



2008 BUDGET BRIEFER

CONGRESSIONAL PLANNING AND BUDGET DEPARTMENT

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ASSESSMENT FRAMEWORK OF THE NATIONAL GOVERNMENT BUDGET*

The national budget must be balanced. The public debt must be reduced; the arrogance of the authorities must be moderated and controlled. Payments to foreign governments must be reduced, if the nation doesn't want to go bankrupt. People must again learn to work, instead of living on public assistance.

Cicero, Marcus Tullius, 55 BC
Roman author, orator, and politician

The national government budget can serve various developmental objectives. It can promote economic stability. It can increase productive capacity and spur economic growth. It can finance the provision of public goods and services that promote the welfare of the people, especially the poor and marginalized sectors. However, an improperly designed and poorly implemented budget can also result in poor investment choices, unmanageable budgetary deficits, and stunted economic growth. When the economy falters, it is usually the poor who suffers the most.

To be an effective instrument for economic development and poverty alleviation, budget formulation should strive to promote fiscal discipline, strategic resource allocation, and operational efficiency.

FISCAL DISCIPLINE AND MACROECONOMIC STABILITY

Governments, like ordinary households, may choose to spend more than its current income by borrowing. As long as the proceeds of borrowing are invested or spent on activities that increase income-earning capacity and allow the payment of the debt obligation, then deficit spending is not bad. However, just as households can be mired in debts, there is also the danger for governments to engage in profligate spending and incur unreasonable amount of debts.

* This paper was prepared by Romulo E. M. Miral Jr. as input to CPBD's "Analysis of the President's Budget for 2008".

The moral hazard of unsustainable borrowing is greater for governments than for ordinary households. Heads of families are in general permanent, but heads of governments and their administration have limited term. Most of the debts entered into by governments are medium- to long-term, exceeding the term of office of the government officials who negotiated the loan agreements. Thus, the present government can enjoy the pleasures of spending and pass on to the succeeding administration the burden of servicing the debt it had incurred. Government officials can always claim that they are acting on behalf of the people. The people, however, may have very limited appreciation of the benefits and costs of public goods and services.

The nature of public goods and the manner of their financing bodes big government spending. The national government budget supports various programs and projects, the benefits of which are enjoyed mainly by certain localities and groups of individuals although they are financed by taxes collected from the entire citizenry. For example, a school building or health clinic constructed in a certain municipality are likely to be primarily used by families residing in the locality; a provincial road or bridge will serve mainly the residents of the province and nearby areas. However, the costs of these public facilities and infrastructure will only be partially shouldered by their beneficiaries, since they will be funded out of the taxes collected nationwide. Thus, the demand for these public goods and services from the different localities and constituencies will always tend to be high.

Governments also have greater access to loans than ordinary households. Governments can access not only commercial loans, but also bilateral and multilateral credit facilities. Moreover, government loans have sovereign guarantees that facilitate government borrowing. It is worth noting that the debt stock of the Philippines and many developing countries ballooned in the late 1970s and early 1980s, when states such as Saudi Arabia, Kuwait, and Qatar amassed large surpluses of petrodollars but did not have the domestic activities to which they could be invested. Moreover, the recessionary condition of the world economy made investment in corporations less attractive and lending to governments of developing countries, which were covered by sovereign guarantees, became the most preferred alternative.

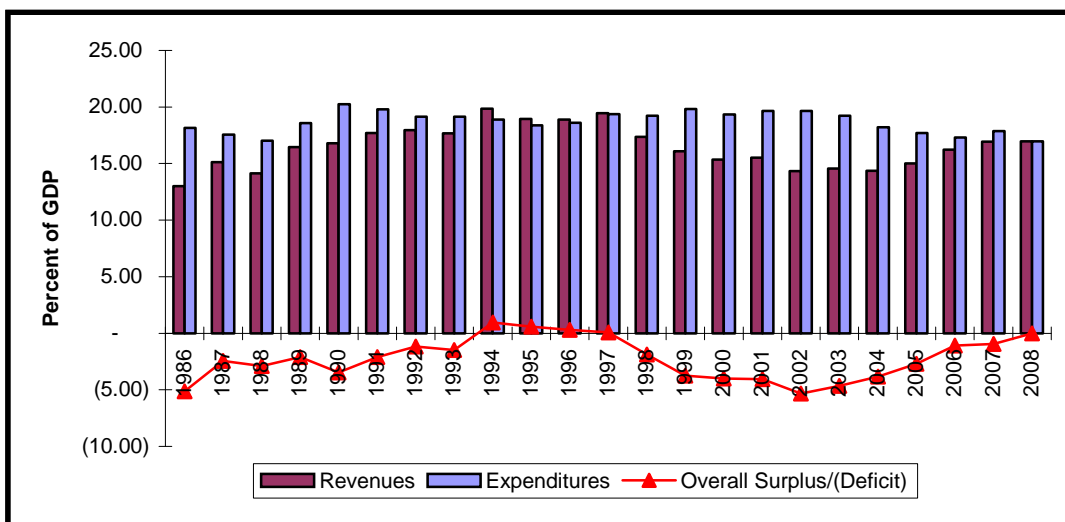
In the last 47 years (1960-2007), the Philippines' annual national government budgets were in deficit except for eight years. As can be gleaned from Figure 1 below, the budget deficits in the recent years were mainly due to the deterioration in revenue collection effort.

The government has three major options of financing budget deficits. The first is through money creation, when the Central Bank holds on to government debt papers and prints money that eventually ends up in the hands of the public or in bank vaults as excess reserves. The second is by domestic open market borrowing, when government debt is voluntarily held

by the banks or the public for the interest it pays. The third is by foreign borrowing, when the national government borrows abroad (*Remolona, 1985*).¹

These alternative means of financing the deficit affect certain economic variables and can lead to macroeconomic instability. Money creation can trigger inflation. Domestic borrowing can cause interest rates to rise. Foreign borrowing and its servicing can affect exchange rate movements. Inflation, high interest rates, and unstable exchange rates are bane to investment and capital accumulation since they increase the costs and risks of doing business. Thus, chronic and unsustainable deficits can stymie economic growth, as measured by the country's gross domestic product (GDP) or gross national product (GNP).

FIGURE I
NATIONAL GOVERNMENT REVENUES,
EXPENDITURES AND DEFICITS, 1986-2008



Economic variables likewise affect the different budget components and the size of budget deficit. The budget is formulated in the context of certain assumptions made on these macroeconomic variables. The nominal GNP or GDP affect the government's revenue base. High GNP or GDP growth rates could help government revenues or tax collection. High inflation rates on the other hand, tend to raise the nominal revenue of the government but, at the same time, raise the government's cost of procuring goods and services.

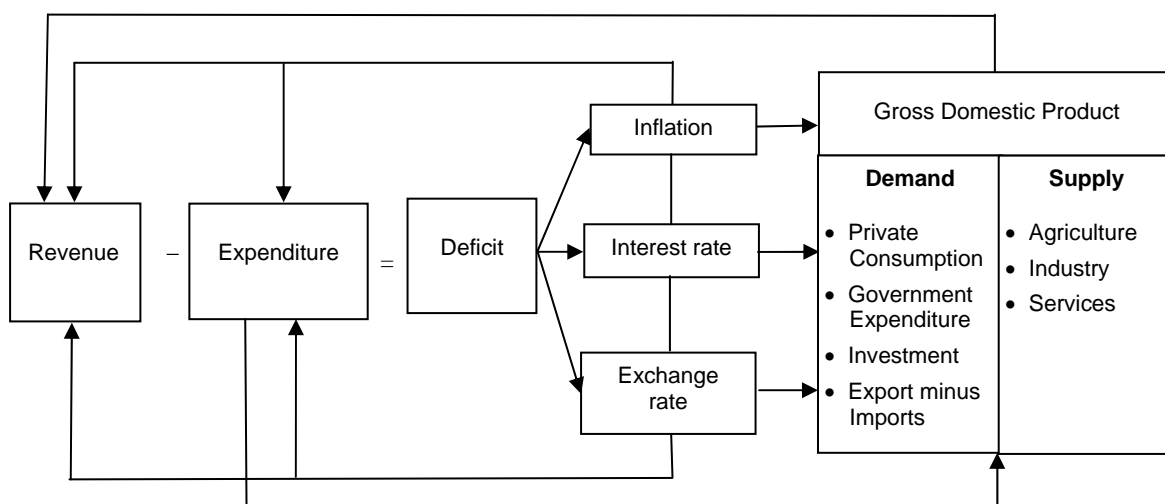
Interest rate hikes also affect the budget in two ways. On the revenue side, it can increase government revenues, particularly from withholding tax on interest income. On the expenditure side, it can increase the interest payments of its debt-servicing obligation.

¹ *Remolona (1985) identified a fourth source of deficit-financing, which is raising reserve requirements, when banks are made to hold additional required reserves in the form of cash, balances with the Central Bank, or eligible government securities. However with financial liberalization this means financing the deficit had ceased to be important.*

Similarly, the depreciation of the peso increases revenues from the higher peso proceeds from import taxes, but it also raises expenditures through higher foreign debt service payments and other foreign exchange-sensitive expenditures. The relationship of the budget and the economy is illustrated in Figure 2.

Unmanageable budget deficits can result in a vicious cycle of macroeconomic instability (high inflation and interest rate and unstable exchange rate), inadequate physical and social investments, weak economic growth, weak revenue collection, and bigger deficits. Thus, containing the deficit or balancing the budget have been regarded as signs of good housekeeping and are viewed favorably by investors, creditors and credit rating agencies.

FIGURE 2
RELATIONSHIP OF BUDGET VARIABLES
AND MACROECONOMIC VARIABLES



Efforts to contain the deficit should start with the sound formulation of the annual national government budget. The President's proposed budget sets the maximum amount of expenditures that can be incurred by the national government. Oftentimes, the macroeconomic assumptions and the revenue projections underlying the budget are too optimistic. This leads to the authorization of a bigger expenditure program than what can actually be supported by available revenues, rendering it difficult to contain government deficits.

Note also that the President's budget consists of programmed and unprogrammed appropriations. The amount of programmed appropriations serves as the official ceiling of the national government budget. Together with the projected revenues of the government, it

determines the government's targeted budget deficit. To contain the budget deficit within the target level, unprogrammed appropriations can only be expended when revenue collections exceed the original revenue targets. However, foreign-assisted projects (FAPs) including those classified under unprogrammed appropriations can be implemented as long as there is a perfected loan agreement, even if the government does not meet its revenue targets. This exception to the implementation of unprogrammed appropriations poses risks to the government's breaching its deficit target.

Another risk to containing the national government deficit is its contingent liabilities. These include: (a) direct guarantees on loans to government owned and controlled corporations (GOCCs) and government financial institutions (GFIs), (b) guarantees on risks under build-operate-transfer (BOT) contracts, (c) unfunded liabilities of public pensions institutions, and (d) deposit insurance (The Government of the Philippines, The World Bank, and The Asian Development Bank, 2003). A significant amount of the national government's outstanding debts represents assumed liabilities from these various entities, the servicing of which is automatically appropriated thus automatically bloating government expenditures.

STRATEGIC ALLOCATION OF RESOURCES AND ENHANCEMENT OF PRODUCTIVE CAPACITY

In addition to the promotion of economic stability, the national budget is instrumental in increasing the productive capacity of the economy, reducing poverty, and improving the overall welfare of society. In this regard, attention is given to the composition of the budget—by sector, by function, by type and object of expenditure, and by agency—and its resulting trends. As a poverty reduction instrument, it is also important to consider the access by the disadvantage sectors to, and equity in the geographic distribution of, public services.

Economic growth theory emphasizes the importance of capital accumulation in the attainment of economic growth—i.e., the higher the stock of capital, the higher the level of economic output in the long-run. Governments invest in physical infrastructure in order to increase the productive capacity of an economy. Public infrastructure, such as roads, bridges, and airports reduce transactions cost and increase the profitability of businesses, thus, paving the way for greater private investments (*Diokno, 2007*).

Another key factor in economic growth is technical change, which can occur either in the process of producing the same outputs more efficiently or in producing entirely different and superior outputs or “high-tech” products. Technical change is promoted through investment in human capital or education, “learning by doing”, and research and development. Thus,

government spending on human capital formation is very important. Public health and education spending for example not only increases the productivity of labor and allows for higher economic growth, but also allows benefits of growth to be widely shared by individuals in the society.

However, governments have the tendency to over-expand and venture into areas outside its vital functions. Programs, projects and activities once initiated tend to self-perpetuate. While new government offices are created to respond to emerging needs, offices which have outlived their usefulness are seldom abolished. There are too much overlapping and duplication among the functions, programs, and activities of many departments and line agencies. As a result public resources tend to be spread too thinly which prevent government from effectively performing its vital functions and core services.²

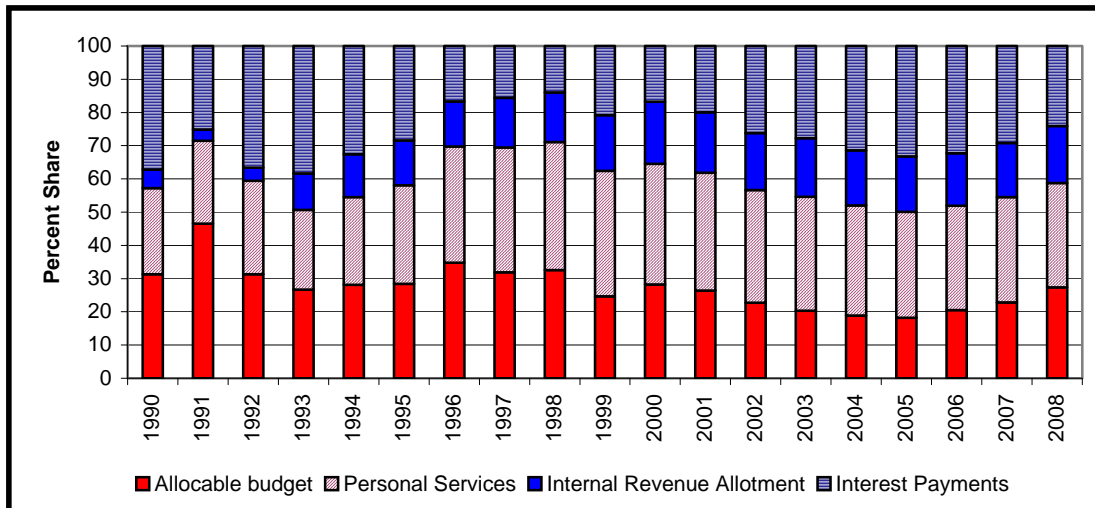
The debt-service requirements of the government have also crowded out expenditures on vital public services and have severely constrained the flexibility of the national government budget. As shown in Figure 3, interest payments alone have accounted for an average of 26.64% of the proposed annual national government budgets from 1990 to 2008. Aside from interest payments, there are other major mandatory expenditure items, such as the Internal Revenue Allotments (IRA) to Local Government Units, and Personal Services. The IRA has increased from 5.6% to 17.2% of the proposed annual budgets over the same period, while the share of personal services has averaged at around 32.0%. In effect, only around 27.0% of the annual national government budget is freely allocable.

Given the limited allocable resources, how should the budget be allocated to different sectors, agencies, functions, activities, programs and projects of the government? What should be the bases for proposing budget cuts or augmentation? Would bigger budgets result in more or better services?

Good expenditure management has always emphasized the need for strong linkage between planning and budgeting. The allocation of the budget should be based on the goals, priorities and thrusts of the government, as articulated in the Medium Term Philippine Development Plan (MTPDP) and in the President's Budget Message. But, how can the broad goals and priorities in the MTPDP be translated into budgetary allocations for specific functions, activities, programs? Or looking at the budgetary allocations, how can one be assured that the government's medium term plan goals and objectives are likely to be met?

² On 4 October 2004, President Gloria Macapagal-Arroyo issued Executive Order 366 directing a strategic review of the operations and organizations of the executive branch. The strategic review aims to focus government efforts on its vital/core functions; improve the quality and efficiency of government services by eliminating/minimizing overlaps and duplication; and improve agency performance through the rationalization of service delivery and support systems, and organization structure and staffing.

FIGURE 3
BREAKDOWN OF THE PROPOSED NG OBLIGATION BUDGET
INTO MAJOR MANDATORY ITEMS AND ALLOCABLE PORTION



Recent reforms in public expenditure management note the importance of performance-based or results-based budgeting. Performance budgeting can help enhance the government's capacity to assess competing claims in the budget by arming budgetary decision makers with better information on the results of both individual programs as well as entire portfolios of policies, tools, and programs designed to address common outcomes. The programs, activities and projects of the different departments and agencies of the government that are contained in the national government budget should be able to demonstrate how they contribute to the achievement of the societal, sectoral and organizational goals and objectives. The Organizational Performance Indicators Framework (OPIF) suggests a useful approach in this regard (*See Figure 4*).

The OPIF that is being rolled out by the Department of Budget and Management is useful not only in the budget formulation, but in the other phases of the budget cycle—budget authorization, budget implementation, and budget monitoring and evaluation.

FIGURE 4
THE LOGFRAME OF THE OPIF

WHAT ARE SOCIETAL GOALS? ↓	Societal Goals are what the Government wants to achieve for society – the Government's ultimate policy objective. They are defined as the <i>societal benefits derived from sectoral changes</i> . Societal Goals describe the intended desirable impacts of goods and services on the country, the environment or the economy. As end-points to be aimed for, they represent the high-level vision the Government has for the country.
WHAT ARE SECTORAL GOALS? ↓	Sectoral Goals are the longer-term benefits for the sector from organizational changes. They are the intermediate link between organizational outcomes and societal goals. Sectoral goals can encourage greater sectoral integration. Where more than one agency contributes to a sectoral goal, agencies should be encouraged to work together to achieve the shared goal and also to clarify how individual agency's organizational outcomes and outputs contribute differently to the same sectoral goal.
WHAT ARE ORGANIZATIONAL OUTCOMES? ↓	Organizational outcomes are the more immediate objectives for the delivery of major final outputs (MFOs). Organizational outcomes also contribute to the achievement of sectoral and societal goals. An agency will be able to have more influence over organizational outcomes than sectoral or societal goals, although others (industry, related or other agencies) may also contribute to these outcomes. Organizational outcomes should reflect the impacts on the community or sub-groups of the community, as desired by the Government in providing funding to an agency, for it to do what it is doing or what an agency is capable of doing or striving to do.
WHAT ARE MAJOR FINAL OUTPUTS (MFOs)? ↓	MFOs are the products, goods and services an agency delivers to external clients. MFOs can be defined relative to: <ul style="list-style-type: none"> • the outcomes that they contribute to • the client or community group that they serve • the business lines or functional 'business unit' (in certain circumstances)
WHAT ARE PROGRAMS, ACTIVITIES, AND PROJECTS (PAPs)? ↓	There are three components to PAPs. For the purposes of OPIF, they are: <ul style="list-style-type: none"> • <i>Program</i> – an integrated group of activities that contribute to a particular objective • <i>Activity</i> – a work process that contributes to a program, subprogram or project • <i>Project</i> – activities that result in the accomplishment of an identifiable output within a specified period
WHAT ARE PERFORMANCE INDICATORS FOR MFOs? ↓	Performance indicators (PIs) for MFOs look at how efficiently an agency delivers its services, as well as the quality, access and timeliness of the service delivery. Unlike performance indicators for outcomes, an agency will have direct control over MFO PIs. They are measures of exactly what an agency has accomplished in terms of service delivery. MFO PIs do not tell directly whether MFOs have made a difference to society. However, cumulative improvements in an MFO PI should also result in an improvement in a corresponding outcome PI.
WHAT DOES EFFICIENCY MEAN?	Efficiency measures the ratio between inputs used to produce a given level of outputs. There are three types of efficiency measures: <ul style="list-style-type: none"> • <i>Technical efficiency</i> means minimizing the amount of inputs used to produce a given quantum of outputs; or maximizing the amount of outputs produced for a given amount of inputs. • Allocative efficiency involves using a combination or mix of inputs to produce a given level of outputs at least costs • Cost efficiency is achieved when both technical and allocative efficiencies are present.

Source: P.D.P Australia PTY LTD. 2007

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