ISSN 1608-7143
OECD Journal on Budgeting
Volume 7 – No. 3
© OECD 2007

Off-Budget Expenditure: An Economic and Political Framework

by
Allen Schick*

This paper, originally presented at the 1981 meeting of the OECD Working Party of Senior Budget Officials, discusses the fundamental purposes of budgeting and explores how off-budget expenditures weaken a government's financial control. The paper gives insights on many aspects of budgeting that are still relevant today: the transformation of the public sector, the interface with the private sector, the scope and size of government, the role of regulation, the emergence of new organisational forms, and the use of performance objectives and long-term planning.

* Allen Schick is Visiting Fellow, Governance Studies, The Brookings Institution, Washington DC, and Professor, School of Public Affairs, University of Maryland, United States. At the time this paper was written (1981), Professor Schick worked in the Congressional Research Service, United States.

A sense that government expenditures are out of control pervades contemporary budgeting. This feeling is not confined to critics of enlarged public spending but is shared by government officials in many developed countries. Budget officials hold to this view most intensely; they see the process which they command as unable to control the trend in government spending. Their best efforts are of little avail against the forces that dictate fiscal outcomes.

Evidence of weakened budget control is plentiful. Governments habitually announce their determination to curb public sector deficits and to hold spending increases to the growth in gross national product (GNP), only to have these objectives aborted by economic and political realities. Total expenditures and the amounts spent on particular programmes often exceed the levels authorised in the budget. For many programmes, the budget has been transformed from an instrument for making government financial decisions into a process for estimating the costs of decisions made by other means. Worse yet, major expenditures are undertaken without any cognisance of them in the budget. The budget no longer controls: *force majeure* rules public finance.

Inadequate financial control affects not only the amount of expenditure but its propriety as well. Fraud and abuse have become widespread concerns in many OECD countries, and the controls that once guarded against the misuse of public funds seem incapable of restoring trust to public expenditure.

The erosion of financial control has seriously weakened the effectiveness of government budgeting. The primary function of budgeting, upon which other critical uses are predicated, is to ensure that public funds are spent only for authorised purposes. Without reliable financial controls, the budget cannot be used for other important government functions such as managing the economy, improving administrative efficiency, and formulating public objectives and priorities. If actual expenditures do not conform to the levels specified in the budget, or if the real spending decisions are made outside of the budget framework, it is of little value for the government to go through the rituals of deciding what should be in the budget. Only when it controls spending can the budget be effectively applied to larger political, economic and management purposes.

When modern budget systems were introduced (in the late 19th century in some European countries; in the early 20th century in the United States), reformers gave highest attention to the imposition of financial controls. Toward this end, accounting practices were standardised, budget staffs were

organised and empowered to review the activities of spending ministries, rules for the handling of public funds were elaborated, and audit procedures were developed. By the 1950s, budgeting in various OECD countries had progressed to the point where the basic requirements of financial control were deemed to have been satisfied. It was possible, therefore, to orient budgeting to more ambitious purposes such as economic stabilisaton and programme planning. Planning programming budgeting (PPB) and other advanced budget techniques reflected this shift in emphasis from financial control to policy formulation.

Budget makers are no longer confident that the controls they operate are adequate to the conditions of contemporary government. Every budget brings fresh confirmation of their lack of control. They must constantly remake their budgets in response to changes in economic conditions and other factors beyond their control. Rather than the budget controlling expenditures, spending controls the budget.

No single factor accounts for the attrition in budget control. Weak economic performance, the indexation of government expenditures, expansion of entitlements and other legal claims on public funds have all taken a toll. This paper examines one of the factors in the loss of budget control: off-budget expenditures. In order for the budget to be an instrument of financial control, it has to be the process by which financial decisions are made and enforced. Off-budget expenditures violate this condition and thereby impair budgetary control.

Strictly defined, off-budget expenditures refer to financial transactions that are not accounted for in the budget. Rather than being a complete statement of public expenditures, the budgets of most countries exclude certain governmental activities. Off-budget expenditures can apply to direct spending by government ministries, but they are more likely to involve special transactions such as the activities of public enterprises, credit provided or guaranteed by government, or subsidies channelled through the tax system. Because of their special characteristics, these types of activities are often excluded from the regular accounts.

From the perspective of financial control, a mechanistic definition of off-budget expenditures does not suffice. The key issue is not whether an item happens to be entered in the budget, but whether its expenditures can be effectively controlled through the budget. Many of the off-budget expenditures have characteristics that would impair their controllability even if they were nominally brought within the budget's scope. In addressing the problem of off-budget expenditures, one should focus on the factors that facilitate or impede budget control, not on the accounting issue alone. (It might be

appropriate if these transactions were designated "extraordinary" expenditures, but this term is applied in some countries to different purposes.)

Yet one must also be wary of broadening the off-budget concept to cover any expenditure that escapes effective budget control. Although governments typically exercise weak control over entitlements, indexed programmes and payments on the public debt, these generally are not classified as off-budget expenditures. Perhaps the most useful definition of off-budget expenditure is one that considers both the extent to which an activity is accounted for in the budget and its controllability. As used in this paper, off-budget refers to various classes of transactions that are often (but not always) excluded from the budget and are difficult to control through ordinary budgetary processes.

Off-budget expenditures pervade contemporary governments. They are neither aberrations of the budget process nor occasional deviations from established norms. Although they are sometimes used to escape budget control, off-budget practices are normal incidents of modern governments. They flourish where government actively seeks to manage the economy, redistribute resources, promote investments and pursue a broad range of social objectives. Off-budget expenditures are most likely to occur in mixed, interventionist economies where the boundaries between the public and private sectors are blurred and where the government attempts to influence private behaviour with incentives and sanctions.

1. The transformation of the public sector

To understand the contemporary problem of off-budget expenditure, it is necessary to take account of the transformation of national governments from providers of public services into purchasers of services provided by others and redistributors of income. This transformation has proceeded in all OECD countries, though not to the same extent everywhere. Although the traditional service role (for example, the protection of health and safety) continues, it consumes a declining portion of the government's budget. A much larger share is disbursed to various private or quasi-governmental spenders.

At one time, governments operated in a simple two-stage expenditure process. First the national legislature voted appropriations for agencies; then the agencies spent these funds on their own operations. This arrangement applied to almost all of the public sector though, of course, agencies also spent some of their funds to purchase goods and services from private vendors. The budget was essentially an accounting for government administration, and it covered virtually all of the financial activity of government. In these circumstances, "comprehensiveness" emerged as one of the cardinal principles of budgeting. Since the budget was spent on agency operations, it was not difficult to satisfy the comprehensiveness rule. The main violations occurred

in the treatment of extraordinary income (earmarked revenues, bond proceeds and development assistance) and extraordinary expenses (capital improvements, development projects and spending out of special funds). In many countries, the budget was divided into ordinary and extraordinary accounts, but by annexing the special funds to the budget, it was possible to display the full financial activity of the government. The chief problem was not the incompleteness of the budget, but the preferential status of the extraordinary items.

This simple budget arrangement no longer prevails. Nowadays, the budget is dominated by transfers from government to "third" parties. Most of the budget goes to contractors or enterprises, subnational governments, and recipients of transfer payments. This transformation of the public sector occurred much later in the United States than in most OECD countries. Yet even in the United States, more than 75% of the national budget is distributed to outsiders; the percentage is surely higher in various OECD countries.

When the public sector spills beyond agency boundaries, comprehensiveness no longer offers a useful criterion for determining the scope of the budget. After all, when the scope of the public sector is uncertain, the composition of its budget cannot be fixed with precision. In effect, contemporary governments have inherited budget practices designed for a self-contained public sector, but ill-suited for the interactions that regularly occur between public and private entities.

In place of the two-stage budget process, there now exists a third stage in which appropriations nominally made to public agencies are disbursed to parties on the margins of government. But more has been changed than the locus of final expenditure; the relationship between the public and private sectors has also been altered. By offering financial inducements, governments pursue public objectives through private actions. In so doing, the social costs are no different than if the funds had been directly spent by government agencies. Thus, financial accounts confined to items conventionally reported in national budgets would not show a full picture of the costs imposed on society by government.

2. Guidelines for determining off-budget expenditures

As long as governments spent primarily for their own operations, comprehensiveness provided an operational rule for determining the proper scope of the budget. Now that governments influence private behaviour in myriad ways, a new rule is needed to determine what should be included in the budget (or in a broader process that might supersede the budget for making financial decisions). The rule applied here is frequently used in economic analysis: any cost that serves the same public objectives as a direct expenditure should be included in the government's accounts. This

"substitution" rule would enable government to consider costs borne by society, not only those charged to its own agencies.

Consider, for example, a government objective to relieve congestion at certain airports. It could pursue this objective in a number of ways, some of which would be on budget and some off budget:

- It could appropriate funds to the aviation ministry for the expansion of airport facilities. This direct expenditure is conventionally included in public budgets.
- It could authorise a public enterprise to borrow funds for expansion and to cover debt service with user charges. The extent to which these transactions were accounted for in the budget would depend primarily on the status of the enterprise.
- Alternatively, the government could raise airport fees to discourage use, thereby relieving congestion without new facilities. The fees would normally be recorded as receipts in the budget.
- Rather than raising revenues to discourage use, the government might lower them to subsidise expansion. For example, it could extend tax credits to private airport operators who would invest in new facilities. In conventional budgeting, these credits reduce receipts but would not be recorded as expenditures.
- Instead of tax credits, the government could offer loans (at market or preferential rates) to airport operators. The budget treatment of these loans varies greatly among developed countries. In some instances, loans are converted into grants or repayment is deferred because the borrowers are unable (or unwilling) to repay them.
- A variant of direct loans would be for the government to guarantee loans made to airports by private institutions. Because it is a contingent liability, the guarantee is likely to be off budget, though outlays pursuant to default would be entered in the budget.
- Rather than offering financial inducements, the government could limit use of the airport, thereby obviating the need for expansion. The regulatory costs would not appear in the budget.

This illustration pertains to the use of physical assets, but it could be applied to income transfers and many other public objectives as well. Whenever government has the option of relying on indirect action (through "quasi" public or private entities), it can shift from direct to off-budget expenditure. Clearly this option generally is not practicable for the conduct of foreign policy or the maintenance of armed forces, but it applies to the bulk of public activity.

The airport illustration shows that off-budget expenditures can be measured in a variety of ways. In a narrow sense, off-budget expenditures can

be limited to "government costs" such as direct expenditures or credit provided at concessional rates. A broader definition would encompass all financial costs imposed on society by government, whether or not the goverment bears the costs. According to this "social cost" definition, any government policy or action that uses resources, or compels their use by others, would incur off-budget expenditures, even if no funds were actually spent by the government.

The broader "social costs" approach has several advantages. Inasmuch as interest in off-budget expenditures arises from concern that ministries and governments might conceal the true cost of their policies, it would be inappropriate to disregard the means by which governments shift costs from themselves to society. In terms of the substitution principle discussed earlier, social costs provide a fuller measure of government options than can be gleaned from a consideration of government costs. If the budget were confined to government expenditures, public officials would have an incentive to shift costs from government to society. But if all substitutes for direct expenditures were defined as costs, decision makers would be indifferent on aggregate economic grounds to the form that the costs would take.

Yet, one must be mindful of the real difficulties of devising an expanded resource allocation process to encompass social costs. Not the least of the virtues of conventional budgeting are the ease of accounting for direct expenditures and the political agreement that can be obtained concerning programme costs. Once government ventures beyond its own accounts, however, it encounters technical and political problems in estimating social costs. In lieu of cash outlays, government needs proxy measures for the costs of its policies, and these often entail value judgments.

As a practical matter, governments are unlikely to convert from direct-expenditure budgeting to comprehensive social-cost accounting. They are likely to extend budget coverage only to those costs for which agreement can be secured, while treating other costs in auxiliary presentations rather than in the core budget.

For the most part, this paper deals with government costs. However, in order to provide a broad treatment of the off-budget problem, at various points the analysis is applied to both government and social costs.

3. Choosing among budget options

When governments can operate through direct expenditure or by off-budget means, they often take the latter course. It is convenient and logical to suppose that they behave in this fashion to escape budget controls. From the standpoint of a public official, it would seem costless to shift to society the burden of performing a public objective rather than to show it in government accounts. The natural incentive to behave this way is stimulated when

government operates under political or legal limits on expenditures or deficits. In these circumstances, it is possible to abide by the limits while spending (or borrowing) more through off-budget instruments. In the United States, evidence of this behaviour comes from state governments that authorise public corporations to issue revenue bonds outside the debt limits established in their constitutions.

Several considerations suggest, however, that more fundamental forces are at work than budgetary expediency alone. For one thing, until recently, budget control was not very stringent in most OECD countries. Why should governments try to evade controls which do not restrict their freedom of action? Moreover, the growth in off-budget expenditure has been concurrent with the growth in direct expenditure. It appears that, although the various forms of expenditure are substitutes, they are all subject to the same forces that have expanded the scope and reach of the public sector.

In seeking cause and effect for the rise in off-budget expenditure, the focus must be shifted from economics to politics, from the aggregate effects of government policy to the distributive outcomes. The various spending instruments available to government differ in the incidence of the cost and in the distribution of benefits. When public officials choose among the options, they are deciding how costs and benefits are to be apportioned in society.

The cost of direct expenditure is borne by taxpayers as a whole; the cost of tax credits, by contrast, is apportioned among all taxpayers other than those receiving the credit. Where public enterprises are required to cover their expenses internally, users pay the costs; when enterprises have access to "soft" loans, the cost is shifted to taxpayers or to other borrowers competing for available funds. In the case of regulation, the costs might be internalised (borne by those directly subject to the regulation) or externalised (shifted to third parties).

Just as the distribution of costs varies with the option used, so too does the distribution of benefits, for what is a cost from one perspective is a benefit from another. Direct expenditure for airport expansion benefits air travellers; fees that discourage airport use benefit persons who travel on expense accounts; tax credits assist airport operators in acquiring physical assets; loan guarantees help marginal borrowers who might otherwise be shut out of the market or be compelled to pay higher interest costs.

The conclusion can be drawn that distributive politics, not budgetary evasion, is the principal consideration in selecting the instrument of government policy. The process of selection is not simply one of analysing the economic consequences, but one in which the potential beneficiaries and losers vigilantly seek to influence the decision. The changing composition of the public sector

means not only that government spends more on outsiders, but that these outsiders have become parties to the budget.

Consider again the two-step expenditure process outlined above. An agency seeking appropriations deals directly with central authorities (the finance ministry, a legislative committee, or a cabinet subcommittee, for example). The process tends to be insular; government officials negotiate with government officials and reach agreement on the budget. But when a third step is added to the expenditure process (for example, the transfer of funds from ministries to outside entities), the making of a budget is opened to outside influence. Enterprises manœuvre for loans and subsidies; taxpayers press for various preferences; lenders seek guarantees and borrowers look for below-market loans; subnational governments demand assistance in meeting their own expenses; and interest groups petition for new regulations.

When deciding among the available policy instruments, governments respond to and often negotiate with these outside claimants. Among the arguments used by these outsiders is that it is costless for government to assist them through off-budget expenditures. The arguments are quite familiar to anyone who has served in a central budget role: borrowers claim that loans are costless because government does not have to advance any of its own funds; enterprises promise that, with an adequate infusion of public money, they ultimately will be able to return a profit.

The magnitude of off-budget expenditures attests to the political potency of these arguments. Yet when government chooses among policy alternatives, it does more than apportion costs and benefits; it is also defining its scope and role, and the relationship between the public and private sectors. This side-effect can be shown by comparing direct subsidies and tax expenditures. A tax expenditure represents income forgone by government. From the perspective of the beneficiary, it has the same value as a direct subsidy. But the two forms of expenditure are not politically equivalent. Spending through tax expenditures reduces the relative size of the public sector; direct expenditures enlarge the public sector. Thus, every trade-off between these two policy instruments entails a political decision concerning the scope and size of government.

When examining the various policy alternatives, therefore, it would be appropriate for public officials to consider macropolitical issues (the role of government) in addition to micropolitical questions (who pays and who benefits). Although it is difficult to design and operate, an off-budget expenditure framework is essential for considering these issues.

4. Types of off-budget expenditure

Before assessing the effects of off-budget expenditures on control of the budget and finances, it is necessary to identify the main off-budget practices.

This is not an easy task because there is no limit to the types of off-budget expenditures that can be contrived. Off-budget expenditures can be classified into four categories, distinguished from one another in the type of expenditure. These are:

- forgoing revenues through preferences to taxpayers (tax expenditures);
- providing credit to private borrowers (direct and guaranteed loans);
- imposing private costs on private parties (regulation);
- direct expenditure by entities that are excluded from the budget (public enterprises).

4.1. *Tax expenditures*

Tax expenditures are the revenues forgone by government because of its deviations from its basic tax structure. For government, a tax expenditure is a loss in revenue; for a taxpayer, it is a reduction in tax liability. The term suggests that revenue losses have expenditure and subsidy effects similar to those of direct expenditures. The term was introduced in the United States in the 1970s and has gained currency in other OECD countries, though terms such as tax reliefs, tax aids and tax subsidies are also used.

Tax expenditures take various forms, such as exclusions from income, special tax rates, credits against tax liability, deductions, and the deferral of tax payments. The common element in these techniques is that they reduce tax liability and government revenues.

The concept of tax expenditures has provoked intense ideological controversy. Some reject the term because (they argue) it connotes that all income belongs to the government unless it is returned in the form of tax expenditures. Others insist, however, that the term merely indicates that a government can accomplish public objectives by forgoing revenues and that it therefore ought to regard tax expenditures as alternatives to direct expenditures.

This ideological dispute is linked to the issue of whether tax expenditures entail social costs. Every tax expenditure is by definition a cost to government. A tax expenditure also incurs a social cost if it induces private expenditures that would not otherwise be made. Many tax expenditures change private consumption or investment; some, however, reduce taxes without stimulating additional expenditures. For example, if a firm has already planned for the purchase of equipment, an investment credit might provide it with higher after-tax income without generating additional investment. Those who reject the concept of tax expenditures would not impute any social cost to the investment credit since it leaves society in exactly the same position it would have been without any tax. Those who endorse the concept would regard the

investment credit as a social cost since it produces a different distribution of income than would prevail in the absence of the credit.

Because a tax expenditure is a cost to it, a government can face the issue without trying to resolve the ideological question. The basic issue for government is whether a particular objective is to be pursued through tax incentives or direct expenditures. The trade-off between tax and spending methods involves economic considerations (which is the more efficient course of action?), macropolitical questions (should the activity be conducted in the public or the private sector?) and micropolitical questions (who benefits and who bears the costs?).

Tax and direct expenditures are not pure substitutes. They can lead to quite different distributions of social resources and social costs. These differences, more than the evasion of expenditure controls, account for the widespread use of tax expenditures. If tax expenditures were to leave everybody no better or worse off than would direct expenditure, taxpayers would be indifferent as to the course that government follows. Taxpayers are not indifferent because tax expenditures promise a better deal than they expect to get through direct expenditure.

Tax expenditures are a function of tax burdens. Where tax rates are high, tax expenditures also tend to be high. The simplest way to curb tax expenditures (other than through credits of fixed value) would be to lower the basic tax rates. Conversely, when tax burdens rise (whether because of inflation, economic growth or discretionary policy), tax expenditures also rise. High tax rates have a political as well as an arithmetic link to tax expenditures. Where tax burdens are high, taxpayers have greater incentive to seek relief than if the burden were lower.

4.1.1. Budgeting for tax expenditures

In order for tax expenditures to be used in budgeting, they have to be measurable. But the measurement of tax expenditures is much more problematic than the measurement of direct expenditures. Value judgments cannot be avoided, and these are likely to vary among OECD countries. A classification of tax expenditures that comports with the practices in one country might be unsuitable for international comparisons. In general, the concept of tax expenditures can be more appropriately used to analyse tax and spending policies within than between countries.

The problem begins with definition of the "basic tax structure". It is generally agreed that "structural" elements of a tax system should not be recorded as tax expenditures, while "programmatic" features should be. Most tax subsidies do not pose any difficulty; they are intended for a particular social objective and can be classified as deviations from the normal structure.

Some exclusions or preferences are not so clear cut, however. The United States practice is to exclude deductions for dependents from the list of tax expenditures. On this basis, the United Kingdom child tax allowances might be regarded as structural elements, though the recent substitution of child benefit payments for these allowances suggests that they should be treated as tax expenditures. On the other hand, the United Kingdom Treasury has suggested that mortgage interest relief be considered part of a progressive tax structure and not just a subsidy for housing. Because countries differ in their tax structures, comparisons of tax expenditures in OECD countries would be of questionable value unless they were put on a uniform basis.

Since tax expenditures are not actual outlays, the amounts "spent" are notional; that is, they are based on assumptions and estimates as to how taxpayers would behave under particular conditions. The United States practice has been to estimate the revenue loss of each tax expenditure separately, disregarding the interdependencies among the various items. The virtue of this approach is its simplicity; it is not necessary to consider the extent to which the curtailment of any particular tax expenditure might spur taxpayers to use others. Moreover, this approach assumes that a retrenchment in tax expenditures would not result in changes in the basic tax structure. For both political and economic reasons, this is not a tenable position. Total tax expenditures cannot properly be computed as the sum of all the separately estimated tax expenditures.

Estimates of particular tax expenditures also must be hedged with qualifications. Since the value of any tax expenditure depends on the extent to which taxpayers avail themselves of the opportunities provided by the tax system, the estimates are based on assumptions about private behaviour, not on firm appropriations. These assumptions tend to be grounded on past behaviour and cannot confidently take into account changes that might ensue from inflation, economic growth, or other new conditions. The estimates are especially questionable when they are applied to changes in government tax policy – paradoxically the very instances when they are most needed. In the late 1970s, official United States estimates of the revenue loss that would ensue from a reduction in the taxation of capital gains proved to be wide of the mark. Apparently the lower rates spurred increased sale of assets, substantially offsetting the expected revenue loss.

The foregoing considerations lead to the conclusion that efforts to construct a comprehensive and authoritative "tax expenditure budget" should proceed cautiously. A survey in 1976 found only two countries (Germany and the United States) that published tax expenditure budgets. Since then, other OECD countries including Canada and France have developed tax expenditure budgets. These budgets, which purport to set forth all revenue losses, are of more value for public relations than for analysis. They can encourage public

officials to make simplistic decisions. In 1979, for example, a leading member of the United States Congress filed legislation to establish a single limitation (as a percentage of GNP) on combined direct and tax expenditures.

A more appropriate use of tax expenditure data would be to assist government officials to gauge the total input of public resources into a particular activity such as housing or education. They would then be prepared to trade off between direct and tax assistance or to vary the mix of the two. Yet trade-offs are hampered in many countries by the fact that different sets of officials are involved in the making of direct expenditure and tax policies. In the usual case, the finance ministry is the dominant voice in tax matters while the functional ministry has a lead role in shaping direct programmes. Thus, a trade-in of a tax expenditure for a direct expenditure (or *vice versa*) might redistribute political power as well.

Fiscal experts do not agree on the value of comparing direct and tax expenditures. Some believe that it is impossible to fully compare the two types of expenditure, while others insist that the principal gain from the tax expenditure concept is to facilitate such comparisons. Regardless of the arguments, these comparisons have become much more prevalent since the mid 1970s, though they have been incorporated into the basic budget routine in only a few countries.

Trade-offs can be made even in the absence of a tax expenditure budget. The shift from child tax allowances to direct benefits in the United Kingdom has already been mentioned. In a similar move, the Netherlands now provides family allowances in lieu of child tax relief. New Zealand substituted higher cash payments for families with dependent children for tax subsidies in 1972, while Germany followed suit in 1977 and Austria in 1978. Trade-offs in the United States have tended to be less formal. In the late 1970s, Congress faced demands for assistance to parents of college students. One proposal would have provided tax credits to help offset tuition payments; another would have made direct grants to low-income students. The budget committees juxtaposed the two proposals (which had been advanced under separate auspices) and showed that if both the tax credits and the direct payments were enacted, the cost to the treasury would be far greater than the advocates of either proposal intended. This analysis contributed to rejection of the tuition tax credit.

Trade-offs appear to be most formalised in Canada where a new (and not fully tested) "envelope" system requires ministers proposing tax expenditures to offset the revenue loss with reductions in direct expenditures. The great virtue of the system is that it sensitises ministers to the reality that tax relief is not costless. Yet a one-for-one trade-in poses two problems. First, even when the tax and direct expenditures are estimated to be of equal value in the

year that the trade-in is made, the costs to government might diverge from this pattern in subsequent years. Second, presumably the trade-in system should also allow ministers to increase direct expenditures by curtailing the tax expenditures in their sectors. But, as noted earlier, this exchange would lead to growth in the relative size of the public sector.

4.1.2. Distributing tax expenditures

Tax expenditures entail not only revenue losses but private benefits. The distribution of tax benefits is not likely to be the same as the distribution of direct expenditure. The reasons for this difference include: 1) the incentive for those who would benefit more from tax preferences to pursue this course rather than seek direct assistance, and 2) the likelihood that different government officials (with different perspectives and constituencies) would be in charge of tax and direct spending decisions.

The main reason, however, for the differences between the two forms of assistance is that the value of most tax expenditures depends on tax liability. A dollar of deductions or exclusions is three times more valuable to a taxpayer in a 60% marginal tax bracket than to one taxed 20% at the margin. Since higher income taxpayers tend to be in higher marginal brackets, tax expenditures tend to be much more valuable to them than to lower income persons. Moreover, expenditures are generally "open ended", the limit (in most cases) being full tax liability. Thus, the higher the tax that would otherwise be paid, the greater the potential value of the tax expenditure.

A study in the United States found that tax expenditures in 1977 and 1978 amounted to 8.2% of adjusted gross income for all taxpayers, but 22.2% of adjusted gross income for taxpayers with more than USD 50 000 in income. Further, tax expenditures ranged from 30.2% of "full taxes" (the sum of actual taxes and tax expenditures) for middle income taxpayers to 41.6% for those in the highest income class. Significantly, tax expenditures provided less percentage reduction in tax liability for middle income taxpayers than for those in the lowest or the highest income categories.

It is technically feasible to hold the value of a tax expenditure constant across all income classes and to retain the progressivity of the basic tax structure. One possibility would be to substitute credits against actual tax liability for deductions from taxable income. Another approach would be to allow deductions at a fixed percentage rate for all taxpayers rather than at marginal tax rates.

Although techniques are available for mitigating the redistributive effects of tax expenditures, they tend not to be used much. Obviously a "neutral" tax expenditure system (that is, one that does not impair the distribution of burden in the basic tax structure) would offer less incentive for seeking tax

benefits rather than direct benefits. There is reason to believe that one of the underlying purposes of tax expenditures is to counter the high marginal rates in countries with progressive tax structures. For various political reasons, governments and voters need to believe that their country has a highly progressive tax structure. However, high "real" rates are not politically or economically acceptable; hence, governments resort to tax expenditures. As a result, effective tax rates tend to be more proportional than the nominal rates. The difference between the real and nominal rates represents the discrepancy between the type of tax system society believes it ought to have and the one it is willing to have. This discrepancy reflects a common condition in modern democracies: the clash between egalitarian values and the unequal distribution of economic power.

The United States has moved to improve the progressivity of a few tax expenditures by making them "refundable" (or "nonwasteable"). In these cases, if the value of the tax expenditure exceeds tax liability, the taxpayer receives a direct payment from the treasury for the excess. Refundable tax expenditures virtually erase the boundaries between direct and tax expenditures and can give rise to new off-budget practices.

4.1.3. Controlling tax expenditures

Tax expenditures are not as amenable to budgetary control as are direct expenditures. A comparison of the two types of expenditure would help to illustrate the lack of control over tax expenditures.

Consider a government decision to assist investment in a particular area. One course of action would be to issue grants to firms that make the desired investment; another would be to reduce the tax liability of these firms. When it proceeds by direct grants, government typically formulates detailed rules setting forth eligibility requirements, application procedures and other administrative prerequisites for obtaining a grant. Moreover, government officials review the applications for grants and can turn them down if they are not convinced that the funds would be spent for the intended purposes. They can also require periodic reports by grantees and can audit the investments to determine whether they are being properly made and recorded. A further element of control comes through the appropriations process, by means of which the government limits total spending for the programme.

A tax incentive, by contrast, is likely to be open ended, with the amount of expenditure dependent on the behaviour (and skills) of taxpayers rather than on direct government decision. A firm would not have to satisfy any application procedure, nor would the expenditure be reviewed by government officials in advance. Tax incentives usually operate unilaterally, with taxpayers making their own determination as to whether they are eligible for the relief.

While some portion of the tax returns would be audited, the likelihood is that most would escape serious review.

This illustration enables us to identify some of the reasons for the comparative lack of control over tax expenditures. These transactions tend to be encumbered by fewer administrative rules than are applied to direct expenditures. Government programmes are often criticised for red tape, delay and cumbersome procedures; tax expenditures avoid these problems, but only because government control is looser.

Tax expenditures are also subjected to weaker political control. Many tax advantages are established on a permanent basis. Unlike regular appropriations, there is no periodic review by the legislature. Because they are deemed to be permanent features of the tax structure, tax expenditures often continue in practice without examination of their effectiveness. Political control also is impaired by the "invisibility" of these expenditures. Although estimates of their cost might be published when they are introduced, in subsequent years, tax expenditures are absorbed into aggregate revenue forecasts.

There is widespread belief that, once implemented, tax expenditures are more difficult to terminate than direct expenditures. This proposition lacks empirical support, but it reflects a feeling that tax expenditures escape effective government control.

In assessing the impact of tax expenditures on fiscal control, one must be mindful of their implications for the tax system as a whole. The proliferation of tax subsidies has complicated the tax structures in most OECD countries. It is difficult for ordinary taxpayers to determine whether they are paying more or less than the law requires, and for tax officials to monitor compliance with the laws. In addition, these incentives erode the tax base and compel governments to levy high marginal rates in order to obtain needed revenues. Marginal rates in most countries would be significantly lower if tax expenditures were curtailed. The 1981 Netherlands "Budget Memorandum" comments that taxpayers increasingly "resort to deductible items to counter the increased pressure observed in the tax bands and to mitigate the feared increase in the burden of taxes." It further notes that one of the reasons for "the scale of the fraudulent practices is … the level of taxation and the increase in the tax burden over the years." The Swedish government's 1980/81 "Budget Statement" came to a similar conclusion, that "deductions are being abused more and more and contribute to a systematic erosion of the progressive tax system."

Tax expenditures will not be effectively controlled unless they are perceived by the public and by government as the functional equivalents of direct expenditure. Clearly, such is not the case at present. For the most part, tax expenditures are seen as the retained income of taxpayers, not as a grant from government. Under these circumstances, it is quite understandable that they

are not subjected to the same measure of control as is commonly expected of direct expenditures.

The foregoing considerations lead this author to the conclusion that a tax expenditure budget is likely to be more useful for economic analysis than for budget practice. One should be wary of pushing the tax expenditure concept to the point where it is treated in the same manner as direct expenditures. Notional budgets can provide useful supporting material but they cannot be decisional budgets for controlling and managing public resources.

4.2. Government loans

When governments spent public funds solely (or predominantly) on their own operations, the budget deficit (or surplus) was an accurate measure of their participation in the credit markets. This condition no longer prevails; in addition to paying for their own operations, contemporary governments finance outside activity. When they do so through direct grants, the transactions are usually recorded as budget expenditures, but when they lend money to others, the expenditure is often off budget.

During the 1960s and 1970s, government loans have become a major means of assistance to various groups. Governments make loans to public enterprises, business firms, homeowners, subnational governments and others. They also guarantee private loans, and they buy and sell debt instruments (such as mortgages, debentures and promissory notes). Because these credit transactions are often excluded, the budget tends to misrepresent the government's impact on economic activity and on the allocation of resources.

If credit assistance were fully accounted for, government economic policy in the 1970s would have probably been found more expansive than intended. Credit activities in many OECD countries appear to have shifted capital from investment in plant and equipment to investment in housing. The growth in credit programmes, many observers contend, has contributed to inflation in recent years.

The failure of government budgets to fully report credit activities is partly due to the fact that budgets were once deemed financial statements rather than expressions of economic policy. Accounting and economic criteria differ, especially as they relate to the treatment of government lending. Because budgetary concepts and practices were developed for different purposes than are now called for, new budgetary methods to deal with credit activities have to be devised.

The problem can be illustrated by reference to the treatment of government loans in the United States budget. When the government lends money, the loan is recorded as an outlay, on a net basis – new loans minus repayments. This treatment is a compromise between accounting and economic concepts. From

an accounting perspective, the loan should not be regarded as an outlay since the government's financial condition is not altered by it; the government is merely exchanging one asset (money) for another (a promise of future repayment). Indeed, loans are not recorded on business profit-and-loss statements and appear as assets on their balance sheets. However, from an economic standpoint, the loan should be recorded since the government will have to increase its own borrowing or have a smaller deficit. Moreover, a case can be made for reporting loans on a gross basis (that is, the full amount of new loans) since this represents the full scope of government activity, though it might overstate the economic effect of loans.

The disparity between economic and accounting criteria has opened the door to off-budget practices. Here, too, the United States experience illustrates the problem of handling credit transactions in the budget. When a government agency makes a loan, it receives an obligation (such as a mortgage or a note) from the borrower. The agency can pool these "loan assets" into new obligations which it sells to the Federal Financing Bank, a government agency whose transactions are excluded from the budget. The income from this sale offsets the original loan, thereby reducing the budget outlay to zero, even though the government must still borrow (or reduce its surplus) to finance the loan.

While this particular practice is an intentional evasion of budget control, most off-budget credit activities have a more legitimate purpose. One of the most prevalent off-budget practices is a government guarantee of private indebtedness. Guaranteed loans are generally excluded from the budget because they represent contingent rather than direct liabilities of government. But guarantees can affect the level and distribution of economic activity.

Government loan programmes can impede economic stabilisation because the amount of lending tends to fluctuate more widely than direct expenditures and can deviate significantly from the budgeted level. In recent years, efforts by the International Monetary Fund to require countries to reduce their deficits and public sector borrowing as a condition of assistance have also been impeded by loan practices in some countries.

4.2.1. The cost of government loans

One of the reasons why credit assistance is popular is that public officials often believe (or pretend) that it is costless. Direct loans, the argument runs, do not cost government anything because they are repaid. On this ground, direct loans are often preferred to grants in which the government does not recover any of its expenditure. An even stronger claim is made for guaranteed loans in which the government makes no outlay except in case of default. Government can make a profit by charging a premium for its guarantee.

Yet there is no such thing as a "free" loan. When the government makes or guarantees a loan, it also influences the availability of credit to other borrowers. Under certain conditions, it can significantly raise the cost of credit to those who cannot borrow from public sources or it might force some borrowers out of the market.

4.2.2. Direct loans

The cost of a direct loan depends on the terms under which it is made. When it charges an interest rate below its own borrowing cost, a government provides a direct subsidy which is paid for by taxpayers. But even it if charges the same rate as it pays, a government might bear higher interest costs because of the additional borrowing that it must undertake. If a government has a USD 25 billion deficit in its own operations, but must borrow USD 50 billion in order to finance both the deficit and the loans it is making, it probably would have higher interest charges than if it only borrowed for its own needs.

Even when government charges its full cost, a direct loan usually provides more favourable terms than a borrower can obtain privately. A government generally pays lower interest rates than other borrowers, and it normally passes these savings on to those who borrow from it. A borrower who can get the same terms privately would have little reason to come to government for credit assistance. These borrowers almost always pay below-market rates, and they are thereby accorded preference over those who must seek credit on less favourable terms. Those who borrow from private sources not only pay more but they also might find it more difficult to obtain credit.

Although the declared purpose of many credit programmes is to assist marginal borrowers who might otherwise be unable to obtain credit, they often provide funds to borrowers who would otherwise be willing and able to borrow at market rates. It is difficult to design a credit programme targeted exclusively to those who would be shut out of the market, and there is reason to believe that government officials do not really want to do so.

Interest rates on government loans are usually not standardised. Interest on direct loans is more often determined by the amount of assistance to be provided borrowers than by the cost of money to government. It is common for governments to charge concessional rates below their own borrowing costs. The interest rate can be regarded as a measure of the borrower's political power and of the value attached to the programme by government.

The cost of these loans is affected by fluctuations in interest rates. If, as often happens, the interest rate for a loan programme is fixed, the value of the loan (and the cost to government) will vary with subsequent changes in market rates and in the government's own borrowing costs. Thus, the cost of credit

programmes can rise automatically and uncontrollably without government action.

Some loans have features which make them virtually indistinguishable from grants. Some, for example, have forgiveness provisions that cancel all or part of the debt. Others can be converted to gifts if it becomes evident that the borrower is unable to repay. In still other instances, governments extend credit to marginal borrowers with little prospect of repayment. Sometimes loans are carried on the books long after the borrower has defaulted because the government lacks procedures for writing them off as bad debts. In sum, governments may prefer to label assistance as loans rather than as grants in order to conceal the true costs.

4.2.3. Guaranteed loans

Unlike direct loans, guaranteed loans require payment out of the treasury only in case of default. The guarantee is excluded from the budget because, as noted, it is a contingent liability. However, any payments necessitated by default would be budgeted as outlays. Loan guarantees are not the only form of contingent liability. Governments sometimes guarantee the price enterprises wll receive for their output, or pledge to pay the difference between market prices and the cost of production. These and other contingent liabilities are also excluded from the budget.

Loan guarantees transfer risk from private lenders to the government. This means that two of the credit market's key functions – evaluating the credit worthiness of borrowers and the element of risk – are not adequately performed. Rather than being concerned about the borrower's ability to repay, lenders are primarily interested in whether the guarantee is sound. The task of evaluating risk and credit worthiness thus must be performed by government or not at all. Governments, however, might be unprepared or unwilling to assume this role. A rigorous examination of the financial condition of marginal borrowers might bar them from obtaining the assistance that loan guarantees are intended to provide them.

Guaranteed loans can reduce the possibility of default or bankruptcy by giving marginal borrowers access to credit. It may, therefore, enable these borrowers to disregard market signals and to continue inefficient practices. Nevertheless, governments can condition loan guarantees on the adoption of efficiency-improving changes. Thus, in the United States, loan guarantees to New York City and the Chrysler Corporation required these borrowers to implement cost savings and other changes as a condition of assistance.

Guaranteed loans reduce the cost of credit for borrowers. Sometimes the subsidy is explicit, as when the government agrees to pay the difference between the market interest rate and the rate that lenders participating in the

programme are permitted to charge. In most cases, however, the subsidy is implicit: the borrower is able to obtain credit at a lower rate than would otherwise be possible.

The value of a guarantee depends on the risk of the loan. Marginal buyers usually have to pay a "risk premium" (above-market interest rates) in order to obtain private credit. Thus, the greater the risk, the higher the subsidy provided by the government guarantee. In cases of extreme risk, borrowers might not be able to obtain any credit without government assistance.

Loan guarantees raise the cost of credit to unassisted borrowers. But in periods of tight credit, the main effect might be to reallocate credit from some borrowers to others. In effect, borrowers who lack guarantees subsidise guaranteed borrowers.

In the United States and elsewhere, guarantees tendered in the late 1970s have differed from older loan programmes. In the past, loan programmes guaranteed small loans to numerous borrowers. For example, 97% of the loans guaranteed by the United States government in 1950 went to help families purchase their homes. In these types of loans, the risk of default was pooled among a large number of borrowers, each of whom paid a premium to cover possible default. Some recent loan guarantees (such as for energy development), by contrast, have entailed very large loans to very few borrowers. The risk is concentrated – not shared – and default by a major borrower can compel the government to spend large amounts of money. Moreover, guarantees often go to venture or financially troubled enterprises where the risk of default is higher than in the older types of loan programmes.

4.2.4. Controlling loan programmes

The problems and costs of direct and guaranteed loans have prompted a number of countries to consider credit policies in terms of the overall condition of the public sector rather than in terms of the budget. One approach has been to limit the borrowing undertaken by the public sector. This method is used in the United Kingdom which establishes a public sector borrowing requirement (PSBR) in tandem with the annual budget. The PSBR includes nationalised industries and imposes a single limit on public sector borrowing. The PSBR concept is also used in Australia, where it includes net borrowing by state and local governments and by public enterprises. Italy, under pressure from the IMF, has adopted an "enlarged public sector" concept that encompasses all levels of general government and certain public enterprises. In the United States, where the concept of the public sector is not widely used, control has been sought through implementation of a credit budget which sets annual limits on total direct and guaranteed loans, as well as limitations on individual credit programmes.

Integration of credit transactions into the budget process requires more than information; it also means that credit is seen as a policy instrument that can achieve the same objectives as direct expenditures. This level of integration appears to have been successfully attained in Japan which has a fiscal investment and loan programme (FILP) that covers virtually all of the credit activities of the government. The FILP has been designated "the second budget" not only because of its size (almost half of the general account budget) but also because it is considered to be as important to the economy as the regular budget. The FILP is presented to the legislature in tandem with the budget. It sets forth the supply of funds to public corporations, local governments, government-affiliated agencies and various other institutions.

The advantage of a combined statement of the public sector deficit and borrowing cannot be doubted, but this approach can introduce some problems. Enterprises with standby lines of credit to the treasury can "crowd out" spending on public services by government agencies. This predicament has confronted the United Kingdom in the late 1970s. Perhaps the point to be made is that information on public sector borrowing is not a substitute for financial control. Aggregate controls on credit can be effective only when particular loan programmes are controlled as well.

If governments are to control their budgets and manage the economy, they must be able to control the credit they extend to others. This is often difficult to accomplish because the amount of loans can depend as much on the behaviour of borrowers as on the current policies of government. In many cases, the amount of credit authorised for a particular programme is open ended, and eligible borrowers do not have to compete against one another for available funds. In other cases, government has little choice but to provide needed credit to public enterprises or to weak industries.

4.3. Government regulation

Regulation can be an effective substitute for direct expenditures. If a government wants to curb the pollution of rivers and streams, it could appropriate funds for the construction and operation of sewage treatment facilities. Alternatively, it could provide loans or tax preferenes to firms that invest in pollution control practices. These types of expenditure would be recorded in government accounts, though not all would appear in the budget. Still another option would be to order polluters to stop discharging effluents into the waters. Except for the administrative expenses of government agencies, the costs of these and other regulations would not be reported in government accounts.

Through regulation, it would be possible to shift the costs of achieving many public objectives from public budgets to private ledgers. If stringent

spending or budget limitations were imposed, government might resort to regulation in lieu of direct services. The costs to society would be no less, and might be a great deal more; they would show up in the costs of production, in the prices paid by consumers, and in other adverse effects on the economy.

Concern about the costs of regulation appears to be much greater in the United States than in other OECD countries. This might be due to the fact that regulation is more pervasive in the United States than elsewhere. In other countries, public enterprises operate services (such as railroads, telecommunications and utilities) that are provided by regulated industries in the United States. The prevalence of regulation in the United States might also be due to its legalistic political culture and a tendency to define rights and obligations through laws and rules.

During the 1970s, regulatory activity increased significantly, and social objectives were emphasised (such as protection of the environment, the health and safety of workers, and automobile safety). This new type of regulation has proved to be costlier and broader in its impact than older economic regulations that dealt with rates, services and entry into markets. The new "quality of life" regulations are not confined to a single industry; in many cases, the jurisdiction of the regulating agency extends to most of the private sector. But despite its jurisdictional breadth, the agency usually has a narrow regulatory objective. It is not called upon to weigh the value of its objective against competing ones or to consider the effects of its regulations on particular firms or industries.

It should not be surprising, therefore, that some of the regulations promulgated in the 1970s were extremely costly. According to some estimates, as much as 4% of GNP has been diverted to satisfy regulatory requirements. While the estimates are based on questionable assumptions and have been disputed by critics, there is little doubt that the costs of regulation have been very high.

Only a small portion of the costs of regulation are accounted for in the budget. Regulatory agencies are usually quite small, and their expenses ordinarily are not a major consideration in the preparation or review of the budget. The costs of administering thousands of regulations do not add up to one per cent of the United States budget. It has been estimated that compliance with regulations costs the private sector USD 20 for each dollar spent by the United States government.

The direct costs of compliance include the specifications mandated by government regulators. There is a tendency for government agencies to prescribe specific designs or technologies, leaving the affected industry with little incentive (or discretion) to select the most efficient course of action.

Moreover, once established, regulations often continue in effect long after their original purpose has been served.

Some critics claim that the "opportunity costs" of regulation may be much greater than the directly measurable ones. Excessive regulation, it is alleged, impedes innovation, diverts capital from productive investment to satisfying government requirements, diminishes risk-taking by entrepreneurs and dampens competition. According to this view, the full cost of regulation includes lost employment and production, higher prices, and a reduced ability to compete in world markets.

4.3.1. Controlling government regulation

As the costs of regulation have escalated, so too have requirements that regulatory agencies consider the costs and benefits of their actions. The trend has been toward broader requirements: President Ford called for the examination of the effect of regulations on inflation; President Carter ordered analyses of economic impacts; and President Reagan directed full cost-benefit analyses of regulations.

It would seem ironic that the United States, which has had only limited success in applying cost-benefit analysis to its own budget, would undertake the much more difficult task of analysing the effects of regulation on the private sector. The measurement of the effects of regulations cannot avoid difficult value questions, and the more ambitious the analysis, the more controversial and problematic are the findings likely to be.

The unstated but often primary purpose of regulatory analysis is not to obtain the precise measurement of costs and benefits but to slow down the issuance of regulations. By requiring agencies to prepare formal analyses before promulgating regulations, government hopes to sensitise them to the fact that regulations are not costless. Regulatory analyses encourage agencies to consider less costly alternatives and sensitise them to the added costs of securing marginal improvements in benefits.

The United States has established a regulatory review process in the White House. The purpose is to ensure a broader consideration of costs and alternatives than might be undertaken by the agency issuing the regulations. The White House group can stop, or more likely seek to modify, regulations that it considers too costly. The Reagan administration has intervened more forcefully in the regulatory process than previous administrations did.

A novel cost control scheme has been proposed in the form of a regulatory budget. The regulatory budget would list the costs of government regulation much as direct expenditures are accounted for in the regular budget. Some have suggested that the regulatory budget be used to limit the costs that each agency would "spend" by means of regulation. The concept of a regulatory

budget, however, would have to gain broader acceptance before it could be applied in this manner.

4.4. *Public enterprises*

Conventional budgeting coexisted with an organisational structure in which government operations were the responsibility of ministries and departments. Appropriations to these "core" agencies accounted for the bulk of public expenditure, so that the same agency spent public funds and operated public programmes. These agencies were organised into a cabinet structure which, in parliamentary regimes, exercised collective control, and in presidential systems functioned in a more hierarchical manner. There was little ambiguity as to what constituted a public entity.

Mixed economies do not have neat organisational structures. Governments have contrived a seemingly endless variety of organisational forms in response to particular needs and conditions. Governments set up autonomous agencies outside the cabinet structure or corporations that combine public and private characteristics. In some enterprises, the government holds some or all of the stock; in others, all the stock is privately owned. In some, the officers and directors are appointed by the government; in others, appointments are made by the corporation or its stockholders. In some, employees are covered by civil service rules; in others, they are deemed to be private workers.

Because public enterprises combine elements of public and private organisations, it is difficult to classify them into neat categories. Some are more public than others; some are only nominally public and have all the essential attributes of private organisations. There are so many types of public enterprises, even in the same country, that it is hard to classify them into a few categories.

An OECD working paper (April 1981) reported that "the most difficult aspect of defining the public sector is deciding what makes an enterprise 'public'." The paper noted that while some countries define public enterprise solely in terms of ownership, others add other criteria such as the degree of control exercised by government or the circumstances under which the enterprise became public. The confusion over definition is reflected in the system of national accounts (SNA) devised by the United Nations. The SNA bases the distinction between private and public "on whether the ownership and/or control of an enterprise rests in the public authorities or private parties" but it does not indicate whether ownership and control are joint or alternative criteria. The OECD paper concluded that variations in country definitions of public enterprise are impediments to international comparisons for the public sector.

Many countries have attempted to classify their public enterprises in terms of the control exercised by the government. For example, Sweden distinguishes between public enterprises and government-owned business companies. The government-owned business companies are independent legal entities subject to government regulation. Government exercises control principally through its role as shareholder. The public enterprises are government agencies, though they have more freedom in fiscal and personnel matters than ordinary agencies. These enterprises have no independent borrowing authority; all long-term capital is supplied by the central government.

Japan has a more elaborate classification, dividing its more than 100 public corporations into nine categories depending on the source of financing and the degree of government control. At one extreme are corporations that receive all their capital from the national government and have their budgets approved by the Diet (parliament). At the other extreme are corporations that receive some public financing but enjoy a great deal of autonomy.

Despite the varied forms, it is rare that a public enterprise is subjected to the same financial controls as are applied to core agencies. One of the main reasons for the establishment of state enterprises is to free them from the budget controls applied to regular agencies; it should not be surprising, therefore, that they enjoy considerable fiscal autonomy. Even when they are in the budget, public enterprises tend to have a great deal of freedom, if only because they have their own source of revenues. Moreover, many enterprises are authorised to borrow from the credit markets or from the treasury.

Paradoxically, while enterprises are located on the fringe of government, they do not conduct only fringe activities. In OECD countries, public enterprises run heavy industry, high-risk technologies, communications and transportation, and the production and distribution of energy. These operations are so vital to modern economies that governments cannot remain bystanders if major enterprises encounter financial difficulty or if their policies or performance diverge from the national interest.

But governments have a great deal of difficulty in deciding whether and how to intervene in the affairs of their enterprises. A considerable amount of confusion arises out of the combination of public and private characteristics in the same organisation. Governments frequently establish conflicting norms for their enterprises. They want enterprises to be run efficiently and to serve important social objectives. They want the railroads, for example, to cover their operating costs, but governments also insist that service be provided to many communities regardless of cost. Governments want factories to operate without subsidies, but bar them from dismissing employees and impose costly work rules.

The clash between social and economic objectives can be submerged when public enterprises are growing and showing a profit. But governments frequently turn failing industries over to enterprises, and the conflict between social and economic values leads to zigzagging policies. The inability of the enterprises or the government to maintain a steady course can produce outcomes that nobody wants. Many enterprises are disciplined neither by the market nor by the government budget; they live in perpetual crisis and turbulence. Governments, however, cannot isolate themselves from the problems of their enterprises; the enterprises' financial ills become the government's concern. With or without effective budget control, government must supply the grants and credits to keep the enterprise in business.

4.4.1. Controlling public enterprises

The International Monetary Fund has identified three phases in the financial relationship between governments and enterprises. Enterprises are often established at "arm's length" from the government, with a great deal of discretion. They are purposely given autonomy to insulate them from political influences and to ensure their efficient operation. At a later time, however, the government feels impelled to intervene, either because it is dissatisfied with the enterprise's performance or because the enterprise comes to it with pleas for assistance. Government intervention is not a permanent solution, for it tends to further impair the efficiency of enterprises. In response, therefore, governments seek to set performance objectives, returning to the arm's-length relationship. But, unable to dictate the operations of enterprises, governments might not be able to achieve the level of performance they seek.

The argument for establishng public enterprises outside the normal budgetary framework is that they can thereby be operated in a more businesslike manner than would be possible under government control. Thus, the law establishing the Australian Industry Development Corporation provided that "the corporation shall act in accordance with sound business principles … and … shall not provide finance … or participate in a particular enterprise unless the Board considers that the enterprise … will be carried out in an efficient manner and in accordance with sound financial principles." The law further specified that the corporation "is not subject to direction by or on behalf of the Australian Government".

Once they are vested with political autonomy, public enterprises can maintain their privileged status as long as they stay out of financial trouble. Indeed, enterprises that internally finance their own expenses and have independent access to capital markets often escape any serious scrutiny by government agencies. However, if an enterprise experiences financial difficulty and has to rely on the government to cover its expenses or for investment funds, then the government can recapture some of the political control it yielded in

establishing the enterprise. But at this stage, the government may have no viable option other than to provide the needed financing even if it cannot fully control how the funds are spent.

A penetrating analysis of the problems faced by governments in controlling their public enterprises was issued by Canada's Royal Commission on Financial Management and Accountability in 1979. The commission observed that "the Government must find that delicate balance between excessive control – which would frustrate the purpose of a Crown Agency – and no control, which would be a denial of the Government's involvement and responsibility in the enterprise."

There is no easy way out of the dilemma facing governments in their relationship with enterprises. As the boundaries between the public and private sectors erode, one can expect enterprises to become more prevalent and more important. Governments cannot ignore the impact of enterprises on their budgets, but neither can they impose tight fiscal control over these entities. The trend seems to be to incorporate enterprises into the public sector budget, but not necessarily to control them by means of the budget. In terms of the enterprises, the budget is more an information tool than a means of making and enforcing financial decisions.

5. The problem of control

Off-budget expenditures weaken budget control. This statement has two meanings that lead to different policy conclusions. First, a government's capacity to budget its expenditures has been impaired by the removal of these items from the budget. The obvious remedy would be to return the off-budget expenditure to the budget, thereby restoring the budget's status as a comprehensive process for handling the government's funds.

Second, the statement can mean that the government's capacity to control off-budget expenditures has been weakened by their special status. Here the concern is not restoration of the budget's lost prominence, but an overall weakening of the government's control of its finances. The appropriate remedy, from this point of view, might be to control off-budget expenditures by off-budget means.

Much of the literature on budget control wells out of the first conception of the problem. It assumes that a sound budget is the purpose of government, and that having a comprehensive budget assures financial control. This author would challenge this budget-centric premise, and argue instead that placing off-budget items in a comprehensive account might amount to little more than a bookkeeping improvement. To understand why this might occur, it is necessary to examine how off-budget practices affect government operations.

Off-budget expenditures impair budget control in three ways: they entail a loss of political control, financial control, and internal control.

Political control refers to a government's capacity to dictate the objectives for which the expenditure is made and to enforce its decisions. Political control is strong in line ministries and weak whenever the actual spending is done by outsiders. Within government, command and control processes are well developed. Ministries generally spend funds on the purposes for which the appropriation was made. Despite universal misgivings about bureaucracy, government agencies generally abide by the dictates of higher authority. But when funds are transferred to outsiders, political control is attenuated. A minister does not have the same leverage over an enterprise (even one nominally under his/her jurisdiction) as over a line agency. The minister is likely to have even less say over the behaviour of an entrepreneur making private use of tax credits or guaranteed loans.

Financial control over off-budget expenditures is often weak because, unlike direct expenditures, they tend to be open ended. The amount spent by government (including the social cost) is not usually fixed in appropriations but determined by the behaviour of the beneficiary. Tax subsidies depend on the extent to which taxpayers avail themselves of the opportunities provided by government. Enterprises often have a line of credit to the national treasury. The cost of regulation varies with the response of those affected by it. The cost of subsidised loans depends on interest rates.

Moreover, since government exercises only weak political control over off-budget spenders, even when limits are fixed on these expenditures, they might not be enforceable. The United Kingdom's unfortunate experience with state enterprises shows how ineffective political control can lead to a loss of financial control.

Internal control refers to the fidelity of spenders to the rules and procedures established by government for the handling of public money. When formal budget systems emerged in the Continent and in the United States in the late 19th and early 20th centuries, adherence to these rules was enforced by external control – that is, central budget personnel, auditors and others policed the financial activity of agencies and required approval before obligations were incurred. Their massive expansion and ambitious policy objectives have forced modern governments to rely on internal control. The agency spending the funds has first-instance responsibility for ensuring that the expenditure is proper, for an approved purpose, and in accord with government regulations and its own rules.

Internal control depends on the basic norms of behaviour, more on attitudes than on rule books. Internal control is firmly implanted in many government ministries around the world, though occasional scandals are a

reminder that breaches still occur. But the norms have not been internalised by external spenders. They have their own values and objectives, and these often run counter to those of the government. It should not be surprising that much contemporary fraud and waste in public programmes are concentrated in off-budget expenditures.

The growth of off-budget expenditure produces what might be labelled "the paradox of control". As this paper argues, off-budget expenditures have resulted from the transformation of the public sector from one in which spending was done within government to one in which spending largely occurs outside government. Not the least of the reasons for this transformation has been the striving of government to strengthen its control of the economy, the distribution of income, investment policy, and the supply of goods and services. The paradox is that, in its effort to extend its control over the private sector, government has surrendered a good deal of its control over the public sector.

Restoring off-budget items to the budget would not accomplish much in the way of political control, financial control, or internal control. The budget would be more comprehensive, but this could be deemed salutary only if fundamental changes were made in the relationship between government and outside spenders.

This relationship operates through incentives rather than command and control. By extending credit, changing tax liabilities, chartering independent enterprises and other activities, government "hopes" that the affected parties will behave in accord with its expectations. However, incentives involve not only the expectations of government but those of the recipient as well. And these may be at variance with those of government.

A comprehensive budget process, in sum, might make for a better budget, but not necessarily for more control. If the latter is the pre-eminent objective, governments should devise new methods of control, leaving to secondary consideration the question of whether these controls should operate through the budget process.

6. The problem of planning

The problem of control leads to a second paradox. With the rise in off-budget expenditures, governments sense a heightened need to plan their programmes and finances beyond the next fiscal year, but the efficacy of these plans diminishes as governments transfer funds to outside spenders.

When governments spent primarily on their own operations, they felt little need to plan ahead for a number of years. They could prepare for the future through the normal programming activities of government agencies. But with the transformation of the public sector, government is interested not

only in what it is doing, but in what others (principally the outside spenders) are doing as well. The emergence of national planning has, in fact, been concurrent with the developments described in this paper. There has also been, in most OECD countries, the emergence of multi-year financial plans, such as the public expenditure survey committee system devised in the United Kingdom.

These plans (national, sectoral and financial) attest to the futility of planning when government control is weak. The paradox is that, as the future becomes less certain, the felt need for planning increases; but as the future becomes less certain, the reliability of the plans decreases. Plans are quickly overtaken by unexpected events, especially those outside government control.

Strong planning cannot coexist with weak budget control. But the failure of planning has not diminished the yearning for more effective plans. In response to the control problem, planning now takes two different paths. Indicative planning (such as has been pioneered in France) abandons control in favour of information and consultation. It informs various sectors (particularly the off-budget ones) of government expectations in the hope that, once informed, they will act in a way that makes it possible to achieve the plan's objectives.

The other course is to use planning as an instrument of control. Governments recognise their lack of short-run budget control and try to compensate for this deficiency by establishing a planning process – in effect a multi-year budget process – to strengthen their control over future budgets. The United States is moving in this direction, as are Canada, the Scandinavian countries and the United Kingdom. But one must question whether future budgets will merely accommodate to the lack of control or be used to devise and implement realistic plans and objectives.

7. The path to control

Governments everywhere are troubled by attenuation of control over their budgets. They perceive that off-budget expenditures often escape effective control and they assume, therefore, that placing these transactions in the budget will lead to the restoration of control.

Before stretching their budget processes to encompass off-budget expenditures, governments should contemplate what might be gained and lost from this move.

The notion that off-budget items ought to be incorporated into the budget is predicated on the concept of the budget as a resource allocation process. National budgets have been moving in this direction for more than a generation; in most OECD countries, finance ministries have shifted from

expenditure control to economic management. But this is not the only purpose served by government budgets.

Contemporary budgets excel as instruments of managerial control. They define the programmes to be conducted by ministries and allocate resources for these purposes. They set the operational objectives of ministries and limit the amounts that may be spent on various activities. As instruments of management, budgets can effectively control only where managers can. Extending the budget to off-budget expenditures would be of no avail if government does not dictate the programmes or policies of the off-budget spenders.

Budgets cannot be all things to all users. The skills and data appropriate for managerial control are not the same as those essential for fiscal control. Governments, therefore, must decide whether to use their central budget process for the one purpose or for the other. They must, in effect, choose between using the budget to allocate government costs or to allocate social costs.

Understandably, governments try to avoid choosing one or the other course. They want both types of control. Further, they sense that surrendering the managerial functions of the budget would weaken their macroeconomic capabilities as well. The old budget predicament of "the parts *versus* the whole" would come back to plague them if they settled for a "big picture" budget process.

Perhaps governments will succeed in expanding the budget's scope without losing their hold on the budget itself. This author's view is that not all the off-budget expenditures discussed in this paper equally warrant inclusion in the budget. Not all are equally suitable for trading off with direct expenditures. Governments need many paths to control, not only the one that eventuates in a budget decision. The United States, for example, is experimenting with a credit budget which, though annexed to the regular budget, involves different allocation decisions. Regulatory costs similarly might be "budgeted" for in a separate process. Public enterprises might have their own decision and control procedures. These distinct processes might be linked by an umbrella (rather than omnibus) resource allocation process or by a public sector planning process. The budget would then be but one component of the larger process. It would continue to operate as an instrument of managerial control, but broader control would be sought by other means.