the changes are being proposed in the context of broad public sector reform and have strong support from the government. However, implementing these changes will be challenging due to the size and traditions of the public service.

This chapter is divided into two sections. The first addresses the fiscal challenge facing Portugal, and the second describes the government's reform agenda.

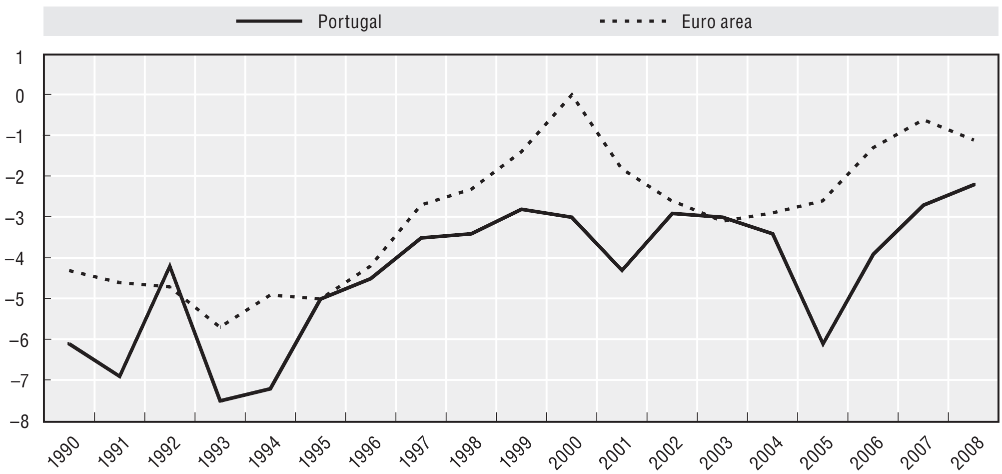
1. Fiscal challenge

Over the past two decades, Portugal's fiscal policy has struggled to achieve acceptable sustainable deficits. High deficits (often above 5% of GDP) were recorded until the mid 1990s. The general government's deficit was reduced progressively to below 3% in 1999/2000, helped by falling interest rates and by high tax revenue fostered by strong economic growth. Portugal qualified for the European Economic and Monetary Union (EMU) in 1998.

The improvement in the budget balance was temporary, however, with deficits rising to 4.25% of GDP in 2001. The underlying situation remained weak, with the consolidation programme including one-off measures amounting to 2% of GDP while expenditures were still growing too fast. One of the reasons for the fiscal slippages against the Stability and Growth Programme in the period 2000-04 has been the systematic overestimation of economic growth. The doubling of the deficit from 2004 to 2005 (from 3% to over 6%) occurred to a large degree because of the decision to stop the reliance on one-off measures. One of the main reasons for this persistent weakness of public finances is that primary spending has been on an upward trend over the past 15 years (Guichard and Leibfritz, 2006, p. 6).

In the autumn of 2005, for the second time since 2002, Portugal was put under the European excessive deficit procedure. Portugal was not alone in breaching EU fiscal rules, but its performance regarding fiscal control has long been worse than that of most other euro area countries.

Figure 1.1. Fiscal balances in Portugal and other euro area countries as a per cent of GDP



Source: OECD (2008), *OECD Economic Outlook No. 83*.

The government elected in mid 2005 proposed budgets with substantially reduced deficits over the coming years. The last update of the Stability and Growth Programme for 2007-11 presents deficits of 3.9% in 2006, 3% in 2007, 2.4% in 2008, and 1.5% of GDP in 2009.

Between 2005 and 2007, Portugal steeply reduced its budget deficit and, in 2007, succeeded in bringing its budget deficit to 2.6% of GDP – below the government's budget target (3.3%). So far, Portugal is on course to do the same for 2008 (OECD, 2007a, p. 158).

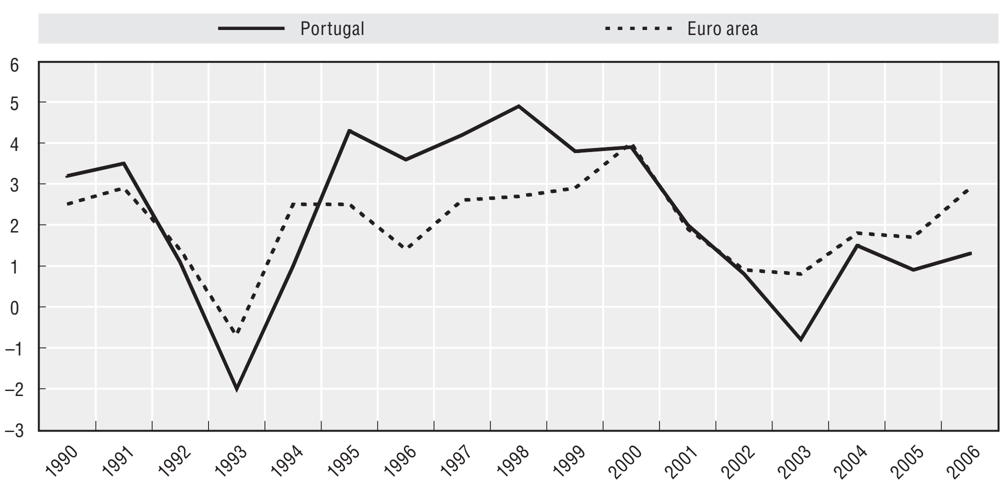
Total expenditure proposed for the Portuguese government in 2008 is EUR 72.8 billion, or 45.1% of GDP. Total expenditure for regional and local governments is projected to be 5.7% of GDP. Projected social security expenditure is 16.6% of GDP. The government has no off-budget expenditures.

In addition to the EU fiscal rules discussed in Box 1.1, Portugal applies rules to the various government sub-sectors: spending aggregates for the central government, total funding for the investment budget (PIDDAC), transfers to social security and government pensions, and transfers to regional and municipal governments. In the past, there have been issues about overspending and borrowing at the lower levels of government. Legislation in 2007 introduced new fiscal rules for local and regional governments. The new laws establish borrowing limits. These rules are discussed in more detail in Chapter 2.

The challenge for Portugal is to boost economic growth. In the 2000s, Portugal's economic growth was lower than the EU average. In 2006, Portugal's economic growth was only 1.3% compared with an average economic growth of 3% across the then 25-member bloc. The current budget is based on relatively conservative assumptions about economic growth, inflation and employment. However, given the financial credit crisis and the inflationary pressure from high oil prices, achieving the deficit target for 2008 and 2009 has become more challenging (OECD, 2008a).

Portugal's reform agenda is seeking to address the structural causes of fiscal imbalance, to strengthen economic growth, and to increase the competitiveness of the Portuguese economy. The government is creating a better business environment by streamlining rules to promote greater labour flexibility and stronger competition, particularly among small and medium-sized enterprises, simplifying the tax system to make it more equitable and efficient, and reducing red tape.

Figure 1.2. Portugal's economic growth compared with the EU average



Source: OECD (2008), *OECD Economic Outlook No. 83*.

Box 1.1. The EU fiscal rules

The Stability and Growth Pact: The Stability and Growth Pact, adopted in 1997, enshrines the member states' political commitment to fiscal discipline, defined as: *i)* budgets must be close to balance or in surplus over the medium term; *ii)* in any given year, the budget deficit must not exceed 3% of GDP; and *iii)* government debt must not exceed 60% of GDP. The EU fiscal rules are complemented by a process of multilateral budget surveillance and a sanctions mechanism for countries breaching the pact. EU countries that have not adopted the euro follow the same rules, but are not subject to sanctions.

Budget surveillance: At the end of each year, the EU members submit updated fiscal plans to the European Commission, called stability and growth programmes (or convergence programmes for EU countries that have not adopted the euro). The Commission makes a judgment on whether these are credible and consistent and whether they are in line with the EU policy objectives, not only for fiscal policy but also for employment and economic reform.

The council of EU finance ministers (Ecofin), supported by the Commission, also monitors the implementation of the stability and growth programmes. The Commission draws up reports about budgetary developments in member states twice a year. If it foresees trouble – in particular if a country's budget is heading towards the 3% of GDP threshold – it recommends that Ecofin issue an early warning to the government concerned.

The excessive deficit procedure: If the Commission, as part of its bi-annual reporting exercise, finds that a euro zone member has breached the 3% limit, it recommends that Ecofin starts an "excessive deficit procedure". The procedure is only set in motion if Ecofin declares the deficit excessive with a two-thirds majority; it will not do so if the deficit results from a deep recession. Ecofin launched excessive deficit procedures against Portugal in 2002 and in 2005.

Once Ecofin has decided that an excessive deficit exists, the country in question has four months to adopt budget measures designed to reduce the deficit to below 3% the following year. If it does not, Ecofin can decide to impose sanctions. The decision is not automatic. Sanctions consist of a non interest-bearing deposit of up to 0.5% of the offending country's GDP.

Ecofin recognised the existence of special circumstances causing the Portuguese excess deficit and set a deadline of 2008 to correct the excess, recognising that correcting the excess in one year would harm the Portuguese economy. The Council recommended a reduction of the deficit by 1.5% of GDP by 2006 and by 0.75 percentage points of GDP each subsequent year, until the excess deficit was corrected.

On 8 May 2008, the Commission recommended that the EU Council abrogate the excessive deficit procedure for the Czech Republic, Italy, Portugal and the Slovak Republic. Ecofin closed the procedure concerning Portugal one year in advance of the 2008 deadline established in the recommendation of 2005. Against a background of low but gradually improving economic growth, the deficit was reduced from 6.1% of GDP in 2005 to 2.6% of GDP in 2007.

2. Correcting structural fiscal imbalance: the reform agenda

The government elected in mid 2005 introduced a public sector reform programme with ambitious goals for the long term and visible results in the short run. The short-run targets set at the time have been met.

In 2005, Portugal implemented short-term deficit reduction measures and began a process of in-depth structural reforms to ensure fiscal sustainability. The actions taken have corrected the fiscal imbalance, reducing the general government deficit from 6.1% of GDP in 2005 to 3.9% in 2006 and subsequently to a deficit of 2.6% in 2007.

The temporary measures adopted to control the wage bill included freezing automatic public sector career progressions, limiting the increase in public wages to 1.5% in 2006, reducing the number of civil servants by allowing only one out of two vacancies to be filled, and imposing a zero increase for spending by local authorities. The standard VAT rate was increased from 19% to 21% in July 2005, a rate among the highest in the EU. The tax rate on tobacco is being increased between 10% to 15% each year between 2006 and 2009, taxes on oil products were increased by 5 cents per litre in 2006 and 2007, and a new tax bracket was established for personal income over EUR 60 000 at a 42% marginal tax rate.

Significant structural reforms are under way in several areas. The government has launched an impressive reform of the public administration, including the initiatives discussed below.

Restructuring Programme for the State’s Central Administration (PRACE): The PRACE has involved the redesign of structures, roles and responsibilities to consolidate organisations and reduce the numbers of managers. Directorate-generals and public institutes, as well as upper and mid-level managers, were reduced by around 25%.

Shared services in public administration: The development of shared services allows public administration bodies to focus on their core missions and on investment in areas dealing with citizens and businesses. Human resource management and financial management functions are being consolidated by the Ministry of Finance and Public Administration in a corporate public entity, the Company for the Shared Management of Public Administration Resources. Similarly, a National Public Purchasing Agency was created to consolidate the purchase and management of the state’s motor vehicle fleet. These shared services are designed to increase process efficiency and cost management efficiency, to take advantage of economies of scale, to reduce waste and to share infrastructure.

Human resource management reforms: Reforms include shifting to contracts for most hiring, reducing the number of career categories, strengthening the performance basis for promotion and compensation, establishing a new mobility system, and adopting hiring constraints to reduce public employment.

In Portugal, the Constitution provides protection to civil servants for continued employment throughout their careers. Over the last 25 years, public sector employment has more than doubled from 372 000 civil servants in 1979 to 748 000 in 2005, a rate of increase exceeding the growth in population.

Since 2005, the government adopted a practice of "one in, two out", allowing only one person to be hired for each two that leave the public sector. From January 2006 to June 2007, public sector employment was reduced by 14 792 people. A mobility pool was created to provide an outplacement tool for public managers. Approximately 1 200 staff have been transferred to the mobility pool; about 200-250 were involuntary transfers. Staff transferred to the mobility pool go through three stages:

- transition: two months on full pay;
- requalification: 10 months on 5/6 pay;
- compensation: after the first year, 2/3 pay.

The overall goal of these measures is to reduce civil servant employment by 75 000. The number of designated career paths was reduced from approximately 1 400 to three general careers. Under the current system, seniority has been the primary factor determining promotion and salary increases. Personnel appraisals are to be modified to place greater emphasis on performance. In future, pay increases will be tied to performance.

There will be a new contractual employment scheme which envisages only two types of employment: by appointment and by contract. Contracts by appointment will only apply to essential functions of the state. The second type of general civil service employment contract will be applied in most cases. Under this type of contract, employment will be for an unlimited time or for a defined period. This contract shall comply with the Portuguese labour code, and there will be adaptations to protect the public interest. However, these contracts could be terminated for reasons of collective dismissal or job eliminations. When this type of contract is implemented, it will provide managers with greater flexibility.

Pension reform: A new framework law on social security was enacted in January 2007, implementing the reform agreement reached among social partners in October 2006. The law was enacted after a two-year process of negotiation and is designed to make the system sustainable while treating all employees equitably. This impressive reform established agreed principles in relation to pension calculations regarding the sustainability factor, accelerating the transition to the new pension calculation formula and the retirement-age flexibility scheme.

In Portugal, there are two public social security sub-systems: social security which covers workers in the private sector and civil servants hired since January 2006, and the *Caixa Geral de Aposentações* sub-system which covers all other civil servants. The pension reform changes apply to both systems. The changes to the pension calculation formula include:

- introduction of a weighted analysis that allows a pension to be redistributed over a greater number of years, as a consequence of changes in average life expectancy;
- introduction of a new pension update rule, indexing pensions to the development of consumer inflation according to the value of the pension and the real GDP growth rate;
- fostering active ageing, by increasing the financial penalty for early retirement. The system is open to beneficiaries with at least 30 years of contributions and 55 years of age. The penalty is 0.5% for each month of retirement in advance of 65 years of age.

The pension reforms are expected to make pensions sustainable over time. The post-reform expenditure is projected to be unchanged by 2010, but by 2020 expenditures will have been reduced by 1.5% of GDP and, by 2050, by 4.8% of GDP. The overall impact of these reforms will be to reduce pension expenditure from an estimated 20.8% of GDP to 16% by 2050.

Higher taxation was viewed as the necessary evil to address the Portuguese fiscal situation. Looking forward, structural reforms are beginning to assume an increasing portion of the consolidation measures, with more than half of the deficit reduction resulting from public administration reform, social security reform, and reforms to the health system and education. The deficit reduction from 2005 to 2007 (–3.5 p.p. of GDP) reflects a larger share of adjustment through the reduction in expenditure (–1.9 p.p.) than through the revenue increase (1.6 p.p.).

As part of its overall reform agenda, Portugal is reforming its budget process and plans to introduce a medium-term expenditure framework and programme budgeting. The 2006 State Budget Law established that, at the latest, the state budget proposal for 2010 must be structured according to a programme budget. The Committee for Programme Budgeting was established in 2007 to examine how to implement this new requirement and how to introduce more of a performance focus into the budget process (see Box 1.2). This committee is also considering wider reforms to the budget process.

Box 1.2. The Committee for Programme Budgeting (COP)

In 2007, the Minister of Finance and Public Administration established the Committee for Programme Budgeting to make recommendations on the implementation of programme budgeting. The Committee is expected to address three major innovations compared to current practice: the assessment of results, a medium-term expenditure framework, and expenditure rules. The Committee submitted a mid-term report in May 2007. The Committee is expected to submit its final report by July 2008. In February 2008, a task force called the GTIPOP – *Grupo de Trabalho para a Implementação Piloto da Orçamentação por Programas* – was established to follow up on the recommendations of the Committee and to prepare a few pilots to be included in the 2009 budget. The task force consists of five people from the following areas: the private sector, the DGO, the GPEARI and the IGF.

3. Conclusion

Portugal has made substantial progress in addressing fiscal imbalance through a combination of fiscal restraint and an ambitious structural reform agenda. Over the past few years, a political and public consensus has emerged over the need to curb public expenditure and debt. While recent efforts to reduce the deficit partially reflect external pressure from the EU, they are also the result of a shift in attitude on behalf of the political establishment. The Portuguese experience highlights that improving fiscal discipline does not just depend on having institutional mechanisms and rules in place; it also requires sustained political commitment, especially when cutting public expenditure. It is important that the government maintains momentum in structural reforms to ensure further consolidation. Over the long term, prudent budget policies promote stable and sustained economic growth.

Budget institutions and processes are vital to promoting sound budget policies and to improving fiscal discipline and public sector efficiency and effectiveness. The following chapters address different aspects of the current budget process and the ongoing and proposed efforts to reform the system. Chapter 2 will discuss the budget formulation process and proposed changes. Chapter 3 will address the role of Parliament and the Court of Audit in the budget process. Chapter 4 will examine the budget execution process, and Chapter 5 will discuss efforts to introduce accountability for results and performance budgeting.

Chapter 2

Budget Formulation

The Portuguese budget system has already undergone significant change and is continuing to reform. Traditionally, the budget system was based on a hierarchical administrative culture which concentrated mostly on the legality and regularity of public expenditure. The result was an inflexible and incremental budget system which, despite its detailed emphasis on managing inputs, failed to control expenditure increases. In the past two years, the budget system has been improved and is seeking to use budget planning and formulation to achieve medium-term fiscal goals and to shift towards a more streamlined system.

This chapter examines the current budget formulation process in Portugal and, where applicable, discusses it in the light of OECD member country experiences. It is divided into seven sections. The first describes the organisation of the Portuguese government. The second provides an overview of the Portuguese budget system. The third examines the organisation of budget responsibilities. The fourth examines the annual budget formulation process. The fifth discusses medium-term expenditure frameworks. The sixth examines macroeconomic forecasting. The final section provides recommendations for improving budget formulation.

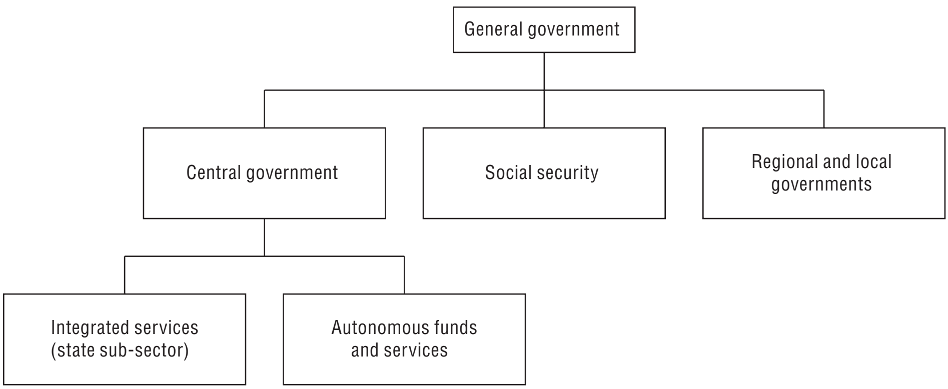
1. Organisation of government

The Portuguese government has three major components: central government, social security, and regional and local governments. There is also a substantial state-owned enterprise sector. Each of the major components of government will be described in turn.

Central government: The 14 government ministries plus the Prime Minister's Cabinet make up the basic organisational core of the central government. Under each minister there are "integrated services" and "autonomous funds and services". The integrated services (state sub-sector) have administrative autonomy but not financial autonomy. Some of the autonomous funds and services have both administrative and financial autonomy, but their degree of autonomy varies.

Social security: Social security is an autonomous organisation, managing transfer payments for illness, unemployment, pensions linked with employment, social insurance for low income, and minimum income supports. The Institute for Financial Management for Social Affairs, an autonomous organisation, develops the budget estimates for social security. The programme expenditures are mandatory and are available to individuals who meet legislated eligibility criteria.

Figure 2.1. Institutional scope



Source: Budget General Directorate (DGO), Portugal.

Regional and local governments: There are two regions – the Azores and Madeira – and 308 municipalities. The regions and municipalities have budgetary independence, but some government functions are carried out jointly by the central ministries and by the regional and municipal governments. Municipalities are responsible for school buildings, the central government for teachers' salaries. Municipalities provide water supply, waste disposal, local roads, streets and gardens. Police and hospitals are central government responsibilities. Forty-four per cent of municipal finance comes from transfers from the central government, 25% from two real estate taxes, and 6% from EU transfers.[1] Municipal borrowing is now limited by law to 125% of the prior year's revenues. Since 2005, transfers from the central government have been limited as part of the effort to stay within EU budget targets. The 2006 budget law imposed a zero increase in payroll spending by local authorities, one of the measures to reduce the deficit in the short term.

The 2007 Local Finance Law (LFL) establishes an indebtedness ceiling individually applicable to each municipality. This ceiling is based on the concept of net municipal indebtedness which may not exceed, at year's end, 125% of the previous year's total revenue.[2] In order to promote effective compliance with the rule, municipalities that exceed the indebtedness ceiling face penalties. These include a reduction in transfers from the state budget to the municipality in question which is equal to the value of the excess verified debt.

The new Regional Finance Law (LFR) states that indebtedness ceilings for regions will be stipulated annually by the State Budget Law.[3] According to these limits, the autonomous regions must prevent debt service (interest and debt repayment) from exceeding 25% of the current revenue recorded in the previous year (excluding transfers and co-payment from the state). Any infringement of indebtedness limits will result in a penalty which consists of a reduction in transfers from the state equal in value to the verified excess of debt. The new law further establishes the general principle that the debt issued by the regions cannot be guaranteed by the state.

State-owned enterprises: The Portuguese public enterprise sector is composed of public companies (companies where the state has the full or at least a majority of shares and votes) and "participated" companies (companies where the public participation is a minority). In the December 2005 report on the public enterprise sector, there were 113 companies. Almost all of these companies are overseen by the Directorate General for the Treasury and Finance (DGTF), a service of the Ministry of Finance and Public Administration (MFAP).

2. Overview of the Portuguese budget system

Portugal was among the earliest OECD countries to establish a legal framework for budgeting. Its first budget law was enacted in 1761. Since then, over fifty laws have been passed that modified the budget procedures of the country.

Portugal's current legal framework for budgetary management comes from the 1976 Constitution, the 1990 law of public accounting principles, the Budget Framework Law of 2001 as amended in 2004 and 2006, and the 2007 local and regional finance laws. Annual budget laws, annual budget execution decree-laws, and budget-related circulars also contribute to the legal framework for the Portuguese budget system. The Portuguese Constitution prescribes the contents of the budget, conditions underlying budget preparation, the contents of the budget bill voted by Parliament, and the attributes of the Court of Audit.

The Portuguese budget consists of a summary report with explanations of major policy initiatives, the provisions of the draft budget act, and detailed budget maps defining expenditure ceilings for 16 ministries and around 600 individual departments. The expenditure ceilings are further organised into 4 major functional categories broken down into 16 lower levels, an economic classification, and administrative categories. Budget documents contain information on about 740 line-item appropriations. In total, the budget provides 5 000 pages of backup detail reflecting these categories.

The budget includes allocations for the investment budget (PIDDAC) by ministry and project. It also includes detailed breakdowns for tax revenues, non-tax revenues and tax expenditures. The budget law may alter tax codes and set new revenue measures. The budget determines the level of central government transfers to the local and regional administrations in accordance with corresponding financing laws. As previously discussed, the budget establishes borrowing limits for sub-national levels of government consistent with the Stability and Growth Programme.

Social security has its own budget, but the social security budget is part of the general budget. There are no off-budget funds in Portugal. State-owned enterprises have a substantial role in Portuguese society, but the income and expenditures of these business-type activities are not integrated into the budget. In 2005, the total value of the public enterprise sector was EUR 12.4 billion.

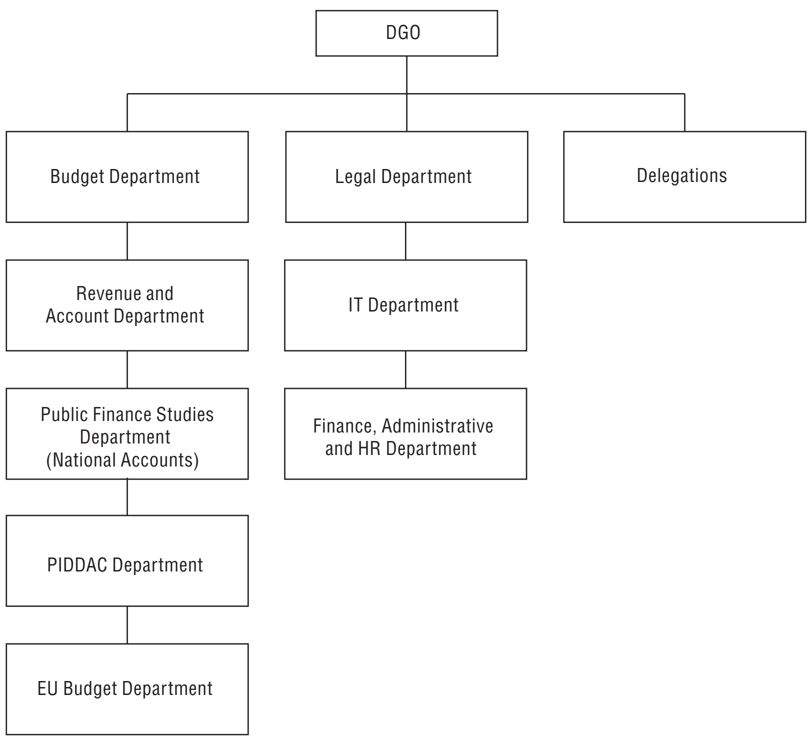
Public-private partnership (PPP) contracts are presented in a memo attached to the budget with a table showing the expected full annual payments to be made for PPP contracts. The budget for 2008 reports EUR 980.3 million in PPP projects for the central government. This memo excludes the PPPs of state-owned enterprises and of local governments. It also excludes the life-cycle costs of the PPP projects. In 2005, the Court of Audit estimates that the life-cycle cost of PPP transport projects amounted to almost EUR 20 billion.

3. Organisation of budget responsibilities

Central government budget functions in Portugal are the responsibility of the DGO in the MFAP. The DGO was established about 150 years ago as the General Directorate of Public Accounting. Originally created to monitor the legality, regularity and economy of the financial administration of the state, the DGO has been restructured on various occasions to respond to changes in the organisation and functioning of the government. The DGO reports to the MFAP through the Secretary of State for the Budget, one of four Secretaries of State within the ministry (the other three are for Treasury and Finance, Tax Affairs, and Public Administration).

Most of the DGO resources are targeted towards technical details of budget formulation and execution, rather than on analysis of budget policy. The DGO has functional services dealing with: overall budget; revenue and the General State Account; general government national accounts; PIDDAC (*i.e.* the investment budget); the EU budget; budget legislation; and information systems for budgeting (see Figure 2.2). The budget formulation and execution tasks are carried out by the "delegations" which are divided into six sections covering the government's main functional areas. The total staffing of DGO is 290. Many staff members are heavily involved in very detailed scrutiny of the legality and regularity of expenditures, leaving little time for more substantive analysis of the budget. A relatively small portion of the staff have university degrees (38%), while another 38% of staff have up to nine years of schooling. The average age of the staff is 50 and the average length of service in public administration is 26 years. Restrictions on public sector pay and hiring create impediments to recruiting new staff and make it difficult to retain some of the best people that have not reached management positions.

Figure 2.2. Departments and services of the Budget General Directorate



While the DGO has responsibility for detailed budget formulation and execution, responsibility for macroeconomic forecasts is in the hands of the

Office of Planning, Strategy, Assessment and International Relations (GPEARI), also in the MFAP. This office develops medium-term macroeconomic forecasts for the updates of the Stability and Growth Programme released in December. It does a short-term forecast in October for budget purposes and an intermediate forecast in April (released in the Budgetary Policy Steering Report, "ROPO"). The GPEARI is also responsible for co-ordinating the performance assessment of administration services (SIADAP), a public sector reform shifting the focus of assessment from inputs to the performance of the public sector. Each ministry has a GPEARI responsible for strategic planning and co-ordination of public sector reform.

Budget oversight for other specific functions or categories of activity is assigned to other directorates of the MFAP. The Directorate General for the Treasury and Finance provides oversight for guarantees and state-owned enterprises and PPPs and manages public real estate. Parpublica SA, a government firm fully owned by the Treasury, serves as a resource and expertise centre to the Treasury in carrying out these functions. The Cash Management and Government Debt Agency (IGCP) manages cash and debt in the public sector. The Directorate General for Taxation is responsible for tax administration, resulting in approximately 75% of public revenues.

Audit functions are divided between the General Inspectorate of Finance (IGF) within the MFAP, which is responsible for internal financial and performance audits, and the Portuguese Court of Audit, an independent body that oversees the legality and regularity of public expenditure.

A 2006 law required the establishment of financial controllers in each ministry, charged with overseeing expenditure within that ministry. The financial controllers tend to be economists, not accountants. Their primary function is to anticipate problems. They meet regularly with the Minister of Finance and Public Administration and the Director General for the DGO. However, in practice, they appear to have only limited influence, as they have no staff of their own and very limited powers.

4. Annual budget formulation process

The Portuguese budget formulation process follows an interactive top-down sequence that moves from broad policy outlines based on a preliminary budget outlook to the development of detailed budgets within these constraints. The annual budget formulation timetable consists of three major phases:

- Determination of the global expenditure level compatible with revenue forecasts and of the general government balance underlying the previous year's Stability and Growth Programme (April to June).
- A political process consisting of allocating the expenditure ceilings to the various ministries, formally endorsed by a meeting of the Council of Ministers (June and July).
- Compiling a detailed budget draft (August to 15 October).

The starting points for the annual budget are the revenue, expenditure and balance estimates and the major government policy assumptions stipulated in the Stability and Growth Programme. Under EU procedures, the Stability and Growth Programme is updated annually at the beginning of December. Portuguese policy is more fully elaborated in the Government Plan (GOP) and the Budgetary Policy Steering Report (ROPO), both of which are released in April/May. If there are changes in the economy or budget requirements, the targets of the Stability and Growth Programme can be updated in April.

Table 2.1. Budget formulation timetable

December (t-2)	Stability and Growth Programme update.
April/May (t-1)	Government Plan (GOP).
	Budgetary Policy Steering Report (ROPO).
June (t-1)	Total expenditure ceiling for operational budget (state) is established.
End of July (t-1)	Individual ministries' spending ceilings for operational and PIDDAC budgets are approved by the Council of Ministers.
	DGO circular.
August (t-1)	Allocation of spending among services within each ministry.
September (t-1)	Ministries submit budgets to the DGO.
Before 15 October (t-1)	Approval of budget by the Council of Ministers.
15 October (t-1)	Submission of initial budget to Parliament.
Within 45 days	Approval of final budget by Parliament.
1 January (year t)	Budget for year t enters into force.

From these figures, and using the underlying policy assumptions, the amount of the total general expenditure of the state is calculated. The transfers to social security and to government pensions (*Caixa Geral de Aposentações*, CGA) are based on estimated budget requirements under current law. (In recent years, social security has had significant surpluses, making social security revenues a significant component of total revenues.) Transfers to regional governments and municipalities are based on laws governing support to sub-national governments; however, the budget sometimes proposes to reduce these transfers.

The MFAP establishes a proposal for the expenditure allocation among the various spending ministries, taking into account the political priorities and the execution of the current year's budget. The DGO prepares a preliminary allocation among the different ministries, including the split between operational expenditure and expenditure to be made under the Central Government Development Expenditure and Investment Programme (PIDDAC), the amount of transfers for social security and government pensions (CGA), and the transfers to the regions, municipalities and the EU. Informal discussions are held between the minister (MFAP) and the Cabinet ministers on the preliminary allocations during June and July.

During a meeting with the Prime Minister, the MFAP presents the total expenditure ceiling compatible with the most recent revenue projections and the targeted balance as defined in the previous December's revision of the Portuguese Stability and Growth Programme. The Prime Minister sets the general rules that will guide the allocation of the expenditure ceiling among the spending ministries, according to next year's political priorities.

The draft budget allocation is formally presented to the Council of Ministers in late July or early August. The ceilings for individual spending ministries are formally approved in the meeting of the Council of Ministers. There are sometimes disputes between the sectoral ministers and the MFAP concerning the proposed expenditure ceilings. If an agreement cannot be found, these disputes are ultimately resolved by the Prime Minister. The MFAP advises the Prime Minister on the net impact of possible spending ministry increases on the targeted general government balance as a percentage of GDP.

Following the approval of the budget allowances by the Council of Ministers, the ministries begin allocating these allowances among the different services. Adjustments to these allocations are sometimes approved during the final budget preparation process and in response to parliamentary consideration. The MFAP continues to work to ensure that the ceilings of the Stability and Growth Programme are not exceeded by the final budget.

Box 2.1. Development of the budget within the ministries

Budget formulation within the ministries involves three stages paralleling the budget process followed by the DGO. First, the ministry budget offices develop estimates of the ministry's needs for their minister's discussions with the MFAP in preparation for the approval of ceilings by the Council of Ministers. Once the ministries are informed of their approved ceilings, they must allocate among their services and then prepare the detailed budget. Finally, they submit the budget to the MFAP. Many ministers appear before Parliament to present and explain their ministry's proposals. Budget formulation in individual ministries differs according to the structure of their programmes. For example:

- The **Education Ministry** is responsible for the staffing of elementary and secondary education in Portugal. In total, the Education Ministry budget supports 3 500 ministry employees and 147 000 school personnel. Over 85% of its budget is for personnel. The Ministry provides staff to 1 100 school groupings and 7 000 schools. The Portuguese government has undertaken a major programme to reorganise the school network, closing under-utilised schools and consolidating others. Thus far, 2 200 schools have been closed. The Ministry has undertaken a broadly focused assessment of school performance as part of its efforts to strengthen the Portuguese school system. In developing its budget proposals, the numbers of teachers and students are important budgetary factors. As performance information is improved, the Ministry budget office expects schools to have more flexibility in allocating resources.
- The **Health Ministry** is responsible for the national health system of Portugal which consists of 35 public enterprise entities (EPE hospitals) representing about 80% of the hospital activity in the country, "SPA" (public administration sector) hospitals, local health units, and health centres. Prior to the budget being submitted, studies are carried out analysing past expenditure patterns and planned future activity. For the EPE hospitals, a new system is being tested that allows the government to contract with the institutions to purchase a level of services for a controlled price. The hospitals are developing strategic plans detailing their provision of clinical care and quality of patient attention, as well as economic and financial requirements. The hospitals are given a commitment for future costs, and the government achieves more control over health expenditure.

Concurrent with the approval of the ceilings, the DGO issues a budget circular specifying the rules with which the services' budgets must comply, within the approved allocations. These rules cover, in particular, personnel expenditure, own and assigned revenue budgeting, and requirements for developing the PIDDAC. In the past, the PIDDAC instructions were defined by the Department of Forecasting and Planning, but this responsibility was recently transferred to the DGO.

The services are required to upload their budgets to the central budget IT system before the start of September. Once this is performed, the process of verifying and harmonising the budget starts. Finally, data are compiled to permit consolidated accounts to be drawn up, on both a cash and national accounting basis. The State Budget Report is drawn up at the same time. This report presents and justifies the proposed fiscal policy and includes the information required by the Budget Framework Law. The Council of Ministers approves the final version of the draft state budget by early October, before submitting it to Parliament. Parliament has to complete its budget process within 45 days and approve the budget one month before the new fiscal year begins. The approved budget comes into force on 1 January.

5. The medium-term expenditure framework

Currently, budgeting in Portugal does have medium-term aspects but does not have a comprehensive medium-term expenditure framework. The current government's medium-term target is a structural deficit of 0.5% of GDP. In 2005, the newly elected government set out its programme and its medium-term priorities in the Stability and Growth Programme. The medium-term targets and multi-year estimates are specified at the aggregate level for investment and major categories of expenditure and revenue. These estimates are revised annually as part of the annual revision of the Stability and Growth Programme.

In the annual budget, most estimates are presented on an annual basis. The budget does include medium-term estimates, for the budget year plus three years, but only for the PIDDAC investment programme, major programme initiatives and multi-year contracts. The budget provides estimates for social security and pension reform through 2050.

There have been improvements in recent years in terms of developing a more medium-term perspective. However, Portugal does not have a complete or comprehensive medium-term expenditure framework. Reports by the IMF in 2003 and 2007 recommended the strengthening of budget planning and moving towards more comprehensive multi-year budget targets. One of the proposals being considered by the Portuguese Committee for Programme Budgeting (COP) is the establishment of a medium-term expenditure framework for programmes.

Most OECD countries have developed a medium-term expenditure framework (MTEF) to support the goal of achieving sustainable public finances over the long term. The MTEF can lend stability and credibility to the government's fiscal objectives. In order to achieve this, the government should clearly state its medium-term fiscal objectives in terms of high-level targets such as the level of aggregate revenue, expenditure, deficit/surplus, and debt. The government then needs to operationalise these high-level targets by establishing budget constraints for individual ministries and programmes over a number of years.

Although the level of detail of such a framework varies from country to country, it generally mirrors the format of the budget, *i.e.* the medium-term framework is at the same level of detail as the annual budget. This means that a formal framework (or budget constraint) exists for each and every appropriation, most often for three years beyond the current fiscal year. These frameworks are presented with the budget each year; year-1 in the previous year's framework becomes the basis for the budget, and a new year+3 is added. Adoption of a medium-term expenditure framework has increased the effectiveness of planning and has reduced conflict in the annual budget process (Kraan *et al.*, 2006).

In the budget documents, current budget proposals should be reconciled with forecasts contained in earlier fiscal reports for the same period; all significant deviations should be explained (OECD, 2002, p. 8). This exercise will improve transparency of the budget.

Medium-term expenditure frameworks can be fixed or flexible. Currently, the majority of OECD countries have a flexible framework. A flexible framework is adjusted from year to year in light of changes in macroeconomic circumstances and/or new estimates of the consequences of current policies or new political priorities. Thus, at the start of the budget cycle each year, revisions are made to the aggregate totals for expenditures and to the ministerial or sectoral ceilings.

A fixed-term framework is one in which the aggregate totals or ceilings for expenditures cannot be adjusted from year to year. Fixed frameworks can be periodic (the Netherlands) or rolling (Sweden and the United Kingdom). A periodical framework is one in which the ceilings are fixed for a set period, generally the term of the government, and only drawn up anew at the start of a new period of government. For example, in the Netherlands in 2004 at the start of the term of the new government, a new four-year framework for 2004-08 was drawn up. In a rolling framework, an additional year is added to the end of the sequence of annual ceilings every year. For example, in the Swedish budget bill of 2007, a ceiling for 2009 was added to the existing ceiling for 2006-08 (Kraan *et al.*, 2006, p. 23).

The fact that a framework is fixed does not mean that no changes are possible. Fixed frameworks do allow updating for new inflation estimates and reallocating between ministries or sectors and within ministries as long as the aggregate totals remain unchanged. Having binding aggregates makes the framework fixed (Kraan *et al.*, 2008).

The budgetary discipline for ministers comes from having to fit multi-year estimates of expenditure under the pre-established ceilings and targets (Kraan *et al.*, 2008). These ministerial ceilings can help to control overspending and force the shifting of appropriations within ministries. This disciplinary effect has been noted in both flexible and fixed frameworks, although it is stronger in fixed frameworks.

In flexible frameworks, the ceilings can have a disciplinary effect because last year's ceiling for the upcoming budget constitutes a clear baseline which the finance ministry can use in budget negotiations. In fixed frameworks, ministerial ceilings are more effective because the overall fixed aggregate total or ceiling cannot be altered, so any increase in a ministerial ceiling has to be compensated by reducing another ministerial or sub-sector ceiling.

The main difference between fixed and flexible frameworks is that, under fixed frameworks, the changes that are needed to accommodate new priorities or setbacks are found exclusively in reallocation or in the use of a reserve, whereas with a flexible framework changes can be found by adjusting the overall aggregate totals or ceilings and by adjustments on the revenue side.

In Portugal, the budget would benefit from moving to a more comprehensive medium-term expenditure framework. Decisions on the type of medium-term expenditure framework – fixed or flexible, periodic or rolling – should consider the recommendations of the Committee for Programme Budgeting on an expenditure rule (see Box 2.2).

Medium-term estimates could be prepared for the entire budget, with more detailed focus on mandatory programmes, such as social security, and on revenues. This baseline could be used in the budget documents to show comparisons of budget proposals to the baseline, highlighting the impact of policy. The budget could include an analysis of changes from the prior baseline, to focus policy makers and the public on why budget aggregates are changing. Key assumptions used in developing the baseline should be explained. Developing more comprehensive and better multi-year estimates as well as a better assessment of fiscal risks is the first step in the development and implementation of an MTEF.

Box 2.2. Expenditure rules

The fiscal rules that currently apply in Portugal are deficit and debt rules. The 2007 report of the Committee for Programme Budgeting recommended the adoption of a different type of rule: an expenditure rule. The Committee was not the first group to recommend this change. In 2001, the Public Expenditure Reform Commission also called for the adoption of an expenditure rule to limit the growth of current expenditure.

Expenditure rules promote stronger fiscal discipline than deficit rules.[a] Applying a ceiling on annually appropriated expenditures avoids budgetary adjustments motivated by short-term macroeconomic fluctuations which bring a pro-cyclical element into budgetary policy.[b] In addition, these rules can be more transparent and easier for both politicians and the public to understand.

With expenditure rules, a key issue is what to include within the expenditure ceilings. The report of the Committee for Programme Budgeting recommends that the expenditure ceiling be for the primary expenditure of the central government including social security, public investment and transfers to regional and local governments, but excluding interest payments and programmes financed by revenues raised by regional and local governments.[c] The ceilings would be defined on a national accounts basis.

OECD countries have taken different approaches regarding what to include within the expenditure ceiling. In some countries, for example the United Kingdom and the United States (under the Budget Enforcement Act which expired in 2002), only discretionary spending is included. Mandatory spending arising from entitlement laws such as social security is excluded. The reason for this exclusion is that social security expenditure is determined by macroeconomic fluctuations, and excluding it from the ceiling contributes to automatic stabilisation. In contrast, in countries such as the Netherlands and Sweden, mandatory entitlement spending programmes are included under the expenditure ceiling. The justification is that many of these entitlement programmes – for example, health, education and disability pensions – are not really influenced by macroeconomic fluctuations.

In most countries, transfers to state and local governments are included under the ceiling. This is especially the case when spending by these levels of government makes up an important share of total government expenditure.

In addition, having an expenditure ceiling which includes a larger part of total expenditure is more effective for creating stricter limits on total expenditure and forces the government to make policy decisions and priorities which stay within these limits. If this type of approach to budget formulation is to be viable, it requires a medium-term rather than annual budget focus, since the adjustments to entitlement programmes can only affect expenditures in the medium term.[d]

a. Anderson and Minarik (2006).

b. This could also be achieved by having a cyclically adjusted deficit constraint; however this has the disadvantage that there are arbitrary elements in calculating the output gap on which the cyclically adjusted deficit is based.

c. *Mid-Term Report* (Committee for Programme Budgeting, May 2007), p. 16.

d. Kraan *et al.* (2006).

6. Macroeconomic forecasts

In the past, deviations from forecast economic assumptions underlying the budget have been one of the Portuguese government's key fiscal risks. The IMF reports of 2003 and 2007 stressed the need to improve the quality of the budget projections and analysis of risk (IMF, 2003 and 2007). In 2006, the OECD reported "one reason for the fiscal slippages against the Stability and Growth Programmes since 2000 has been the systematic overestimation of future economic growth" (Guichard and Leibfritz, 2006). The Portuguese Stability and Growth Programme for 2005 and subsequent updates have generally been viewed as being based on conservative economic assumptions. While Portugal is considered to have improved its economic forecasting, it remains important that all key government economic assumptions be disclosed explicitly and be as accurate as possible.

The macroeconomic scenario underlying the Portuguese budget is prepared by the GPEARI in the MFAP. The impacts of the budget in the macroeconomic forecast are estimated iteratively. Broad fiscal policy assumptions are defined in the updates of the Stability and Growth Programme in the GOP and ROPO reports. Ministries are aware of the Stability and Growth Programme and the GOP and ROPO economic assumptions when they develop their budget estimates. According to the Institute for Financial Management for Social Affairs (the office responsible for developing social security budget estimates) and the Health Ministry, the ministries have some discretion in determining the macroeconomic assumptions that they use in preparing budget estimates.

For the external assumptions, the latest forecasts available from international organisations (European Commission, IMF and/or OECD) are usually used as a reference. Assumptions are made about the growth of foreign economies, international prices (notably oil prices) and interest rates. Within Portugal, the only other institution that develops comparable forecasts is the Central Bank.

The OECD budget transparency guidelines emphasise that economic estimates are often improved by introducing an independent element into the process (OECD, 2002). While the practices vary across OECD countries, in order to improve transparency and fiscal responsibility, increasingly there are calls for a more independent element in generating economic assumptions. This is achieved either through having an independent body or panel generate the assumptions or having an independent review of the assumptions produced by the government. In countries such as Austria, Chile, Germany and the Netherlands, there is an independent organisation or committee/panel that generates the assumptions.

For example, in Austria all of the macroeconomic assumptions used in the budget process are prepared by an independent institute called the Austrian Institute for Economic Research. In the Netherlands, the Central Planning Bureau fulfils this role. In Chile, the forecasts are generated by an independent panel made up of 14 leading economists from academia and research bodies; the Minister of Finance appoints the members of the panel, each for a one-year renewable term (Blöndal and Curristine, 2004, p. 13). The same economists are generally re-appointed. In other countries, for example New Zealand and the Slovak Republic, an independent panel reviews the government's economic assumptions. In Sweden, in 2007 the government established an independent fiscal council to provide an independent scrutiny of fiscal policy, promote active public debate and strengthen the credibility of fiscal policy.

Portugal could improve public confidence in its economic assumptions and forecasts by having an independent panel of experts to generate or review the economic assumptions.

7. Conclusion and recommendations

The Portuguese budget system is undergoing significant reform. It is evolving from a traditional legalist and highly input-oriented system which concentrates on controlling expenditure through very detailed oversight of budget execution towards a more modern budget process. This modern budget system aims to improve fiscal discipline through better budget formulation and a medium-term focus on fiscal goals.

This is an ongoing and long-term reform process. In order to build on progress and to continue to consolidate public expenditure, the Portuguese budget process could benefit from considering the following key recommendations for improving budget formulation.

Key recommendations for improving budget formulation

A comprehensive medium-term expenditure framework (MTEF) is needed to lend stability and credibility to the government's fiscal objectives. The Portuguese budget process needs a comprehensive medium-term expenditure framework that establishes detailed multi-year estimates for all ministries and programmes for the baseline year plus three years out. Generating more comprehensive estimates is the first step towards creating an improved framework.

Newly elected governments should set a medium-term fiscal target for their period in office and establish hard budget constraints with appropriate enforcement devices. The type of MTEF should be consistent with the decision on whether to adopt an expenditure rule.

An expenditure rule would promote stronger fiscal discipline. If the government accepts the recommendation of the Committee for Programme Budgeting to adopt this rule, careful consideration should be given to the expenditures to be included or excluded under the rule. To be effective, it is important that the rule be as simple and as comprehensive as possible. To increase pressure for compliance, it is essential that the general public understand the rule.

Macroeconomic assumptions should be reviewed by an independent panel. In the past, macroeconomic assumptions have at times been overly optimistic. Improving the government's economic assumptions and forecasts is necessary to generate a comprehensive MTEF. Having an independent panel of experts review the government's assumptions would promote improvement and increase credibility. The members of the panel should be recognised experts in fiscal policy.

Changes are needed to enhance the transparency of the budget. The proposal to shift to a programme budget will improve transparency. Focusing on programmes rather than on 5 000 detailed sets of budget data will help to improve public understanding of what the government is achieving with its money. Removing this extensive detail in budget documentation does not mean that budget control would be reduced. Instead, a programme budget will make it easier to understand the budget, talk about budget proposals, and build support for budget policy.

The investment budget, PIDDAC, should be integrated with the operating budget by programme. Summary information on investments should include approved levels and remaining commitments. Summary information on public-private partnerships (PPPs) should show risk analyses for all PPPs over the long term. Public investment in state-owned enterprises could be included in the programme budget.

The role of the Budget General Directorate (DGO) in budget formulation needs to shift from detailed budget execution to a stronger emphasis on more global oversight and an analytical review of the overall budget. The DGO has an important role to play in the implementation of the MTEF, programme review, the development of baselines and the implementation of accrual accounting, as well as generally helping to collect information for the government.

Key recommendations for improving budget formulation *(cont.)*

A programme review staff should be established within the DGO. In order for the DGO to take the appropriate leadership role in programme budgeting (and to ensure that programme budgeting is not consumed by the day-to-day demands of detailed budget execution), the DGO should newly establish programme review staff of economists, programme analysts or other personnel with analytical training. Their initial functions would be to:

- Support the Programme Budgeting Task Force (GTIPOP);
- Support the DGO programme delegations.
- Perform central overview of programme effectiveness.
- Provide training for programme budgeting functions.
- Develop and maintain a budget baseline.

Notes

1. These percentages are from the final accounts of 2006.
2. In addition, the LFL sets net debt ceilings for each municipality in terms of short, medium and long-term loans. These debt ceilings are established as a percentage of revenue. For example, short-term loans may not exceed 10% of the total revenue relative to the previous year, while medium and long-term loans may not exceed 100% of the same total revenue.
3. For each year, the State Budget Law sets these ceilings by prohibiting any increase to each region's net indebtedness, defined as the difference between total financial liabilities (irrespective of their form) and total financial assets.

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Chapter 3

The Role of Parliament and the Court of Audit

This chapter examines the role of Parliament in the budget process. It is divided into five sections. The first provides an overview of the Portuguese political system and the organisation of the committee structure of Parliament. The second examines the parliamentary budget process. The third section examines the resources available to Parliament to oversee the executive. The fourth describes the role of the Court of Audit. The final section discusses recommendations for enhancing the role of Parliament in the budget process.

1. Political system and organisation of Parliament

The Portuguese political system can be characterised as semi-presidential (Schleiter and Morgan-Jones, 2008). It is a dual system with both a president and a prime minister. The President is directly elected by popular vote and the Prime Minister is the leader of the majority party in Parliament or the head of coalition parties sharing powers.

The President of Portugal, who is elected for a five-year term, on paper has considerable power. He/she is head of the nation and the supreme commander of the armed forces with powers and duties to promulgate laws, declare a state of siege, call elections and dissolve Parliament. On the other hand, the Prime Minister is the head of the government and has authority to select Cabinet ministers and co-ordinate their work. He/she is in charge of managing the nation's affairs on a daily basis. In practice, however, the division of power between the two institutions can be ambiguous, and individual personalities or political circumstances become an important factor in determining who retains more power.

Since the political transition to democracy in 1974, Portugal has developed a party system with a full spectrum of political parties that go from the far left to the far right. At present, a moderate Socialist Party which is led by the Prime Minister, José Sócrates, holds the majority in Parliament, and the Social Democratic Party has the second largest number of seats.

The Portuguese Parliament (*Assembleia da República*) is unicameral and composed of 180 to 230 MPs who are elected for four-year terms. The Assembly has authority to dismiss the government by a vote of no confidence and to impeach the President. It also has power to review and approve government policy proposals, ratify treaties, and enact legislation and budget bills. A lot of parliamentary work is conducted by the committees. The rules of Parliament allow it to form permanent or *ad hoc* committees for discussing government policies and inquiring into government actions. Committee membership is in proportion to the number of seats each party holds in the Assembly. MPs are usually not allowed to serve on more than two committees. The committees review legislative proposals (most of which are proposed by the executive branch), hold hearings and listen to expert testimony. Once a committee approves a bill, it can be delivered to the plenary session and put to the final vote.

There are 12 committees within the Portuguese Parliament, including the Committee for Budget and Finance (Budget Committee). The Budget Committee, which is composed of 19 MPs (ten from the ruling Socialist Party), has authority: to hold hearings on the government's budget proposal; to allocate the articles to be discussed in the Committee or in the plenary session; and to debate and vote on the government's budget proposal and the amendments proposed by MPs.

The Budget Committee also has authority over budget control. The settlement of the government accounts is analysed annually by the Committee, together with the report of the Court of Audit. The Budget Committee holds two hearings a year with the Secretary of State for the Budget, to discuss the results of budget execution.

2. Parliamentary budget process

The parliamentary budget process was established by the Constitution, the Budget Framework Law, and the Rules of Procedure of Parliament. The Constitution stipulates general principles governing the parliamentary budget process, and the Budget Framework Law and Rules of Procedure detail the process. The Budget Framework Law stipulates that the budget proposal should be submitted to Parliament by 15 October. The Constitution and the Budget Framework Law specify the documents that the government is required to submit with the budget bill.

The Budget Committee plays the leading role in the parliamentary budget process. After the finance minister's presentation of the budget proposal, not only the Budget Committee but each sectoral committee begins discussing it. The staff of the Parliamentary Budget Technical Unit (UTAO) have only ten days to complete their review of the budget. Each sectoral committee should deliver its opinion on the government's budget proposal to the Budget Committee within 15 days after the presentation of the budget to Parliament. However, these opinions do not bind the decision making of the Budget Committee. The Budget Committee usually gives its formal opinion on the government's budget proposal within 20 days after the finance minister's presentation. This formal opinion is necessary in order for the budget proposal to be debated and for the general principles to be put to a vote in a plenary session convened exclusively for this purpose. This plenary session and general debate take place in late October and usually last two to three days.

Table 3.1. Parliamentary budget timetable

15 October	Finance minister's budget presentation.
15 October – late October	Debate on the government's budget proposal in the Budget Committee. This debate includes two hearings: one with the finance minister and one with the social security minister.
	Technical analysis of the budget by the UTAO unit within ten days of the finance minister's presentation.
	Sectoral committees send formal opinions on the government's budget proposal to the Budget Committee within 15 days of the finance minister's presentation.
	The Budget Committee gives its formal opinion within 20 days of presentation of the government's budget proposal.
Late October	General debate on the government's budget proposal in the plenary session.
Early November	The Budget Committee holds hearings with sectoral ministers.
Late November	The Budget Committee votes on proposed amendments. The plenary session votes on proposed amendments and the budget as a whole.
1 January	Start of the fiscal year.

In early November, the Budget Committee holds hearings with the finance minister, associated sectoral ministers, representatives of local authorities and experts from the non-governmental sector. Amendments can be proposed either by individual MPs or by political parties. MPs who want to amend the budget have to present their amendment to the Budget Committee and explain its effects and fiscal impact. Finally, the proposed amendments are voted on in the Budget Committee within 20 days after the general debate in the plenary session. The plenary session then votes on the proposed amendments from the Budget Committee and on the whole budget.

The Portuguese Parliament has unlimited power to amend the executive's budget proposal. It can increase expenditures or reduce revenues. It is not bound by a pay-as-you-go rule when amending the proposed budget. Even though the Portuguese Parliament has legal power to amend the government's budget proposal without any restriction, in practice in recent years only a small number of amendments have been approved by Parliament. This is partly due to the Portuguese political tradition of strong party discipline with a majority ruling party.

There are a large number of proposed amendments. In 2007, a total of 868 amendments were proposed, but only 68 were approved. The approval rate is very low (7.8% in 2007, and 7.2% in 2006), particularly for proposals made by the Opposition MPs (1.2% in 2007 and in 2006). A large majority of amendments are proposed by the Opposition MPs (92.9% in 2007 and 94.6% in 2006).[1] From 2006 to 2008, amendments made by Parliament impacted on total expenditure by less than 0.1% on average. It should be noted that the executive has no power to veto a parliamentary amendment of the budget.

Table 3.2. Timetable for budget submission and approval in selected OECD countries

	Start of fiscal year	**Deadline for submission (A)**	**Deadline for approval (B)**	**Duration of budget review (B-A)**
United States	1 October	First Monday in February	Before the start of the fiscal year	About 8 months
Netherlands	1 January	Third Tuesday in September	Before the start of the fiscal year	More than 3 months
Mexico	1 January	8 September	One month before the start of the fiscal year	About 3 months
France	1 January	First Tuesday in October	Before the start of the fiscal year	About 3 months
Japan	1 April	Within January	Before the start of the fiscal year	More than 2 months
Sweden	1 January	20 September	One month before the start of the fiscal year	More than 2 months
Korea	1 January	2 October	One month before the start of the fiscal year	2 months
Portugal	1 January	15 October	One month before the start of the fiscal year	1.5 months

Source: OECD Budget Practices and Procedures Database (2007), *www.oecd.org/gov/budget/database*.

A unique feature of the Portuguese budget process is that, while budget drafting within the executive branch is completely based on a top-down approach, budget deliberation within Parliament does not follow this approach. In Portugal, the Budget Committee has more authority over the sectoral committees than is the case in many other OECD countries. The Budget Committee formally considers all budget-related matters rather than considering only budget aggregates (total level of revenue and expenditure). In other OECD countries, the equivalent of the Budget Committee would consider aggregates and expenditure ceilings for each policy sector, with sectoral committees formally considering spending for specific appropriations within the sectoral expenditure ceilings (Posner and Park, 2007).

Box 3.1. Provisional budget

If the budget is not approved before the start of the new fiscal year, the previous year's budget still remains in force, according to Article 41 of the Budget Framework Law. Therefore, the government is allowed to spend money corresponding to one-twelfth of the previous year's budget in each month. This situation happened in the past when new governments took office between 1 July and 30 September because they had little time to prepare a new budget based on their political commitments. Besides these exceptions, the budget has usually been approved by the legal deadline of 1 December.

The Budget Framework Law states that the parliamentary budget process has to be completed within 45 days and the budget approved one month before the new fiscal year begins. The time period given to Parliament to review the budget has reduced over time from three months in 1977 to its current 1.5 months. This current timetable is very tight compared with other OECD countries where, on average, parliamentary budget deliberation takes more than two to three months. The "OECD Best Practices for Budget Transparency" state that Parliament should have the opportunity and the resources to effectively examine any fiscal report that it deems necessary (OECD, 2002). The best practices recommend that Parliament have at least three months to review the budget. To improve transparency, therefore, the Portuguese government should consider providing Parliament with more time to review the government's budget proposal.

3. Resources of Parliament

In 2006, the Portuguese Parliament established a special unit called the UTAO (*Unidade Técnica de Apoio Orçamental*) as a support unit for the Budget Committee. It is a nonpartisan unit composed of experts in economics and law. It supports parliamentary budget deliberation by providing the committee with quality analytical reports on the executive's budget proposal. The unit conducts technical analysis on budgetary matters including assessment of the General State Account, technical monitoring of budgetary execution, and analysis of revisions of the Stability and Growth Programme.

Besides producing analytical reports, the UTAO is to give support to the Committee as a whole. Individual requests by MPs are directed via the bureau of the Budget Committee to the UTAO; they are not sent directly to the unit. Annually, the UTAO produces almost 40 documents, half of which are technical notes. These notes are available to the public on the Internet. MPs in the Budget Committee claim that this unit has contributed to enhancing parliamentary capacity for scrutinising the executive's budget proposal, and they are satisfied with its performance.

However, the capacity of this unit is limited because it only has three staff persons (two of whom are seconded). This is a very small number compared with similar organisations in OECD countries (see Table 3.3). In addition, the unit only has access to publicly available information or information sent to Parliament by the government. The unit cannot directly request any kind of information from the public administration or the government. All requests for information must go through the Budget Committee to the Minister of Parliamentary Affairs and from there to the relevant minister. This process is very time-consuming. Even though the staff are qualified specialists in fiscal policy, it is very demanding to cover all requests from the committee and to respond to the executive's budget proposal within ten days. Consideration should be given to extending the duration of the unit's mandate and to expanding its size and capacity by appointing additional permanent staff.

The *Centro de Informática*, which deals with Parliament's computer information system, has developed a special computer programme where all data and information related to proposed laws and the budget process are available. The Centre has also developed a parliamentary Intranet where individual MPs can access information on the status of proposed budget amendments.

Table 3.3. Staff numbers of parliamentary budget offices in selected OECD countries

United States	Korea	Japan	Mexico	United Kingdom	Portugal
220	96	21	20	20	3

Source: OECD Budget Practices and Procedures Database (2007), *www.oecd.org/gov/budget/database*.

4. The Court of Audit

The Portuguese Court of Audit (*Tribunal de Contas*) is the statutory supreme audit body of Portugal; its authority is based on the Constitution of the Republic. The Court has 18 members and 600 staff, including the regional chambers of Azores and Madeira. All public spending is subject to review by the Court of Audit. The Court conducts *a priori* audits of the legality and propriety of public expenditures, financial audits, and value-for-money audits. The primary focus of its *a priori* audits is on procurement contracts whose value is in excess of EUR 317 000. There are about 4 000 *a priori* audits each year. The Court also reviews all debt financing of municipal governments to ensure that the borrowing is consistent with the legal limit.

During 2006, the Court undertook 50 financial audits and 35 performance audits; in 2007, approximately 70 financial audits and 35 performance audits. Fifty per cent of the Court's budget is funded by the state, and the other funding comes from fees charged for services. The Court charges a maximum of EUR 15 000 for its audits. The Court's reports are submitted to Parliament.

The General State Account is submitted to Parliament no later than 30 June following the end of the fiscal year. The Court prepares an annual report, "The Opinion of the General State Account", which is submitted to Parliament no later than the end of the year. Parliament takes a formal vote to approve the General State Account. Without Court approval for *a priori* audits, expenditure may not occur. Its findings for *a posteriori* audits can be enforced by Court-ordered restitution of funding or by fines.

5. Conclusion and recommendations

According to the law, the Portuguese Parliament wields strong power in the budget process. There are no limits to its ability to amend the government's budget proposal. In practice, however, the power of Parliament is limited because in Portugal the leader of the majority party or coalition parties holds power. This situation, combined with strong party discipline, generally means that the government's budget passes with few changes.

In recent years, some efforts have been made to strengthen the role of Parliament in the budget process, *e.g.* creating a technical support unit (UTAO) to produce specialised analysis of the government's budget proposal, and setting up a budget information system to provide MPs with real-time information on the budget.

Expanding Parliament's capacity for budget review enhances fiscal transparency by providing more information on public finance in the public domain and stimulating discussions on the effectiveness and appropriateness of resource allocation. From this perspective, recent efforts by the Portuguese Parliament can be seen as an important cornerstone for improving the budget system. Below are recommendations that can be considered to further enhance the transparency of the budget process and the role of Parliament.

Key recommendations for enhancing the transparency of the budget process and the role of Parliament

The period given to debating the budget should be extended to at least three months to be in line with the OECD guidelines on budget transparency, established to ensure sufficient time for parliamentary review and action.

The parliamentary Budget Committee should adopt a more top-down approach, focusing on approving the total aggregates. In light of the introduction of programme budgeting and the development of a medium-term expenditure framework, consideration should be given to how parliamentary committees operate in the budget process. One proposal would be for the Budget Committee to approve the budget aggregates and then the sectoral committees would be given a large role in examining the proposed budget and the goals, performance indicators and results of individual programmes.

The Portuguese Parliament should consider increasing the number of staff in the technical support unit (UTAO) and increasing the duration of its mandate while ensuring the unit's independence. An increase in staff is important to provide sufficient support for Parliament under the current budgetary regime, and to help prepare for the upcoming programme budgeting. The introduction of programme budgeting will require this unit to conduct additional analysis of the budget proposals. More experts will be necessary to review the performance information provided by the government. The mandate of the unit should be extended, and an independent head would help to further increase the unit's credibility.

Parliament needs to be engaged and consulted in the development of the new programme budget. This can be done by having an *ad hoc* group or a subgroup of the Budget Committee to obtain the opinion of MPs, in advance, on the presentational details of the new budget. In addition, it would be helpful to have seminars to inform MPs and the Budget Committee of the details of programme budgeting and how their own roles will be affected.

Note

1. Based on information from Valente (2008), pp. 201-218.

Chapter 4

Budget Execution and Financial Management

In Portugal, the budget process has strongly emphasised budget execution as a means of controlling expenditure. Some improvements to the process have been introduced, such as enhancements in the coverage and timeliness of the budget execution data published in the DGO monthly bulletin; financial controllers have been established in individual ministries; and the cash management system has been modernised. However, more reforms are needed, especially to streamline budget execution and the financial control process and to introduce accrual accounting.

This chapter examines the current budget execution and financial management processes. It is divided into four sections. The first looks at budget execution, the structure of appropriations and budgetary flexibility; the second discusses financial accounting, internal audit and cash management; the third addresses transparency and accountability issues in state-owned enterprises (SOEs) and public-private partnerships (PPPs); and the fourth provides recommendations for moving forward.

1. Budget execution

1.1. Main steps in the budget execution process

The budget bill approved by Parliament enacts budget maps by ministry, function, and economic and administrative classifications (over 5 000 budget maps are made available to Parliament). Once Parliament approves the budget bill at the beginning of the year, the government issues the budget execution decree-law setting the rules for budget execution in that year. Afterwards, the DGO issues a circular with some operational procedures to be followed during the year.

After the release of budget funds is authorised by the DGO sectoral delegations, the corresponding amounts are transferred to the ministries' individual treasury accounts (sub-accounts of the Treasury Single Account). The ministries subsequently transfer the amounts to their creditors' bank accounts, using the nation-wide inter-bank fund transfer systems.

As discussed in Chapter 2, the Portuguese central government is divided into "integrated services" and "autonomous funds and services". Integrated services (the state sub-sector) have administrative autonomy but not financial autonomy. Integrated services can only create commitments, providing these are compatible with the respective department's approved budget. The information regarding the budget is available through the integrated services' IT systems, where it is posted when approved by Parliament. Commitments are also recorded in the integrated services' IT system. The integrated services' accounting records are exported to the central IT system, allowing the DGO delegations to monitor budget execution on a daily basis. Before the deadline for payment, the integrated services request that the DGO sectoral delegation releases budget funds. The DGO must analyse the request for funds and authorise it.

Some autonomous funds and services have both administrative and financial autonomy. These departments' relationship to DGO sectoral delegations and to the MFAP within the budgetary process mainly concerns requesting the release of budgetary credits and reporting requested budget execution information.

Portugal has implemented two mechanisms to ensure the necessary control of budget execution. The first is "budget freezing": a percentage of certain categories of non-mandatory spending may be frozen at the beginning of the budget year, *i.e.* the gross appropriation is frozen by a 15% reserve for a net appropriation of 85% of the original approved amount. The second mechanism is called the "twelfth-basis system". This mechanism allows the gradual execution of government expenditure to ensure that expenditures are spread throughout the year. One-twelfth of the appropriation net the "freezing" amount is allocated for expenditure each month.

There are two regular reports on the execution of the budget: the DGO monthly bulletin and the annual General State Account (*Conta Geral do Estado*). The General State Account contains the budget execution data for all central government departments and funds, as well as social security, on a cash basis. The General State Account is submitted to Parliament by 30 June, following the end of the fiscal year. The General State Account is also submitted to the Court of Audit. Both the DGO monthly bulletin and the report on the General State Account are available to the public on the DGO website. In addition to these regular reports, the DGO prepares internal reports on expenditure overruns – analysis of deviations in budget execution – and on additional financing requirements.

With regard to preventive control, it must be emphasised that, at present, the DGO sectoral delegations' intervention is mainly focused on verifying that the requested funds fall within the budgeted amounts. Therefore, it cannot be said that the control is preventive, in the full meaning of the expression. The heads of departments have administrative autonomy and are responsible for their managerial decisions. The internal and external audits determine when possible irregularities are committed.

Spending can occur after the beginning of the budget year if the appropriation law is not enacted in a timely manner. The Budget Framework Law (Art. 41) allows an automatic time extension of the previous year's budget act. In this case, a twelfth-basis system is provisionally applied for expenditure appropriations.

1.2. Budget flexibility and reallocations

There is some flexibility regarding reallocations once the budget act is approved by Parliament. The ministries are organised according to an administrative structure, and each major administrative category includes departments with similar objectives or functions. The global amount of each "administrative chapter" cannot be surpassed unless one of the following happens: a department generates a higher-than-forecast level of own receipts; legislation allows balances to be carried forward from the preceding year; another department of the same ministry, or other ministry within the context of a budget programme, transfers budget funds; or the Minister of Finance authorises an increase of the expenditure ceiling financed by a transfer from the contingency reserve fund. There could also be shifts from within line items or budget chapters. These shifts could occur among departments under the same "administrative chapter" providing that the functional category implicit to the budget remains unchanged. All these rules are specified in legislation, mainly the 2001 Budget Framework Law, a 1995 decree-law on basic rules for budget changes by the executive, the annual budget execution decree-law, and DGO internal circulars.

Internal reallocations occur rather frequently, for managerial reasons – the most common being the need to provide additional resources to departments that do not have the capacity to support the annual increase of the wage base determined by the government.

If the budget allocations of other departments could compensate unforeseen expenditure needs, such reallocations could occur in some circumstances. Otherwise, the sectoral minister requests additional funds from the Minister of Finance. The Minister of Finance can respond if there are sufficient amounts available in the contingency reserve. Before approving a request for funding from the contingency reserve, the Minister of Finance or the Secretary of State for the Budget decides whether to authorise it or not, based on the DGO analysis of the merits of the request. (The contingency reserve for Portugal in 2008 is EUR 600 million, 1.04% of total expenditure.)

When reallocations are not possible and there is no funding available from the contingency reserve, an increase in spending can only occur if a supplementary budget is enacted. In the last decade, between the years 1998 and 2007, there was generally one supplementary budget per year with the exception of 2000 and 2003. In the last two years, 2006 and 2007, no supplementary budget was presented to Parliament.

For 2008, all changes that do not affect the deficit will be approved at the level of the line minister, with the constraint that they cannot make reallocations that would affect the chapter or functional allocations. This new arrangement should substantially increase the budget accountability of the line ministries and reduce the micro-budgetary focus of the DGO.

Table 4.1 shows Portugal's current budget reallocation system and who must approve the different categories of budget reallocations.

1.3. Streamlining financial controls and delegating responsibilities to line ministers

The current overly detailed and inefficient financial planning and control processes need to be streamlined. There should be a comprehensive review of financial management processes.

The DGO currently exerts direct control over more than 500 spending units, which makes it rather difficult to develop an overall view of individual ministries and/or major spending areas. To promote these changes and those envisaged by the programme budgeting initiative, it is essential that the DGO role moves from detailed control of budget execution to more global oversight and analysis.

The DGO could shift its focus from detailed monitoring of transactions to analysis of budget execution anomalies and reviews of programme financial performance. The DGO should provide agencies with clear guidance on budget execution requirements and deadlines for budget reports. It could organise training for ministry/spending unit staff on delegated budget responsibilities.

Detailed review of budget adjustments could be reduced, as programme managers assume responsibility for spending and as appropriations are shifted to programme categories. Funds could be apportioned or distributions approved on a programme basis, with the distribution of funds on an automatic quarterly basis, unless specific programme requirements warrant an alternative distribution. Distribution of the funds should be contingent upon programme requirements, such as submission of implementation plans or evaluation structures.

Table 4.1. Nature and competence for authorising budget changes

Nature	Scope and description	Competence to authorise
Internal budget realloca-tions	Between different ministries, administrative chapters[a] or functional categories, with the following exceptions:	Parliament
	Between different departments:	
	• Between different ministries or "administrative chapters" owing to: *i)* changes in government or ministries' organic law; *ii)* changes in a department's missions or arising from the creation of new departments.	Government (line minister)
	• Between different ministries, "administrative chapters" or functional categories, if transfers authorised from the contingency reserve fund.	Government (Minister of Finance)
	• Within the same "administrative chapter", providing that the corresponding functional category does not alter the budget act Map III[b] approved by Parliament.	Government (line minister)
	Within the same department's budget:	
	• Reallocation from employees' compensation to another economic category.	Government (Minister of Finance)
	• Reallocation from pensions, health spending and financial assets to another economic category.	Government (line minister and Minister of Finance)
	• Reallocation of budget funds authorised from the contingency reserve fund.	Government (line minister and Minister of Finance)
	• New or increased expenditures with transfers to other levels of Public Administration.	Government (line minister and Minister of Finance)
	• New (*i.e.* not foreseen in the approved budget) or increased transport material expenditure.	Government (line minister and Minister of Finance)
	• Remaining situations.	Government (chair of the department's board)

a. "Administrative chapter": the ministries are organised according to an administrative structure, and each major administrative category ("administrative chapter") includes the departments with similar objectives or functions.

b. Map III: expenditure of state sub-sector (*i.e.* departments with administrative autonomy), by functional categories.

Table 4.1. Nature and competence for authorising budget changes *(cont.)*

Nature	Scope and description	Competence to authorise
Increase in global level of expenditure	Increase in global expenditure of a ministry, "administrative chapter" or functional category, with the following exceptions:	Parliament
	• Arising from levels of collected department's own revenues higher than initially projected.	Government (line minister)
	• Additional expenditure deriving from balances carried forward from previous years, if foreseen by legislation.	Government (line minister and Minister of Finance)
	• Due to transfers of other entities of Public Administration, Social Security or EU.	Government (line minister)

The streamlining of financial management, the shift to programme budgeting and changes in the role of the DGO pave the way for delegating responsibilities to line ministries, who should take primary responsibility for programme management and budget execution. Delegation could be done on a selected case-by-case basis depending on programme performance and the success of ministries in putting accountability structures into place. Recognising Portugal's history of expenditure overruns, it is important to check capacity and accountability structures before delegating authority to the ministries. Each ministry should have a budget and finance office, which could take responsibility for budget execution and provide oversight on programme budgeting within the ministry. This office should be under the supervision of the financial controller who should report directly to the minister. In addition, all ministries need to ensure that they have a GPEARI with the function of strategic planning and management. This is necessary to implement the programme budgeting initiative.

There should be clear accountability structures and implementation of the current accrual accounting requirements. Within the context of a medium-term expenditure framework, each line minister should be primarily responsible for any spending overruns within his/her own ministry. These changes should take place within the context of the wider government reform agenda.

2. Financial accounting and cash management

Until September 2007, the debt and cash management functions of Portugal were the responsibility of two different entities, the IGCP (the Cash

Management and Government Debt Agency) and the Treasury. The IGCP was responsible for minimising long-term debt cost. The Treasury was responsible for cash management functions, both liquidity management and financial services to public entities. The two functions have been consolidated under the IGCP. The IGCP manages the Treasury Single Account based in the Bank of Portugal. It develops an annual cash management plan which is updated daily and monthly. The IGCP serves as the state's bank, processing all of the state's payments and receipts. The IGCP also manages the debt functions of the Portuguese government. Thus far, the direct tie between borrowing and cash management has allowed the IGCP to reduce unnecessary cash by EUR 1 billion, resulting in substantial interest savings.

According to the European Payment Index (spring 2007), Portugal placed last out of 25 countries with regard to payment risks. Late payment has been recognised as having a negative effect on business competitiveness. Portugal's 2008 budget presented a programme to reduce payment delays in the public administration. Under this programme, reducing payment delays will be a mandatory item in managers' mission statements. The financial "twelfth-basis" system may be accelerated to reduce payment delays.

Accounting systems: One of the government's objectives for 2008 is the application of the Public Accrual Accounting Implementation Plan (RIGORE) in the entire public administration; this would mean that all ministries would adopt accrual accounting for their financial reporting. The MFAP has been developing a financial and human resources platform in the programme called RIGORE and in a single technology available across the entire public sector. The government began the introduction of accrual accounting in 1997. Since only a few departments have introduced it to date, it may be unrealistic to assume that the plan will be fully implemented during 2008. The Portuguese government is ultimately planning to adopt international accounting standards for the public sector.

The integrated services (state sub-sector) continue to use cash accounting. Some of the autonomous funds and services have implemented accrual accounting. The finances of the integrated services are reported on a monthly basis through the DGO budget execution reports. Monthly accounts of the state, including autonomous funds and social security, are published 20 days after the end of the month. The local government finances are available quarterly, with a 50-day delay. The General State Account is prepared after the end of the year and submitted to Parliament no later than 30 June of the following year.

Regional governments report data on a cash basis. However, an adjustment is made for the accruals basis. This adjustment consists of adding the figures for expenditure due but not paid, and deducting the commitments from previous years which were paid during the year in question. Municipalities’ accounting is on an accruals basis, including the same kind of adjustments as for the regional government. Despite the implementation of the Official Plan for Local Authority Accounting (POCAL), a full accruals basis has yet to be adopted, due to the fact that the new information reported by the municipalities is still being analysed by the National Statistic Office.

Internal audit: The General Inspectorate of Finance (IGF) is the home of the inspectors general of the Portuguese government, an internal body responsible for: financial system, value-for-money and IT audits; reviewing performance evaluation; and establishing standards for government agency finance in Portugal. The IGF mandate covers all central departments and agencies, local departments and agencies, state-owned and municipal-owned companies, and all private entities financed by national or EU funds. The annual audits of the IGF are accompanied by a risk assessment and meetings with the ministries’ internal audit units. The IGF develops an annual audit plan to complement the ministries’ audit plans. It presents its results in an annual report synthesising the ministries’ audit reports. The IGF has undertaken value-for-money audits on a pilot basis. The IGF has established co-ordinating committees to establish strategic directives for the audit system, a training plan for auditors, requirements for annual audit plans, and standards for audit activities. The IGF shares its audit plan and its findings with the Court of Audit on an ongoing basis.

The IGF has a staff of 160, virtually all university-trained auditors. The IGF staff members are frequently recruited to fill senior positions in ministry audit offices. Recruitment for the IGF has become an issue, because of the current one-for-two replacement constraint that has been applied to the Portuguese public administration.

3. Transparency and accountability issues of state-owned enterprises and public-private partnerships

With the growth of state-owned enterprises (SOEs) and public-private partnerships (PPPs), Portugal should promote further transparency and accountability regarding the operations of the two structures.

State-owned enterprises (SOEs): Public enterprises are a major presence in transportation, water supply, infrastructure management, hospitals and urban redevelopment. After a long period of privatising of these companies during the 1990s, Portugal's public enterprise sector amounts to 5.6% of GDP. In 2005, the nominal value of the public participation in these enterprises was about EUR 12 billion. Improving the transparency and accountability of SOEs is important because they are a growing share of the Portuguese economy. According to the OECD, SOEs are responsible for 2.5% of all employed labour (OECD, 2008c). In 2006, SOEs received a financial flow of EUR 704 million from the government. The growth of SOEs should be supplemented with efforts to benchmark SOE efficiency and to analyse incurred losses. In 2007, Portugal passed a law governing the state-owned company sector. This law is designed to strengthen the accountability of public sector companies and to increase incentives for performance management (OECD, 2008c). The law strengthens financial control mechanisms and introduces specific duties for reporting information. The *ex post* effects of this reform have not yet been measured.

SOEs escape thorough review of their operations because information on income and expenditures is excluded from the budget. In addition, since the MFAP and the DGO focus on budgets that are tied with future appropriations, the fact that SOEs receive direct loans rather than appropriations will continue to keep them outside the scrutiny of the MFAP and the DGO. This is a reason for concern and caution, especially when SOEs are not operated in full by government finances but rather by a mix of both public and private. SOEs with such a financing scheme are vulnerable to private sector financial shocks where losses are borne by the government and hence taxpayers' money. The level of SOE indebtedness should be disclosed. To further promote efficiency gains from the use of SOEs, disclosure of their financial statements with emphasis on government subsidies (*i.e.* direct loans, guarantees, etc.) should be included in the budget as a memo or appendix for decision makers to be better aware of the scope and scale of contingent liabilities.

Public-private partnerships: In Portugal, PPPs are subject to two reviews: a budgetary quasi-appropriation and a methodology assessment to check for efficiency and sustainability. For each project, there is an interministerial steering committee including representatives of the MFAP and a PPP expertise centre housed in Parpublica SA. Each central government PPP project is subjected to a gateway process at the points of preparation, negotiation and renegotiation. This gateway process allows the Minister of Finance to stop the project and gives him/her veto power if the project does not provide efficiency or could endanger fiscal discipline. The project team prepares an initial feasibility study and undertakes a public sector comparator (PSC) analysis – an analysis of the expected cost of the project if it were developed under procurement with no resource to private finance. Tender boards are required to consider the PSC value as a limit-value for establishing a contract, while reserving the right to cancel the call for bids if the proposals are lower than the PSC.

PPP contracts allow costs and risks to be shifted from the present to future generations and may accept too much risk. Portugal has recognised this moral hazard issue by creating the PPP unit in Parpublica SA and by establishing the gateway process. This process applies to the central government; it does not apply to state-owned enterprises or to local governments.

Transparency and accountability could be promoted by including public investment in SOEs in the programme budget. With regards to PPPs, summary information should include risk analysis. In addition, before a decision is taken on the launch of a PPP, the public sector comparator should be discussed by Parliament.

4. Conclusion and recommendations

The Portuguese budget execution system focuses on ensuring the legality and propriety of expenditure. The current detailed budget structure results in excessive review of budget adjustments. Detailed review of pre-payments and budget amendments by the DGO are not productive. The fragmented budget structure creates an impediment to a comprehensive programmatic or policy view of the budget. Staff resources at all levels are used to process transactions rather than to analyse budget policy or performance. To address these issues, the following key recommendations for improving budget execution and financial management should be considered.

Key recommendations for improving budget execution and financial management

Streamline budget execution and financial control processes. Shifting to a results-oriented programme budget will require the delegation of budget responsibility to programme managers and/or ministries. Reducing the number of budget line items from thousands to a few dozens of programmes should reduce the need for detailed DGO oversight and increase the flexibility of programme managers. Ministries, and particularly agencies, should have primary responsibility for programme management and for budget execution. Detailed review of budget adjustments should be substantially reduced, as programme managers assume responsibility for spending and as appropriations are shifted to programme categories. There needs to be a comprehensive review of the financial management processes.

Transfer primary responsibility for budget execution to spending units. The DGO should provide agencies with clear guidance on budget execution requirements and deadlines for budget reports. It should organise training for ministry/spending unit staff on delegated budget responsibilities. Funds could be apportioned or distributions approved on a programme basis, with the distribution of funds on an automatic quarterly basis, unless specific programme requirements warrant an alternative distribution. Distribution of the funds should be contingent upon programme requirements, such as submission of implementation plans or evaluation structures. The DGO could shift its focus from detailed monitoring of transactions to analysis of budget execution anomalies and reviews of programme financial performance.

Strengthen the accountability of ministries. Ministries need to be held accountable for how they fulfil their new delegated responsibilities. Before delegation occurs, it is important for ministries to have the necessary capacities and accountability structures in place. Each ministry should have a budget and finance office, which could take responsibility for budget execution and provide oversight on programme budgeting within the ministries. This office should be under the supervision of the financial controller who should report directly to the minister. In addition, all ministries need to ensure that they have a GPEARI with the function of strategic planning and management. This is necessary to implement the programme budgeting initiative.

Implement accrual accounting. The ministries need to implement the current requirements to introduce accrual accounting. Progress to date in implementing this initiative has been slow. Completing the accounting reform should be a higher priority.

Expand PPP review to state-owned enterprises and local government. PPP control procedures for the central government seem to be organised in an appropriate manner. Similar controls should be applied to PPP contracts undertaken by the state-owned enterprises and by local governments. PPPs have the potential of creating future liabilities for the government. PPP contracts should be carefully reviewed to ensure that they meet efficiency tests and that they do not accept inappropriate risks. In addition, before a decision is taken on the launch of a PPP, the public sector comparator should be discussed by Parliament. While the process for the preparation of a PPP in the central administration is adequate, there need to be improvements in the recording of the associated liabilities.

Key recommendations for improving budget execution and financial management *(cont.)*

To improve transparency in relation to state-owned enterprises, it is important to have clear public accounting rules about whether or not public entities are part of the government sector, based on their degree of autonomy and the nature of their activities. Furthermore, there should be greater clarity and consistency in the rules applied to state-owned enterprises in terms of their borrowing capacity, level of indebtedness and PPP arrangements.

Chapter 5

Improving Accountability for Results

Under pressure to reduce public expenditure and improve the efficiency and effectiveness of public spending, the Portuguese government is designing and implementing reforms to enhance public sector performance. Two recent major reform initiatives are programme budgeting and the Integrated System for Management and Performance Assessment of the Public Administration (SIADAP).

These reform initiatives aspire to shift the focus of management and budgeting away from detailed input controls towards a focus on performance and results. Traditionally, the performance of managers and public services was not measured or evaluated in any systematic manner. The culture emphasised compliance with rules as opposed to accountability for results. As discussed in the previous chapter, this shift to a performance focus requires fundamental changes in accountability and budget processes, but also in the cultural attitudes and behaviour of individuals and organisations.

This chapter examines these reform initiatives and places them in the context of wider OECD experience. It is divided into five sections. The first provides a definition of performance budgeting and discusses implementation trends in OECD countries. The second describes the Portuguese programme budgeting initiative, and the third highlights the challenges and issues which are important for Portugal to consider as it moves forward with this reform. The fourth section describes the SIADAP reform and highlights possible challenges with implementing this initiative, drawing on the experiences of other OECD countries. The final section presents recommendations for implementing performance budgeting.

1. From performance information to performance budgeting: experiences of OECD countries

Most governments of OECD countries have developed performance information. Many have adopted a programme budget classification, and many more have introduced some form of performance budgeting. In OECD countries, the discussion and debate surrounding performance budgeting is often clouded by ambiguous definitions. Therefore, it is important to distinguish between developing programme budgets, performance information and performance budgeting.

Simply put, developing programme budgets and performance information could be independent, stand-alone reforms or they could be steps in the process of developing performance budgeting. The section below defines these terms and discusses trends in OECD member countries.

1.1. Programme budget

A programme budget is a type of budget classification. It refers to structuring the budget on programme lines. The budget could be classified according to output areas or programmes. Programmatic line items are characterised by related objectives or even a single ultimate objective where all activities producing the outputs are financed by the line item.

Normally, programmes will have objectives or mission statements, stating the actions to achieve goals and meet performance targets. Although the level of detail varies with each country, one of the main objectives of introducing programme budgets is to improve transparency. For example, to improve budget transparency, the governments of the Netherlands and Sweden restructured their budgets into policy areas and programmes. Structuring the budget along programme lines improves clarity by tracking the money and associating the funds with desired policy objectives. A budget based on programmes and/or policy goals, as opposed to detailed line items, is better understood by politicians and the wider public. It can also facilitate delegation of financial and managerial responsibilities to programme managers, which in theory improves efficiency.

1.2. Developing performance information

Performance information enables governments to measure progress. It checks whether the government is moving towards achieving its policy and programme goals. It also provides feedback by giving details on which initiatives are working and which ones are not. More and better quality information on the performance of programmes and agencies improves and facilitates decision making by politicians and civil servants.

OECD countries have been working on developing performance information for a number of years. In 2007, 40% of OECD countries reported that they had developed their first government-wide initiative to introduce performance measures during the past decade. Twenty-six per cent of the governments have introduced their first initiative within the last five years (OECD, 2007b).

Today, nearly all OECD countries develop performance information. To assess non-financial performance, the majority of governments have developed both performance measures (and/or targets) and evaluations. In 2007, evaluations were the most common approach to assess non-financial government performance (OECD, 2007c).

Portugal lags behind other OECD countries because it does not have a government-wide strategy for developing performance information. Recently, Portugal has started to engage in producing performance information. Although its availability varies with sectors, some areas such as health and education have made better progress. In the health sector, through the introduction of diagnostic related groups, there has been extensive development of performance and cost information.

The production of performance information is not an end in itself; quite the contrary, to make a difference, it has to be actually used in the decision-making processes. There are a variety of ways. For example, it could be used to develop and plan policy, to improve transparency to the public and the legislature, to help managers manage their programmes and agencies, and to improve budgetary decision making. Performance information is most commonly used by managers to manage programmes (Curristine, 2005, p. 113).

1.3. Performance budgeting

Performance budgeting is concerned with the use of performance information in the budget process and for resource allocation. Key steps in the process of developing performance budgeting are having a budget structured by programme and developing performance information which measures programme achievements. It is impossible to have performance budgeting without performance information.

While it is difficult to have performance budgeting without a programme budget classification, it is still possible. For example, in the United States the budget is structured on a detailed line-item basis. However, the PART exercise (Program Assessment Rating Tool), which evaluates programmes and agencies, provides performance information which is used by the stakeholders in the executive branch in budgetary decision making.

Performance budgeting is about the actual use of performance information in budgetary decision making. There are different models and approaches to performance budgeting (OECD, 2007d). Table 5.1 distinguishes three different categories.

Table 5.1. Performance budgeting categories

Type	Linkage between performance information and funding	Planned or actual performance	Main purpose in the budget process
Presentational	No link	Performance targets and/or performance results	Accountability
Performance-informed budgeting	Loose/indirect link	Performance targets and/or performance results	Planning and/or accountability
Direct/formula performance budgeting	Tight/direct link	Performance results	Resource allocation and accountability

Source: OECD (2007), *Performance Budgeting in OECD Countries*.

The first category is presentational performance budgeting. Performance information is presented in budgeting documents or other government documents. In this category, performance information is included as background information and is generally used only for accountability purposes.

The second category is performance-informed budgeting. Resources are related either to proposed future performance or to performance results in an indirect manner. Performance information is important in the decision-making process but does not necessarily determine the amount of resources allocated.

The third category is direct performance budgeting. Direct linkage involves the allocation of resources directly and explicitly to units of performance, generally outputs. An example is diagnostic related groups in the health sector. Direct linkages are possible in certain sectors, but should be decided on a case-by-case basis rather than by establishing a government-wide system. There are sector-specific instances, such as the health and higher education sectors, where efficiency gains were achieved by applying direct performance budgeting. In the past few years, Portugal applied direct performance budgeting in the health sector in the form of diagnostic related groups. It created 34 enterprise hospitals; to date, this has provided benefits in terms of increased activity, greater volume of operations, and an increase in the number of patients treated.

Box 5.1. OECD country experiences with performance budgeting

Denmark

Denmark has been working on developing performance measures for over ten years. A two-pronged approach was taken. First, government-wide performance-based contracts have been implemented. There are three core elements to these contracts: setting targets, developing the contract, and annual reporting on performance. Ministries develop performance contracts with individual agencies (the contracts are not legally binding). In turn, the agencies are required to produce annual reports that detail the results they have achieved *vis-à-vis* outcomes/output targets, specified in the contract. The Danish government's 2004 review of the performance contract system highlighted that there were 119 contracts between ministries and agencies containing a total of 3 701 performance targets. Over 90% of the targets were measurable and 71% related to the external activity of programmes. The reports are written by the agencies, approved by the responsible ministry, and then submitted to the Danish Parliament. While the submission of these reports has been mandatory since 1997, individual ministries have the flexibility to develop their own evaluation frameworks and to decide which programmes they wish to have evaluated.

Second, Denmark developed what it calls the "taximeter model" or direct performance budgeting. This is a form of activity-based budgeting which creates a direct link between the allocation of funds and the results achieved. First used in higher education, it is now applied in schools and in the health care sector.

In 2007, Denmark also launched a quality reform using a comprehensive preparatory process that included thematic dialogue with citizens and experts. This reform targets several priority areas, such as: improving citizen choice and user involvement; improving the coherence of public service *vis-à-vis* the individual citizen; setting clear objectives and targets together with responsibility for results; and encouraging innovation and increasing the involvement and motivation of public employees, which can go a long way to establishing new ways of thinking and a new public service culture.

United Kingdom

The United Kingdom first introduced a Comprehensive Spending Review (CSR) in 1998. Following this, Spending Reviews have taken place every two years until 2004 with a further Comprehensive Spending Review in 2007. HM Treasury runs the Spending Review process, in consultation with departments. It sets three-year expenditure limits and resource allocations for departments and sets out a series of public service agreements (PSAs) which hold departments to account for delivering the government's top priorities. This performance management framework has been developed and refined with each Spending Review, with a reduction in the number of PSAs from 600 to 30 and a greater emphasis on working across government to deliver better outcomes for citizens. Each PSA is established in parallel to decisions about resource allocation, but there is no automatic or direct link.

Box 5.1. OECD country experiences with performance budgeting *(cont.)*

United Kingdom *(cont.)*

The 1998 CSR contained 600 performance targets, which were mainly outputs. The 2007 CSR concentrated primarily on outcomes. There are now 30 new PSAs which reflect a "cross-government" set of priorities, typically spanning several departments. These PSAs reflect the highest priority outcomes for government, a departure from the broader "business as usual" agenda that it traditionally followed. The PSAs are aligned with departments' over-arching performance and financial management through the introduction of departmental strategic objectives.

In contrast to Australia and Sweden, the United Kingdom system is a top-down centrally-driven performance system. The Treasury has led the development and evolution of the PSA framework. This centrally-driven approach helped gain buy-in from ministers and clearly articulated a set of high-profile outcomes. However, these central performance management frameworks can result in a large number of underpinning measures, sub-targets and data reporting requirements. The costs and the diversion from front-line delivery involved in reporting on all these targets can be significant, and there is a risk that communication and delivery of genuine priorities may be undermined. To manage this risk, the United Kingdom has significantly reduced the number of PSAs, improved alignment with local performance management frameworks and increased the involvement of those responsible for delivering the desired outcomes. This helps to ensure a common shared agenda for improvement and reduces the risk of perverse incentives or distortions to delivery. With a new commitment to reduce the total amount of data that central departments and agencies request from the front line by 30% by 2010, there is currently a firm focus to reduce administrative and unnecessary data burdens.

In the United Kingdom, key objectives and outcomes are integrated into the decision-making process at a high political level. Each PSA has a single responsible officer (senior official) who is responsible for delivery of the PSA agreed outcomes, supported by a cross-departmental delivery board. There is also a specific Cabinet committee for each PSA through which Cabinet ministers can escalate and resolve cross-cutting issues. Ministers are also expected to update their committee on progress on the PSA once every six months. A special subcommittee covers public services and public expenditure, chaired by the Chancellor of the Exchequer. This committee discusses progress against agreed success measures, key strategic objectives and challenges.

1.4. Performance-informed budgeting

The majority of OECD countries that use performance information in the budget process engage in performance-informed budgeting**.** In OECD countries, when performance information (performance measures and/or evaluations) is part of the budget process, it is most commonly used to inform budget allocations along with other information on political and fiscal priorities. It is only one factor in the decision-making process (OECD, 2007d). There is no direct or mechanical link between performance (planned or actual) and funding. The connection is at best indirect; there is sometimes a loose link between resources and performance information. When performance information is used, it could be for planning and/or accountability purposes – that is, the finance ministry could use planned future performance to inform funding decisions or use past performance results to hold the agency accountable.

In a recent OECD survey, over two-thirds of countries responded that they do not directly link funding to performance results on a government-wide basis (OECD, 2007b). It is not recommended that a direct or tight linkage between funding and performance results be applied on a systematic government-wide scale. Such automatic linkages distort incentives, generate gaming, ignore the underlying causes of poor performance, and require a very high quality of performance information that is rarely available.

1.5. The challenges

OECD countries have reported many benefits from the development and use of performance information in the budget process. However, no country has mastered it; even countries that have been working on performance reforms for more than ten years continue to struggle with some aspects. Countries have found the introduction of performance budgeting to be challenging both technically and culturally, where the latter refers to the inherent difficulties in changing the behavioural patterns of key actors in the budget process. Continuing technical challenges include how to improve the measurement of activities and the quality of the performance information gained from evaluations and performance measures. Countries also struggle with how to improve the use of performance information in budgetary decision making, how and if performance information should be related to resources, and how to get politicians to use it in decision making.

Country experiences have shown that the existence of a procedure to integrate performance information into the budget process is a necessary but not sufficient condition to ensure its use. Other factors influencing its application include the quality of the information, the institutional capacity of the finance ministry and spending ministries, and the political and economic environment.

2. Portuguese programme budgeting reform

In 2006, Portugal began its first attempt to introduce a government-wide system of performance budgeting. This reform was initiated by the 2006 State Budget Law, which declared that the Portuguese government's 2010 budget proposal must be structured according to a programme budget. As discussed in Chapter 1, the Committee for Programme Budgeting (COP) was established in 2007 to help design this reform as part of a wider budget reform package which includes proposals to introduce an expenditure rule and a medium-term expenditure framework.

The law requires the creation of a programme budget, and the committee is called the Committee for Programme Budgeting. However, it is evident from the committee's first report that Portugal is in fact seeking to introduce performance budgeting. The overall objective of the initiative is to improve public sector efficiency and performance. To achieve this goal, it is necessary to move beyond establishing a programme budget structure, towards developing and using performance information in the budget process.

The COP produced its first report in May 2007; the second report is due in the summer of 2008. In its first report, the committee recommended the creation of programme budgeting pilots. In early 2007, the GTIPOP (the Programme Budgeting Task Force) was created within the MFAP to implement the pilots. The Minister of Finance selected three programmes to be part of the pilot phase. These programmes are located in the Ministries of Health, Higher Education and Foreign Affairs.

The blueprint of the process for full implementation of programme budgeting is still under discussion. The first COP report contains a description and plan on how to move forward and implement the reform. While many of the recommendations in the report are in keeping with current practices in OECD countries, there are unique features that should be highlighted.

First, the report concentrates on measuring outcomes and the impact of programmes on society. While outcomes are important to citizens and politicians, in practice they are difficult to measure. To concentrate primarily on measuring outcomes at the outset of the performance budgeting initiative is unusual. Australia is an exception: the government started with outcome budgeting. However, it has now decided to increase its focus on outputs. Concentrating on outcomes generated non-measurable, ambiguous and even contradicting information about desired goals. In addition, both Parliament and the Department of Finance complained about the lack of basic information on programmes and outputs.

Most OECD countries produce some combination of both outputs and outcomes, although the level of coverage will vary. In practice, it is important to develop performance assessments focused on outputs and not just on outcomes, especially in the initial stages of reform. Also, most governments complement performance measures with evaluations.

Second, the COP recommends creating a programme co-ordinator with responsibility for achieving agency results. This is an original and welcome idea. The programme co-ordinator requires budgetary stability along with managerial and financial flexibility to achieve these results. To better perform given duties, the exact role of the co-ordinator needs to be clarified. It should be complemented by a clearer outline of the co-ordinator's relationship with other actors in the ministry and by a better description of available authorised resources. The co-ordinator should serve as a champion of reform in his/her agency. The co-ordinator should report directly to the minister. Each ministry should have a working group with all co-ordinators as members. There should be a comprehensive government co-ordinators working group, to which each ministry sends a representative.

While the COP report highlights the potential benefits of introducing performance budgeting, it is also necessary to be aware of the challenges. Specific challenges facing Portugal in the implementation of this reform initiative are examined below.

3. Performance budgeting in Portugal: specific challenges

Portugal faces specific challenges in introducing performance budgeting because it seeks to move from a hierarchical system with very detailed control of inputs to the opposite end of the spectrum, a delegated budget system based on performance results. The timetable for achieving these changes is ambitious because performance information is currently limited both in terms of quantity and quality. The challenge is further compounded by the lack of capacity in the MFAP and line ministries to develop these initiatives. Given this, it is important for the reforms to be introduced incrementally in stages and to develop an implementation plan with concrete deadlines, continuous monitoring and clear responsibilities for enforcement.

3.1. Pace and scope of reform

As many of the participants in the Portuguese budget process realise, the introduction of a programme budget by 2010 is a very ambitious target. It is an ambitious timetable even for a country that already has an extensively developed performance information system, which Portugal lacks.

Therefore, it is important to recognise this difficulty at the outset of the reform process.

The programme budget initiative is part of a larger reform package. In the package, multiple initiatives are sought, such as changes to budget formulation, to human resource management and to the structure of government. The danger of multiple initiatives is fatigue, where the process becomes overwhelming, hence resulting in very little actual change.

Given the environment of a large reform package, it is important to introduce the reforms in clear stages while also attempting to capitalise on the opportunity created by the introduction of such a package. Since Portugal is reforming many aspects of its public sector, the opportunity exists to redesign the whole system and generate a reform package which could coherently link the systems for human resource management, accountability and control, and budgeting and performance. Also, because Portugal is adopting these changes later than other OECD countries, it has the advantage of learning from their experiences. To prevent loss of momentum behind such a reform, strong political pressure and leadership is required to push these changes forward.

The performance budgeting initiative is an overarching reform that should be carried out in an appropriately sequenced approach, following three stages. The first stage is developing a programme budget and a medium-term expenditure framework; the second stage is designing meaningful performance information and necessary performance information systems for programmes and ministries; the third stage involves integrating performance information into the budgetary decision-making processes.

First stage: developing a programme budget structure and a medium-term expenditure framework

The first step in this process has already begun in Portugal, with the selection of three programme budgeting pilots. The second step is to have the respective ministries responsible for major policy initiatives develop their own programme budget working from the experience of the pilots. Based on the national plan it would be helpful if these ministries developed mission statements and strategic goals, and explained how individual programmes contribute to these high-level goals.

Then it is necessary to develop specific goals and performance measures for major programmes (if they do not already exist), and to combine them with established divisional goals of the SIADAP initiative. Budget programmes focused on results would thus be combined with organisational budgets focused on results. As experience is gained with measuring results in the context of strategic objectives, more of these ministries' programmes and activities could be shifted to a programme-based structure.

The third step would be to apply programme budgeting to all ministries based on the lessons learned from the pilots and the experience acquired from implementation in major policy areas. Roles could be assigned to the co-ordination group and the MFAP whereby they would both review submissions by the ministries. Subsequently or in parallel, the DGO would put together the first full programme budget.

The next step would be to align the programme budgets with a medium-term expenditure framework (MTEF). This step assumes that both the MFAP and the line ministries have already been working on improving their economic and spending projections and on creating the MTEF structure. Each programme area would have a base year and a three-year spending projection. This alignment could be done in the first or second year of implementing programme budgeting. The combination of programme budgeting with the MTEF should facilitate better expenditure prioritisation over the medium term.

Second stage: developing meaningful performance information and the supporting systems

In the first stage of the reform, ministries would have engaged in primary efforts to develop performance measures. In the second stage, ministries and agencies should develop meaningful performance information and the supporting systems. Developing performance information is very much a trial-by-error exercise, and it takes at least three to five years to develop meaningful performance information. If countries waited to obtain perfect information before engaging in these initiatives, they would never get started. Given this situation, it is important not to become cynical regarding the early efforts but rather to see them as a required first step in a long-term process. It is helpful if the performance measures and targets are reviewed by an independent body and compared across programmes and ministries, so that agencies learn how to improve their performance information.

OECD experiences highlight that these initial efforts tend to produce a large number of performance measures and targets which concentrate on internal processes as opposed to external results. Although the reform is currently focused on performance measures and targets, it is important not to concentrate solely on one type of performance information. It is necessary to see a role for evaluations and to find ways of including the summary of evaluation results in the budget process.

Developing a performance information system is a complicated technical exercise which requires clear guidelines, well-trained staff and proper IT systems. Countries have taken different approaches to developing IT systems. Some have allowed agencies and ministries to develop their own systems within an agreed format and with a reporting requirement to the finance ministry or the Prime Minister’s Office. Others have developed a new linked-up and co-ordinated IT system in which the ministry of finance, ministries and agencies all have the same system. Instant messaging supports greater co-ordination. The latter system is more desirable, but its costs may be prohibitive and operation complicated. These factors should be considered when making the decision to design a new system.

Third stage: integrating performance information into the budget process

By the time this stage is reached, ministries and the DGO should already have experience in developing programme budgets and performance information. The reform process will have already been evaluated, and the system for auditing performance information will also have been developed.

Throughout the reform process, but especially at this stage, it needs to be clearly communicated to line ministries how the performance information will be used in the budget preparation process. In the health sector, progress has been made with the application of direct/formula performance budgeting, but this is not recommended on a government-wide level. Instead, performance-informed budgeting is recommended. In this case, there would be no direct or mechanical links between funding and performance results; such links should be avoided.

A dialogue takes place along with proposed funding discussions. The dialogue can occur at several levels in the budget process: between the spending ministries and their units or agencies; between the DGO and the spending ministries; or as part of the discussions between ministers, the Prime Minister and the Cabinet.

Within ministries, there should be a discussion on performance goals, performance measures and targets. These discussions should include ministers when discussing key targets and important programme projects. These discussions should take place at the appropriate stage of the budget process.

The performance information should also feed into discussions between the DGO and spending ministries, at a senior official level or at a political level. In the United Kingdom, for example, the discussions on key targets take place at the Cabinet committee level within a special committee. In addition, individual ministers are held accountable for the results achieved by their ministries.

3.2. Relaxing input controls

The relaxation of input controls and the delegation of greater financial responsibilities to line ministries and programme managers could be a fourth stage in the process or one that occurs concurrently with stages two and three.

Positive steps have already been taken to delegate some control of human resource management decisions to directors and programme managers. They have the ability to influence performance results either by using additional funds to employ new staff or by rewarding existing staff with bonuses. If managers are to be held accountable for results, it is vital that they also have the flexibility to better manage their staff. The delegation of financial responsibilities could be implemented as a government-wide reform applied to all ministries or selectively.

The experiences of OECD countries highlight that introducing performance budgeting is a long-term process that requires not only institutional reform but also cultural change. It is important to keep the reform momentum going and to have a clear timeline with dates, goals and milestones for each stage. It is important that reform progress be reviewed and evaluated once each stage is completed, and that progress be compared against set milestones. Political support and pressure are necessary to push these reforms, especially at the launch of each new stage in the reform process.

3.3. Central leadership and co-ordination of reform efforts

A key challenge facing Portugal is to develop the capacity and leadership at the centre to guide the reform process at all stages. OECD experiences highlight that the finance ministry needs to play a key role in providing guidance and leadership for other ministries. In terms of the institutional structure, there should be a unit within the finance ministry responsible for implementing these reforms. The unit should report to the Minister of Finance or a high-level designee. This unit would be responsible for setting central guidelines, disseminating best practices, reviewing the information produced, ensuring consistency with standards across ministries, and creating pressure to implement the reforms. The role could be performed by the DGO, but only if – as discussed previously – the necessary structural changes take place and the programme review staff are hired. In addition, the GTIPOP should continue to exist for a number of years to advise and support the implementation of the reforms.

After the pilot phase of programme budgeting, the Portuguese government plans to establish a co-ordinating group (distinct from the GTIPOP) to implement programme budgeting. This new group should include representatives from the DGO, the GPEARI and pilot agencies. It is important for the DGO to be a partner in this effort. The DGO would ensure the role of the co-ordinating group within the budgetary process. The GPEARI should also be involved, to foster co-ordination with the SIADAP initiative. The pilot agencies should contribute their experience in helping to structure the future programme budget. Furthermore, the group could be expanded to include a programme co-ordinator from each ministry.

The programme budgeting initiative should be closely linked with the Integrated System for Management and Performance Assessment of the Public Administration (SIADAP). This linkage will help reinforce efforts to improve performance, avoid overlaps or conflicts between reform efforts, and reduce excessive paperwork for the line ministries. The programme budgeting co-ordination group should work closely with the Service Assessment Co-ordinator Council (SACC).

Already there are clear overlaps emerging: the indicators being created under SIADAP to measure division results will clearly have similarities with those that measure programme results. In addition, the COP calls for operational efficiency and human resource objectives, which are already part of SIADAP. In designing and implementing these systems, care should be taken not to create an additional performance budgeting and management bureaucracy. The co-ordinating group for programme budgeting and the SIADAP should monitor the information requirements and burdens placed on agencies.

3.4. Engaging line ministries in the reform process

There are two further challenges in implementing performance budgeting: first, getting the support of line ministries for the reforms and, second, building ministries' capacity to generate and use performance information. In Portugal, with the exception of a few ministries and agencies, currently there is very little capacity at this level. Ensuring that all ministries have a budget office and a GPEARI with the function of strategic planning and management would help build capacity. However, in addition there will be a need for extensive training programmes for staff and for programme co-ordinators. The MFAP should play a lead role in promoting and developing this training.

It is vital to gain the support and buy-in of line ministries and of those who deliver the programme. There is no budgeting for results without managing for results. If these reforms are to improve performance, the information they generate should be useful for managers, to help them improve the efficiency and performance of their programmes.

A key aspect of gaining the support of line ministries is communication and dialogue. It is important to engage line ministries throughout the process of designing and developing the system. It is necessary to communicate the reform's objectives, the timetable, the stages and the milestones to ministers and civil servants. It is also important to directly address any concerns or fears of line ministries. Performance targets and measures should be discussed rather than imposed on ministries.

The finance ministries in OECD countries have reported that engaging line ministries is one of the more difficult aspects of implementing the reforms. It is part of a long-term process of cultural change and requires persistence. In the experience of OECD countries, the initial reception by line ministries will be mixed, with some ministries and agencies at the vanguard and others only engaging once the process is seriously under way. Other agencies will wait to see if the reforms persist or disappear before engaging in the reform process. Finally, there will be a group that will never take the reforms seriously unless they experience heavy political pressure to do so.

It is also helpful to create a mixture of incentives to motivate agencies to take part in the process. Staff should participate in training, workshops and seminars. Best practices and the experiences of lead performers could be disseminated through the co-ordinating group. As a complement, formal and informal networks could be created to exchange ideas. Other incentives include generating competition among agencies by publishing and comparing results. Political pressure is important to motivate agencies to implement reform. Hard incentives are also possible by linking better performance to a reduction in regulations, hence rewarding performance with greater flexibility. In addition, linking SIADAP with programme budgeting would also generate financial incentives.

3.5. Engaging politicians in the reform process and in the performance dialogue

OECD country experiences highlight the important role politicians play in creating pressure for change. Politicians can be engaged at a basic level by having the co-ordinating group, and/or the unit responsible for implementing the initiative, report regularly to the Minister of Finance or Prime Minister on progress. In addition, programme co-ordinators could also report to their relevant minister on their agency's progress. In some OECD countries, individual ministers are held accountable for the performance of their programmes, either or to the Cabinet or the Prime Minister and/or Parliament. It is also possible to create interministerial performance committees or Cabinet committees which address performance achievements.

In addition, it is vital to engage Parliament in the reform process and, as discussed in Chapter 3, this could be achieved by having an *ad hoc* group or subgroup of the parliamentary Budget Committee to obtain the opinion of MPs, in advance, on the presentational details of the new programme budget. Furthermore, holding seminars would inform MPs and the Budget Committee of the details of programme budgeting and how their own roles will be affected.

4. Performance assessment of the public administration (SIADAP)

The other major reform initiative to enhance public sector performance is the SIADAP, the Integrated System for Management and Performance Assessment of the Public Administration.

4.1. Description of the reform initiative

In 2007, the Portuguese government enacted legislation to establish SIADAP, which came into force in January 2008. It is a complex reform with multiple goals and is currently in the process of being implemented. Its overarching purpose is to promote performance assessments and greater transparency by publishing the results achieved by ministerial divisions (services). The reform aims to measure performance at three levels:

- SIADAP 1: divisions of government;
- SIADAP 2: managers (high and intermediate levels);
- SIADAP 3: employees.

A framework of assessment and accountability, called QUAR, is an assessment instrument to evaluate performance in state, regional and local government services. The QUAR is a self-assessment exercise using a standard electronic form to be completed by each division in a ministry. Each division specifies its available resources (human and financial) and, in alignment with its mission statement, breaks down its strategic goals into operational goals emphasising improvements in effectiveness, efficiency and quality. In addition, divisions are required to produce performance indicators and targets to measure the progress towards achieving these operational goals. In 2009, achieved results and failures to meet set targets will be published by the divisions on the Internet.

The SIADAP creates an incentive system to promote performance. The top 20% best-performing divisions (services) in each ministry may receive a performance reward. This performance merit reward can take three forms:

- First, an increase in the maximum percentages of intermediate managers and employees who can receive the highest level of performance rating in their individual assessment (relevant and excellent, respectively).
- Second, an increase in funds available to finance changes in the pay grade/step of workers or to award bonuses.
- Third, obtaining budgetary appropriations to support the implementation of new projects which contribute to improve service performance.

An "unsatisfactory performance" ranking will provide grounds for the reassessment of the division's existence, mission, organisation and activities. Although it has not yet been clarified who will conduct this reassessment, the most obvious candidate is the General Inspectorate of Finance (IGF).

The GPEARI unit in each ministry is responsible for conducting and monitoring the self-assessment exercise in its ministry. This unit validates each division's results and recommends to the minister which divisions should receive a performance reward. A Service Assessment Co-ordinator Council (SACC), headed by the Secretary of State for Public Administration, has been created to co-ordinate the assessment process for all services in the public administration. The SACC will promote the implementation of the initiative and good practice. However, the Council is still very much in the development stage.

4.2. Challenges and issues

By evaluating the performance of organisations, managers and employees, the SIADAP initiative takes a comprehensive approach to strengthening public management in Portugal. The initiative is in its early stages. Therefore, some issues and challenges related to the reform's design as well as its implementation and incentive system require careful consideration, as discussed below.

Design issues

The reform aims to achieve multiple objectives; the relationships between these different goals should be clearer, as could the guidance on how to achieve them.

Clarity of objectives would be further enhanced by articulating the difference between the assessment of divisions – namely, whether they are achieving results and meeting performance targets – and the assessment of institutional settings – namely, whether a division has the right management processes and systems in place to support improving performance.

In addition to assessing performance, the SIADAP aims to improve the focus on customers and end-users of services. However, there is no central guidance on how this should be achieved or what systems should be in place. To encourage consistency across government, common principles of customer service and quality service standards could be established, to which all public servants would adhere. This is a common practice in OECD countries, with 50% of the countries having Citizens' Charters which set out standards and goals for providing high-quality services to citizens.

To help develop these standards of quality management and customer service, the government could examine international standards for quality management systems including IS0 900s and the European Common Assessment Framework. Also, some OECD countries have implemented their own standards and approaches. For example, Canada has a common measurement framework and Chile has the Management Improvement Programme (see Box 5.2).

Implementation issues

The role of key institutional actors – the SACC, the GPEARI within the Ministry of Finance and Public Administration, individual ministries, and the IGF – in implementing the SIADAP reform needs to be clarified.

It is necessary to have rigorous central co-ordination and review of objectives, performance indicators and assessments. The SACC, with support from the GPEARI in the MFAP, should take on a stronger leadership role in terms of issuing clear guidance on developing these reforms and ensuring consistency in the application of guidelines across government. These guidelines should include:

- definitions and examples of what is an output and what is an outcome;

- recommendations on setting quantifiable operational goals and on the number of goals;
- guidance on how to develop performance measures and targets, and how to benchmark performance against agreed standards or historical performance.

Box 5.2. Chilean Management Improvement Programme (MIP)

This programme started in 1998 from an agreement with the public sector unions. The programme is similar to ISO standards in that it focuses on improving management processes within agencies against a pre-established benchmark. It enhances performance by improving the internal management processes of ministries, hence better enabling agencies to achieve their wider objectives and targets. The managerial areas include: human resources; quality of customer services; planning, control and territorial management; financial management; and gender focus. Each of these areas is further divided into systems. In every system, progress is measured either in stages 1 through 4 or 1 through 6. By 2004, the MIP functioned in 88 centralised agencies and 89 decentralised agencies.

The programme operates as follows: the Ministry of Finance prepares a general framework which includes areas, systems and stages. The framework is discussed and approved by the interministerial committee. It is then sent to each agency which subsequently prepares its proposal according to the framework. In the proposal, the agency states the overall stage in each managerial system it wishes to reach by the end of the year. These proposals are submitted to the Ministry of Finance, where they are reviewed by a network of specialists. The proposals are then sent to the interministerial committee for approval. This committee consists of members from the Ministries of the Interior, Presidency, and Finance. Once the proposals are approved by the committee, agencies prepare a decree that sets out their new commitments for the coming year. This decree is issued by the relevant ministry and approved by the committee.

In the following year, agencies produce an MIP report detailing their progress against management objectives. The report is certified by a network of specialists, and each agency’s internal auditors check the results. In 2002, 79% of agencies achieved 90-100% compliance with MIP objectives; total compliance with objectives reached 93%. When the agency meets 90-100% of its organisational objectives, staff will receive a 3% salary increase for the following year, and achieving 75-89% of objectives results in a 1.5% salary increase for the following year.

The GPEARI within individual ministries could apply these standards to the work of the divisions. In addition, the SACC should compare the objectives and targets across ministries and highlight best practices. For example, the performance results of divisions and ministries could be compared by combining the reports of the ministries into one annual report.

A clear rating system, developed in consultation with ministries and divisions, would enhance transparency – for example, the United States Program Assessment Rating Tool (PART) or a similar system developed by the Korean government.

The IGF has a key role to play in this process. Since this reform is very heavily dependent on self assessment, it is important to introduce an element of independent evaluation. The IGF should review the objectives, indicators and results of a selection of divisions and provide recommendations for improvement. These reports should be sent to the relevant ministry and the SACC. Furthermore, the IGF could take the lead on assessing divisions that have achieved an unsatisfactory grade, and could make recommendations on how to improve performance. Finally, the IGF and the SACC can play a role in the training of ministerial GPEARI and divisions and in promoting good practices.

In order to ensure that the reforms are actually implemented, the reform process itself and implementation of the reforms within ministries should be evaluated. This could be carried out by an independent commission or the external audit body.

The role of ministries in this reform also needs to be clearer. The SIADAP is designed to integrate the planning system and management cycle of each ministry and to assess compliance with multi-year strategic objectives. In practice, it is not clear how this will be achieved. In theory, it should be a top-down process, with the ministry's mission statement, strategic goals and plans driving the setting of objectives for divisions. However, the SIADAP is a very bottom-up process, with divisions setting their own objectives and targets. While it is important that divisions feel ownership of their goals and targets, it is also necessary that these goals relate clearly to the wider objectives of the ministry and its programmes. This issue highlights the importance of co-ordinating and linking the development of a programme budget with the SIADAP reform.

Incentive issues

The SIADAP directly links individual performance assessment (evaluation) to organisational performance. This assessment is in turn linked to pay.[1] In theory, these linkages should create incentives to motivate individuals and divisions to improve performance.

The quota system sets tight limits on the number of divisions (only the top 20% in each ministry) and individuals that can receive a top merit award

(5%). It is designed to prevent grade inflation whereby, without this safeguard, all divisions could give themselves the top grade to receive bonuses. If there were no quota system, the reform could become a means to increase pay without any improvement in performance.

In Portugal, however, the current reward structure is very narrow in scope; a large percentage of employees are completely excluded. This could lead to de-motivation, especially since the introduction of SIADAP is associated with the creation of a single salary scale in which moving up one step in the pay scale is dependent on an individual's performance ranking (excellent, relevant, and adequate). The individual performance rankings are capped by a quota system, with the result that 75% of the civil servants (*i.e.* those who do not attain the performance ranking of excellent or relevant) must wait at least five years before moving up one step in the pay scale. While this could help to control the wage bill and costs, over the long term it could have a detrimental impact on individual motivation and performance.

There is also the danger that more or less the same divisions monopolise the rewards within a ministry. As the reform develops, consideration should be given to how rewards could be more evenly distributed and how to reward improvements. For example, giving rewards to individuals and/or divisions with the greatest progress and improvement from one year to the next could encourage continued improvements. Also, non-financial rewards such as extra leave or sabbatical leave could be given. Often these non-financial rewards could help to motivate performance.

In addition, given that the SIADAP is a self-assessment exercise, the linkages between organisational performance, individual assessments and pay do create incentives for divisions to set easy targets and manipulate data collection and results. Thus, it is important to foster the involvement of an independent element such as the IGF in evaluating the performance objectives and targets.

This reform will be introduced over a three-year period. It is important to introduce it slowly because it takes time to develop performance indicators that are meaningful and to have standards that are consistent across government. Indeed, this timeframe may not be long enough to develop high-quality performance information.

In Portugal, this move from a system of employee assessment that rewards seniority and length of service to one that emphasises performance is long overdue. More than two-thirds of OECD countries claim to have introduced performance-related pay (PRP) for at least part of their civil service.

OECD experiences highlight that PRP can help improve performance if it is applied in the right managerial context – that is, under conditions of transparency, clear promotion mechanisms and trust in top and middle management (OECD, 2005). Improvements, however, have less to do with the financial rewards given than the changes in work and management arrangements that are needed to implement PRP. OECD research indicates that staff are less motivated than expected with the prospect of better pay for better performance (OECD, 2005). Most public sector employees consider basic pay, and how it compares to the wider job market, as far more important than supplementary increases for performance. Performance rewards are often very limited in the public sector. Job content and career development prospects have been found to be the strongest incentive for public employees (OECD, 2005). PRP should not be introduced to the detriment of the base salary, as the base salary has the more decisive incentive impact.

The SIADAP is part of a wider managerial and organisational change. If PRP is to be a successful lever to support this change, careful consideration needs to be given to the design and the incentive structures. To successfully link organisational performance with individual performance assessments, special attention needs to be given to the incentives generated by this new system, such as reframed career prospects and pay, and how they will impact the behaviour of individuals and teams both in the short term and the longer term.

In sum, as the SIADAP moves forward, there needs to be: further clarification of reform objectives; more central co-ordination and guidance; clearer roles for the IGF and individual ministries; more in-depth consideration of the design of incentive structures; and greater integration with the programme budgeting reform.

5. Conclusion and recommendations

The adoption of performance budgeting is a very important reform for Portugal. Introducing programme budgeting by 2010 is, however, an extremely ambitious timetable. For Portugal, this timeline is particularly challenging because it wants to move from one end of a spectrum, where it has a highly control-oriented system, towards the other end, which is a performance-based system of budgeting.

A more staged and appropriately sequenced approach is needed for implementing these reforms. It is important to have a clear implementation plan with defined timetables, stages and actions to be taken, and milestones to be achieved. It is also necessary to establish clear roles and responsibilities for the key actors in the process and to hold individuals to account for fulfilling their responsibilities. OECD experience shows that this is a long-term process which involves cultural and behavioural change. Despite this challenge, countries are evolving their approaches, not discarding them. As citizens continue to demand better value for money for their tax payments, there will be a continuing need for performance budgeting.

Key recommendations for implementing performance budgeting

Generate realistic expectations about the timeline and the challenges involved in creating a programme budget, to help manage the process. Introducing programme budgeting by 2010, as initially envisaged in the 2006 budget, is not realistic. It would be challenging even for a country with extensive experience of developing performance information, which is not the case for Portugal. The experience of other OECD countries shows that it takes at least three to five years for performance initiatives to develop meaningful performance information. Given this collective experience, it is important to see this reform as the first step in a long-term process which involves learning by doing.

The implementation of the performance budgeting initiative should be in stages. The first stage is the development of a programme budget and a medium-term expenditure framework; the second stage involves the development of meaningful performance information for programmes and ministries, and the design and implementation of the necessary information systems; the third stage is the integration of performance information into budgetary decision-making processes.

Co-ordinate reform efforts. The programme budgeting initiative should be closely linked with the Integrated System for Management and Performance Assessment of the Public Administration (SIADAP) reform. This will reinforce efforts to improve performance, avoid overlaps or conflicts between reform efforts, and reduce excessive paperwork for the line ministries.

The co-ordinating group for programme budgeting should include representatives from the DGO, the GPEARI and pilot agencies. It is important that the DGO be a partner in this effort, to ensure that it is not a one-time exercise implemented outside the budget framework. The GPEARI in the MFAP should also be involved, to foster co-ordination with the SIADAP initiative. The pilot agencies should contribute by sharing their experience in helping to structure the future programme budget. The co-ordinating group should be responsible for setting central guidelines, disseminating best practices and reviewing the information produced. In addition, it could ensure consistency in standards across ministries and create pressure to implement the reforms. The Programme Budgeting Task Force (GTIPOP) should continue to exist for a number of years to advise and support the implementation of the reforms.

The unit responsible for implementing these reforms should report to the finance minister or a high-level designee. In OECD countries, this role is played by either the Ministry of Finance or the Prime Minister’s Office. The role could be performed by the director general of the DGO, but only if the necessary structural changes take place and if the appropriate programme review staff are hired.

Key recommendations for implementing performance budgeting *(cont.)*

Add an independent element in the review of performance indicators and results. OECD experience highlights that it is important to have an independent review or audit of performance information to ensure quality and credibility. This is especially the case for Portugal, since the SIADAP proposes to link performance results to pay. While this linkage creates incentives to achieve targets, it would also generate incentives to manipulate information and might encourage gaming. An independent role could be performed by the General Inspectorate of Finance, the IGF, which is already active in this area and has a technical committee on evaluations. In addition, an independent commission or the external audit body could have a role in reviewing the overall system.

Develop different types of performance information and measures. It is important to develop both evaluations and performance measures. The current proposal for programme budgeting concentrates primarily on developing outcome measures. In practice, outcomes are more difficult to measure than inputs or outputs. Most OECD countries begin with outputs and then move on to outcomes, eventually ending up with some combination of both. It is important to develop outputs and not just concentrate solely on outcomes. In the initial stages, it would be appropriate to concentrate on indicators rather than targets; this will help focus on developing meaningful information rather than focusing on achieving targets "at all costs".

It is vital to gain the support and buy-in of line ministries and of those who deliver the programme. Support could be created through a mixture of soft and hard incentives. It is important to engage line ministries throughout the process of designing and developing the system. The information generated has to be useful for managers themselves. Relevant staff can be asked to participate in training, workshops and seminars. Best practices and the experiences of lead performers could be disseminated through the co-ordinating group. To complement this effort, formal and informal networks could be created for exchanging ideas. Other incentives include generating competition among agencies by publishing and comparing results. Political pressure can help to motivate agencies to implement reform by having programme co-ordinators report to the relevant ministers on their progress. Hard incentives are also possible by rewarding better performance with reduced regulations and greater flexibilities. In addition, linking SIADAP with programme budgeting would also generate financial incentives.

Establish a performance dialogue as part of the budget process. It needs to be clear how the performance information will be used in the budget preparation process. In the health sector, progress has been made with the application of direct/formula performance budgeting, but this is not recommended on a government-wide level. Instead, it is recommended that there be performance-informed budgeting. In this case, a dialogue occurs on proposed funding and performance. The dialogue could take place at several levels in the budget process, for example between the spending ministries and their units or agencies, between the MFAP and the spending ministries, or as part of the discussions between ministers and the Prime Minister and Cabinet.

Key recommendations for implementing performance budgeting *(cont.)*

Engage politicians in the reform process and in the performance dialogue. OECD country experiences highlight the important role politicians play in creating pressure for change. Politicians could be engaged at a basic level by having the co-ordinating group and/or the institution responsible for implementing the initiative report on progress regularly to the Minister of Finance or the Prime Minister. In addition, programme co-ordinators could also report to their relevant minister. In some OECD countries, individual ministers are held accountable for the performance of their programmes either to the Cabinet, the Prime Minister, and/or Parliament. It is also possible to create interministerial performance committees or Cabinet committees which address performance achievements.

Note

1. Pay is linked to organisational performance in a less direct manner. Only two out of the three performance merit reward options that ministers could give is related to pay. The minister can only give an award to the top 20% best-performing divisions, and only those employees in these best-performing divisions can receive a reward.

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