Chairman Price and Ranking Member Van Hollen, I am honored to have been invited to testify before you on process and procedural options for reforming the budget process.

I am a vice president at the Mercatus Center at George Mason University, where my work over the past 15 years has focused on mechanisms that would improve the quality of governance in America. Prior to this, I served as an elected member of the New Zealand Parliament and a member of the Cabinet of New Zealand and was then appointed New Zealand's ambassador to Canada. The New Zealand government implemented a series of reforms to budget procedures when I served as a legislator. Canada made major changes to its budget processes during my tenure there. My comments today will draw on my research and experiences as well as on the research that other scholars at the Mercatus Center have done on budget procedures throughout the United States.

REFORM STRATEGY
My view on a successful reform strategy is to first create a concept of what this activity would look like in a perfect world. Once you are satisfied that you have identified what the very best new systems and procedures would look like, it is necessary to identify what it is possible to get done. You will then know what has been traded off to produce a solution that is doable. It is also possible to design today's reform in such a way that it does not eliminate future desirable reforms that would cumulatively improve the process.

IDEAS ABOUT BUDGET REFORM
When thinking about reform, it is a good strategy to identify the goal or purpose of this particular activity. In the case of a nation’s budget, the document should be the most important strategic document the government produces each year.
As the government’s most important strategic document, some thought should be devoted to prescribing what the document should include. The following points are my views of strategic goal areas that the government should set forth in its budget:

- policy priorities
- debt strategy
- deficit strategy
- revenue strategy
- growth strategy
- competitiveness strategy
- and all of the above, extrapolated over a long horizon

Having set these strategic goals, the passage of the budget means the government now owns the commitments identified in these strategic goals. It also means that the spending and taxing decisions that come later must also respect these strategic goals.

There needs to be a formal process that commits the government to the above strategies so that it is possible to determine if the government is on course to achieve these objectives. As this process is a key function of government, there needs to be a significant consequence for not producing a budget.

In many countries, the above part of the budget is released and debated some months before the spending and taxing part of the budget process. The intention is to have some accord about policy priorities and fiscal-strategy objectives before considering spending and taxing decisions.

**SPENDING AND TAXING**

Spending and taxing decisions are really about how policy priorities are to be achieved and in what quantity. The mechanisms for achieving these priorities are programs, but it is useful to think of them as tools—and when better tools are developed, the old tools should be discarded in favor of improved results.

Good spending procedures include the following assumptions:

- The spending process should identify what is being purchased, expressed in terms of outcome (e.g., *How many less people will be dependent a year from now?*).
- A quantified expectation of results at the time of appropriation dramatically improves the effectiveness of oversight and accountability (e.g., *How much safer we will be a year from now as a result of improved security?*).
- Resources should go to activities that are most likely to produce the desired outcome.
- Activities that address the same outcome should have to compete for a common pool of money.
- Activities that cannot produce evidence of results, expressed in terms of outcome, should not be funded.
- Activities that do not meet the results of the best activities should be eliminated.
EFFORTS TO REFORM THE BUDGET PROCESSES

Over the past 25 years, many national, state, and provincial governments have experimented with changes to their budget processes and procedures, with varying levels of success. In nearly every case, the objective of the reforms has been to develop a closer relationship between the outcomes of government spending and future appropriation decisions. While there are many instances where government agencies have significantly improved their ability to produce quality, outcome-oriented performance information, the initiatives have frequently stumbled at the appropriation decision level in the legislature.

Not the least of these frustrations was the American experience with the Government Performance and Results Act (GPRA) and its later iterations. The Mercatus Center conducted an annual evaluation of the Annual Reports of the 24 Chief Financial Officers Act agencies for the first 10 years of GPRA. In the initial years, Annual Reports produced very poor quality performance information. But by the end of the 10 years, all agencies had dramatically improved the quality and the clarity of their reporting, with some agencies consistently producing excellent reports.

The disappointment with that initiative stems from the fact that this quality performance information was hardly ever used to inform the appropriation process. It is important to emphasize, then, that changed procedures will not, on their own, improve budget decision-making if the legislature does not change its practices as well. But better budget processes that more starkly demonstrate the options available to appropriators—and the consequences of each of the options—may well change the incentives for appropriators.

CONTROLLING DUPLICATIVE SPENDING BY FOCUSING ON OUTCOMES

Maximizing the public benefit by successfully limiting duplicative and wasteful spending requires a change in the thought process behind budget decision-making. This means moving away from funding an activity or program and instead focusing on funding the outcome desired by the government.

It is this concept that led the New Zealand Parliament to reorganize its committees and change the Financial Reporting Act so that parliamentary select committees had direct oversight of sectors of the economy instead of departments and programs. Under this new arrangement, the Education and Science Committee examined all activity that was focused on education, regardless of which agency delivered the program. It oversaw all education programs; could identify which were the most effective and which were the least effective; and how much each cost per unit of success. This change enabled appropriators to strategically allocate resources to achieve the greatest public benefit.

To shift the budget focus to outcome achievement, appropriations are now converted to purchase agreements that spell out precisely what the government expects in outcome results for this investment. For example: this investment of X dollars will buy an increase of 10 percent in ten-year-olds who are reading at their biological age. Or, the purchase agreement is a binding contract between the CEO of the agency and the government. Or, the failure to deliver the commitments in the contract could lead to the termination of the CEO’s employment.

REFORMED CAPITAL BUDGETING

The government owns a number of policy delivery organizations known as departments. Treating these as operational organizations that give the government the capability to be effective in a number of policy areas creates the opportunity to annually assess the government’s ownership interest in these entities. A reformed budget process also opens up the opportunity to approach the issues of capital investment and maintaining assets at peak operating efficiency. By requiring departments to have a balance sheet that identifies all the assets under the control of

the department at market value, it is possible to price the purchase of outcomes to include the monies for asset maintenance.

The Government of New Zealand does this by funding capital maintenance through the purchase of outputs in the performance contract with the department. This process now requires the department to account annually on the ownership interest of the government in that agency. In plain English, that means the department must disclose whether the government’s ability to achieve its objectives through this department have improved, remained static, or deteriorated.

Idle capital can be a major waste of government resources that might be better deployed to higher-priority government activities. Through the identification of assets under the control of a department in the department’s balance sheet, it becomes possible to identify underutilized or idle assets. One strategy designed to free up surplus capital is to develop a “capital charge” across all of government. This works by requiring each department to pay a fee, based on a percentage of the current market value of those assets, to the Treasury for all of the capital assets identified on the department’s balance sheet. The appropriation process funds the department for the assets being used but not for the idle assets. The department must pay the fee on the idle assets from within its budget allocation, which can create a very strong incentive for the department to release those surplus assets back to the Treasury.

In other cases, it is possible to give decision makers a mechanism to compare different claims for capital investment by using a rate-of-return criterion that enables the government to compare the value of different capital investment options.

OVERSEAS TRENDS

Governments in other countries, driven by dissatisfaction with outcomes from existing practices, have been debating and legislating different budget procedures.

1. Many are starting the budget process early by separating budget policy and economic strategy from spending by publishing a budget policy and strategy document as long as six months before the budget. The goal is to allow extensive debate on these issues before the appropriation process.

2. Some have shortened the time for the appropriation process (New Zealand’s is only twelve weeks), since many of the contentious issues have already been debated. As each of these countries has a parliamentary system, the consequence for not passing the budget is an immediate new election.

3. There is a trend toward much greater transparency throughout these new procedures, and some countries have developed statutes that make it more difficult for governments to depart from established procedures and requirements. Some, like Ireland, have set up independent bodies to comment on how well the government is meeting its fiscal and budget requirements.

The following summary of laws from different countries gives a picture of some initiatives (an appendix gives more detail on each of the laws referenced):

- Australia: The Charter of Budget Honesty Act 1998. This was the Australian response to the frustration felt by incoming governments that the country’s fiscal position after an election was often much worse than had been portrayed during the election.

- Ireland: The Fiscal Responsibility Act. This was a response to the perceived fiscal nonaccountability of successive governments. This law did something extraordinary: it set up the statutorily independent Irish Fiscal Advisory Council. The council’s job, as laid out in the statute, is to comment quite specifically on whether the government is acting in a fiscally responsible manner.

• New Zealand: The Fiscal Responsibility Act and the Financial Reporting Act. These laws, and a number of others, were responses to decades of highly inept fiscal management that led the country to the verge of bankruptcy in the early 1980s. “Having cleaned up the mess, don’t let it happen again” probably best describes the rationale driving the compendium of fiscal and operational laws passed in New Zealand.

CONCLUSION
A huge volume of research and real world experience now exists, both in the United States and overseas, on the subject of budget processes and procedures. My testimony has touched very lightly on a number of the initiatives currently in practice to identify options that might be attractive to the House.

What can be said with certainty is that more transparent procedures, a linkage between agency performance and future budget allocations, and a focus on measuring progress against outcome achievements all appear to be goals of these initiatives. It could also be said that there appears to be a cultural shift within these nations toward a greater appreciation of the importance of keeping spending and debt within predetermined parameters that define fiscally responsible behavior.

APPENDIX I

Australia: Charter of Budget Honesty Act 1998

The Charter of Budget Honesty Act 1998 (the Charter) sets out principles and requirements that guide the government’s management of fiscal policy. The Charter requires the government to:

- set out its medium-term fiscal strategy, along with its shorter-term fiscal objectives and targets, which are published in the Budget Papers and in the MYEFO report
- report on estimates for the General Government Sector (GGS) according to an annual reporting cycle, including economic assumptions underlying Budget estimates
- report against specified external reporting standards
- list all proposals for changes to revenue, current and capital expenditure in the forthcoming reporting cycle.

Ireland: Fiscal Responsibility Act

The Fiscal Responsibility Act came into effect in December 2012. The introduction of the Act was part of a wider agenda of budgetary reform, benchmarked under the Programme for Government 2011 and the EU/IMF Programme of Financial Support for Ireland.

The Act established the Irish Fiscal Advisory Council as a statutory body and legislated for the implementation of national and EU fiscal rules. Further EU regulations (July 2013) resulted in the Council being assigned the role of the independent body that would endorse the macroeconomic forecasts produced by the Department of Finance on which Budgets and Stability Programmes are based (implemented by Ministers and Secretaries Amendment Act 2013). The process of this additional function is outlined in the Memorandum of Understanding (signed version) between the Council and the Department of Finance.

Under the Fiscal Responsibility Act the mandate of the Irish Fiscal Advisory Council is:

- To endorse, as it considers appropriate, the macroeconomic forecast prepared by the Department of Finance on which the Budget and Stability Programme Update are based.
- To assess the official forecasts produced by the Department of Finance. These are the macroeconomic and budgetary forecasts published by the Department twice a year.
- To assess whether the fiscal stance of the Government is conducive to prudent economic and budgetary management, with reference to the EU Stability and Growth Pact.
- To monitor and assess compliance with the budgetary rule as set out in the Fiscal Responsibility Act. The budgetary rule requires that the Government’s budget is in surplus or in balance, or is moving at a satisfactory pace towards that position.
- In relation to the budgetary rule, to assess whether any non-compliance is a result of ‘exceptional circumstances’. This could mean a severe economic downturn and/or an unusual event outside the control of Government which may have a major impact on the budgetary position.

The Acts ensure the independence of the Council in the operation of its functions.

The FRA aims to improve fiscal policy by specifying principles of responsible fiscal management and strengthening reporting requirements.

3.1 Principles of responsible fiscal management

a. Governments are required to follow a legislated set of principles and publicly assess their fiscal policies against these principles. Governments may depart temporarily from the principles but must do so publicly, explain why they have departed, and indicate how and when they intend to conform to the principles. The five principles of responsible fiscal management are: Reducing total Crown debt to prudent levels so as to provide a buffer against factors that may impact adversely on the level of total Crown debt in the future, by ensuring that, until such levels have been achieved, the total operating expenses of the Crown in each financial year are less than its total operating revenues in the same financial year.

b. Once prudent levels of total Crown debt have been achieved, maintaining these levels by ensuring that, on average, over a reasonable period of time, the total operating expenses of the Crown do not exceed its total operating revenues.

c. Achieving and maintaining levels of Crown net worth that provide a buffer against factors that may impact adversely on the Crown’s net worth in the future.

d. Managing prudently the fiscal risks facing the Crown.

e. Pursuing policies that are consistent with a reasonable degree of predictability about the level and stability of tax rates for future years.

Definitions such as “prudent” level of debt, or “reasonable” degree of predictability are not specified in the Act. It is left to the Government of the day to interpret the relevant fiscal terms.

Importantly, although a Government can depart from the principles, the FRA requires any such departure to be temporary and that the Minister of Finance specify the reasons for departure, the approach to be taken to return to the principles and the period of time this is expected to take.

3.2 Reporting requirements

Governments must publish a Budget Policy Statement (BPS) before the annual Budget and a Fiscal Strategy Report (FSR) at the time of the Budget (see Box 1). These publications must demonstrate the consistency of the Government’s short-term fiscal intentions and long-term fiscal objectives with the principles of responsible fiscal management (Table 1 provides more detail). The Act requires the FSR to include fiscal projections (the “Progress Outlooks”) covering a minimum of 10 years for the variables specified as long-term fiscal objectives.

The Treasury is required to prepare regular economic and fiscal forecasts (see Box 1). Having the timing and broad nature of the overall forecasts specified in legislation raises their credibility.

Under the FRA, all financial statements included in reports required by the Act are prepared under Generally Accepted Accounting Practice (GAAP). Fiscal reporting follows a set of consistent accounting rules established independently by the Accounting Standards Review Board (which sets accounting standards that are mandatory for both the public and private sector). The use of accrual accounts means that the full cost of policy must be disclosed, including non-cash items like depreciation and changes to government employee pension rights. The predecessor of GAAP was “Table 2” which was prepared on a cash basis.