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Repairing the Budget Contract between Citizens and the State

by
Allen Schick*

This article argues that the budget is essentially a contract between citizens and the state, and that the contract is in a great state of disrepair. The ongoing debate and action in OECD countries should focus on post-crisis revenue and expenditure policies in order to repair this contract. The combination of fiscal stress, high expectations and citizen mistrust, however, greatly complicates the task.

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This article views budgets as contracts that establish rights, obligations and expectations, assign roles and stabilise relationships among participants, promote continuity in policies and allocations from one budget cycle to the next, and reduce both the volume of decisions and the intensity of conflict. The idea of a budget as a contract is not new, but it may have renewed salience in post-crisis countries. The Great Recession has impaired both explicit and implicit budget contracts in many OECD countries, compelling the most impacted ones to abandon established policies and to seek political support for sustainable revenue and expenditure policies. Countries that have escaped financial destabilisation may nevertheless have to reconsider existing budget policies in order to cope with the financial burdens of ageing populations.

Viewing the budget as a contract has several advantages:

- The budget *qua* contract has to be achievable at the time it is negotiated. A contract that provides for parties to the agreement to perform impossible feats is not enforceable in law or achievable in politics.
- The notion of contract injects reciprocity into budget decisions. Rather than viewing the budget solely as a matter of what the government spends and does, a contract is built on the fundamental idea that all parties, including citizens, have mutual obligations.
- As a contract, the parties participate in negotiating the budget's terms. Rather than being bystanders, citizens have a role in influencing what is decided and how public money is spent.
- Finally, contracts have means of enforcement, and these means include accountability for fulfilling its terms and consequences for failing to do so.

As the title of this article indicates, repairing the budget contract is a key challenge facing contemporary governments. Few have the option of going back to pre-crisis conditions, but few have fully charted a sustainable post-crisis course. Defining future budget directions would be facilitated by considering how the budget functions as a contract and the terms that would be appropriate for aligning citizen expectations and government financial capacity.

At first glance, it may appear appropriate to examine how commercial contracts work and contribute to economic growth and stability. There are, however, obvious differences between private contracts and budgets, including their legal status and remedies in case of breach. Some of the differences are discussed in Section 1 which distinguishes four types of budget contracts: fiscal, social, performance and relational contracts. Section 2 examines fiscal contracts, which pertain to key budget aggregates: total revenues and expenditures, the financial balance and public debt. Section 3 turns to social contracts which entitle citizens to a broad swath of cash transfers and other benefits, and which claim more than half of national spending in most OECD countries. Section 4 covers performance contracts which are funded through annual appropriations and finance agency operations and the provision of public services. Section 5 broadens the discussion to the relationship between citizens and the state, including the role of citizens and groups in allocative decisions. The concluding section reflects on whether integrating contract post-crisis-like features into budgeting may help restore public trust and stabilise public finance.

1. The budget as a contract

In his most influential work, *The Politics of the Budgetary Process,* published almost half a century ago, Aaron Wildavsky characterised the United States budget as:

> … a contract. Congress and the President promise to supply funds under specified conditions, and the agencies agree to spend them in ways that have been agreed upon […] Whether or not the contract is enforceable, or whether or not the parties actually agree about what the contract purportedly stipulates, is a matter for inquiry. To the extent the budget is carried out, however, it imposes a set of mutual obligations and controls upon the contracting parties […] A budget thus becomes a web of social as well as of legal relationships in which commitments are made by all the parties, and where sanctions may be invoked (though not necessarily equally) by all.
>
> (Wildavsky, 1964, p. 2)

Although applied specifically to the United States, the notion that the budget establishes contract-like commitments, obligations and controls certainly fits parliamentary regimes where party discipline and/or coalition agreements bind the legislature and government to common budget policies. Contract-like controls are especially important during implementation of the budget to ensure that administrative units use appropriated funds in the amounts and for the purposes prescribed in the budget and supporting documents. When the budget is not regarded as a contract, there may be little correspondence between the numbers in it and actual expenditures. When, however, actual spending deviates significantly from authorised amounts, it is not only the budget contract that is impaired but democratic accountability as well.

As used here, is the word "contract" only a figure of speech, a fanciful metaphor that does not quite fit reality? The question arises both from Wildavsky's words and from governmental practice. Wildavsky labels the budget a contract whether or not it is enforceable, an agreement even when the relevant parties differ on what they have agreed. Apparently, the traditional budget is less than a full-fledged contract, but more than a wish list. It is both an *ex ante* specification of what participants in the process are required to do or barred from doing, and an *ex post* record of what they have actually done.

There are two main reasons why budgets are not conventionally regarded as contracts. One is that budgets perform other functions in addition to authorising expenditures. A government's budget is a political appeal to voters, a statement of its programme ambitions, a guide to economic policy, a means of organising the work and activities of public agencies, a communication link within government, an opportunity for parliament to express its preferences and concerns, a ritual for legitimising public expenditure, an accounting of past decisions and actions, and a means of financing ongoing programmes and operations. Wildavsky concludes that "the purposes of budgets are as varied as the purposes of men […] Nothing is gained, therefore, by insisting that it is only one of those things when it may be all of them or many other things as well" (Wildavsky, 1964, p. 4). By being more than a contract, the budget becomes less of a contract. Its decisions carry significant weight, but not always or everywhere to the same degree. The budget demands both compliance and discretion, and fidelity to its terms, along with flexibility to deal with matters that arise during the year, including shifts in economic conditions or in political circumstances.

The second reason why budgets are not conventionally regarded as contracts is that public budgets are not legally enforceable and often not politically enforceable either. If, for example, a school fails to educate students or does not offer all the services promised in the budget, the government may not be able to sanction it by reducing financial resources. Doing so would likely disadvantage children and would not improve educational services or outcomes.

The school example points to another characteristic of public budgets. They are agreements within government, typically between an administrative entity and its parent ministry or between a sectoral ministry and the finance ministry. Taxpayers and other stakeholders do not directly participate in setting the budget's terms. As internal contracts, budgets do not change citizen-government relations, nor do they give impacted persons means of redress if public agencies breach budget commitments.

Budgets take on genuine characteristics of contracts when they are transformed from internal processes and agreements into spending and policy commitments between the government and the people. In view of the overriding need for political support and administrative flexibility at key stages of the process, budgets cannot always be treated as full contracts. Yet, it is feasible to inject more contract-like characteristics into budgeting by giving explicit consideration to impacts on citizens.

An initial step in reshaping budgets into quasi-contracts is to recognise that they produce different types of commitments. In all OECD countries, the budget's numerous decisions take three distinguishable forms:

- Explicit decisions on fiscal aggregates, such as total spending, deficits or debt, expressed in nominal terms or as proportions of GDP. These are the basic elements of fiscal contracts.
- Statutory obligations for government to make periodic payments to eligible recipients. These obligations, which typically are written into permanent law that continues from one budget cycle to the next, form the backbone of social contracts.
- Annual appropriations for the provision of authorised services. During stable times, appropriated amounts change only incrementally from one cycle to the next. This stability speaks to the contract-like characteristic of performance contracts.

The three types of contracts are established through different processes, have different means of enforcement, and often have different time frames as well. Moreover, the three types generally correspond to the widely used typology for analysing the objectives of public expenditures: fiscal discipline, effective allocation, and operational efficiency.[1]

2. The fiscal contract

Every national government has a fiscal contract. Some governments set contract terms explicitly by establishing limits on total revenue, expenditure or public debt, or on the balance between revenue and expenditure. In others, the fiscal contract is implicit; fiscal aggregates derive from the revenue and spending decisions made in the budget, plus the effects of exogenous conditions such as the performance of the economy. When the fiscal contract is explicit, its parameters are fixed before the budget is decided; if it is implicit, the parameters emerge only after decisions have been taken. An explicit contract constrains budget decisions; an implicit contract accommodates them. An explicit contract usually has an enforcement mechanism, though not necessarily an effective one, whereas an implicit contract rarely has a means of enforcing the aggregates.

There is a pronounced trend toward explicit fiscal arrangements. Approximately 80 countries now constrain one or more fiscal aggregate before they formulate the annual budget. This trend has been spurred by the realisation that implicit fiscal contracts accommodate rather than constrain expenditure demands. Countries have taken different paths in adopting formal constraints. Some countries have limits that are fixed in national law or international agreements, while other countries have a "fiscal responsibility" process for setting the limits each year in advance of budget work. A few have built-in enforcement mechanisms, but most do not. In the absence of automatic enforcement procedures, a government has to act to keep the budget within bounds, typically by adjusting revenue and/or spending policies. Due to political and other pressures, enforcement is likely to be spotty when those who violate the fiscal contract are the ones called upon to repair it (see Anderson and Minarik, 2005; and IMF, 2009).

The Great Recession has severely damaged explicit fiscal contracts in the most heavily impacted countries, and less so in countries that suffered only mild economic dislocation. The key problem is that most of the preset limits devised before the crisis combine excessive rigidity and feeble enforcement. On the one hand, they do not flex with cyclical changes in economic conditions while, on the other hand, there are only weak sanctions or none when the limits are violated. The same rules apply when the economy is robust and when it is faltering, when stimulus is the appropriate fiscal response and when restraint is necessary. To put the issue within the framework proposed in this article, a pro-cyclical fiscal contract is not workable or enforceable; sooner or later, the parties to it – political leaders, in this case – will break the contract because they have no possibility of upholding it when economic conditions take a turn for the worse.

Citizens have a large stake in their country's fiscal contract, but they rarely have a direct voice in setting its terms. Citizens can indirectly express their views on the government's fiscal management at the ballot box, but they do not have seats at the table when fiscal policy is decided. Their exclusion may be a good thing, because opinion surveys in many countries show that citizens habitually prefer smaller governments and bigger programmes. Inviting citizens to actively participate in defining the government's fiscal position might lead to no agreement or to one that inscribes their cross-pressures and inconsistencies in government policy. Yet contradictions in public opinion do play havoc with the fiscal contract, even when citizens lack a direct voice. The tension between the budget's totals and parts explains why many governments have embraced explicit fiscal contracts, as well as why these contracts often succumb to political or economic *force majeure* (Schick, 2003a).

Arguably, however, the inherent fragility of fiscal contracts should impel governments to open the process to citizen participation. A strong case can be made that citizens hold contradictory opinions because they are not responsible for the fiscal consequences of their views. As long as the two sides of the question are separated, it is perfectly reasonable for citizens to want smaller government but more benefits from government. It is only when the two parts of the question are fused together, and when citizens are thus confronted with the arithmetic interactions between the parts and totals, that they have a sufficient basis to adopt internally consistent positions.

It is exceedingly difficult, though not impossible, to engage citizens in constructing their country's fiscal contract. It is technically feasible to conduct a national plebiscite on fiscal options, including tax and spending policies, or to compel voters to choose among revenue and spending alternatives that would reduce or increase budget deficits. Of course, it would be necessary to limit the number of choices, but voting results can indicate whether citizens favour bigger or smaller government, more or less spending on major programmes, and higher or lower tax burdens.

Although it is feasible to poll citizens on budget aggregates, the legitimacy of fiscal contracts does not rest on explicit endorsement by voters. Every fiscal contract is inherently a political covenant in which citizens entrust the government with authority to manage the public finances and the government commits to do so in a prudent manner. It is not specific revenue and spending policies, or even the sum of these policies, that bonds citizens and government, but the combination of trust and stewardship that empowers a government to set the country's fiscal course.

The issue of trust will be revisited in the concluding section of this article, but it is the stewardship component that runs afoul of the political pressures and contradictions mentioned earlier. Political leaders who get mixed messages from citizens may prefer to be stewards of public finance, but often end up promoting short-sighted, opportunistic policies that put the country's fiscal position at risk.

Distortions in political incentives get in the way of trust and stewardship. One distortion is the common resource pool problem: citizens with different interests and demands have incentive to draw as much as possible from the pool of public funds, even though they may be disadvantaged by the consequent destabilisation of public finance. Another problem is that political leaders have incentive to respond to today's voters at the expense of tomorrow's results, even when the likely result is future insolvency or austerity. Failure to recognise these mis-incentives dooms fiscal contracts. Instead of arming the government with trust, citizens besiege it with demands and, instead of acting as stewards, politicians behave as vote-seeking opportunists.

The remedy sought by contemporary governments is to adopt fiscal rules that restrain leaders from acting on the basis of mis-incentives. However, poorly constructed rules neither purge governments of budgetary myopia nor protect the common pool of public funds against political predation.

2.1. The fiscal contract should not harm citizens during adverse economic times

One advantage of viewing the budget as a fiscal contract is that it may sensitise the government to the impacts of fiscal policies on citizens. These impacts habitually are disregarded when national governments construct fiscal rules that ignore swings in underlying economic conditions and that therefore have pro-cyclical biases which deepen downturns when the economy is weak and spur governments to spend more or tax less when the economy is buoyant. Pro-cyclical rules – which include almost all of the rules adopted thus far – harm citizens when income supports and other programmes that benefit vulnerable persons are curtailed or terminated in order to keep within a fixed fiscal constraint.

It is much easier to devise rules that disregard economic cycles than those which seek to build counter-cyclical adjustments into fiscal targets. Fixed rules have constraints that do not vary with shifts in economic conditions and are, therefore, relatively easy to monitor and enforce; pliable rules do vary and depend on assumptions about potential output and other economic variables.

A fiscal responsibility process that enables the government to reset targets annually, or more frequently, when warranted by circumstances, is likely to be more counter-cyclical than a rule that is established in law or international agreement. In setting annual or multi-year targets under a fiscal responsibility process, political leaders can take account of actual or projected economic conditions. While not as constrictive as fixed rules, a fiscal responsibility process may lead to more realistic targets and, consequently, to greater compliance.

A fixed rule can build cyclically adjusted targets into fiscal constraints. Chile has had considerable success with a structural rule, which it adjusted during the recent crisis, that requires a structural financial balance (as a proportion of GDP) but permits a nominal deficit when economic conditions deteriorate.

In designing cyclically adjusted rules, it may be useful to distinguish between the bulk of public expenditures that are not significantly sensitive to economic swings and those, such as unemployment benefits, that do vary. For example, Austria imposes a hard fiscal rule on non-cyclical expenditure and a flexible rule on cyclical components. An additional advantage of this approach is that it protects segments of the population that are injured by economic downturns against further harm from policy changes.

2.2. Fiscal rules should be framed within a medium-term horizon

Fiscal contracts generally span a single fiscal year, presumably because the country has annual budgets. Confining the contract to one year diminishes its utility, first because the fiscal policies implemented one year have consequences for subsequent years, second because short-term contracts invite practices that make the current year's fiscal position appear to be favourable at the expense of future years.

The obvious solution is to extend a fiscal contract to the medium term or beyond. But a rule covering multiple years can only be as sturdy as the framework within which it is housed. A fiscal framework is of little utility when, as often happens, the spending ceilings set one year are treated as floors for spending decisions the next year. To be effective, a framework must have an enforceable presumption that limits will not be reset whenever it is expedient to do so. There are, of course, legitimate reasons for resetting the targets in response to new conditions or information that was not available when limits were initially set for the fiscal year. Political commitment to uphold fiscal limits is a necessary but not always sufficiently effective safeguard against revising or ignoring the limits in order to accommodate popular demands for additional resources.

Some countries have introduced "claw back" rules to put public finance back on track when fiscal limits are breached because of economic or other circumstances. As part of new constitutional rules that will take effect in mid decade, Germany will require fiscal adjustments in subsequent years when one year's deficit limit is breached.

2.3. Fiscal rules are rarely self-enforcing

Fiscal rules require strong mechanisms for monitoring fiscal prospects and out-turns, and for taking appropriate corrective action. Rules limiting budget policies have been adopted by many countries because of concern that, without them, governments would take on more deficits and debt than is fiscally sustainable. Arguably, however, if the impulse to debt finance government activities is so powerful, mere rules may have only minor impact on fiscal behaviour. Rules that lack enforcement mechanisms can be easily brushed aside by cross-pressured politicians. The most direct tactic is to ignore, waive or modify fiscal limits that get in the way of coveted revenue or spending decisions. Even when rules establish preset limits, politicians may undermine them by manipulating economic (and other) assumptions, changing the timing and recognition of revenues or expenditures, hiding the true deficit through off-budget manœuvres, using one-off revenues such as income from asset sales, and other tactics.

Some governments have decided that the surest way to safeguard the country's fiscal position is to vest authority to issue economic projections and monitor budget out-turns in an independent entity. The United Kingdom's Office for Budget Responsibility, established in 2010, is modelled after similar organisations in other countries. Some observers believe that not only forecasts but fiscal policy as well should be entrusted to an independent agency.[2] The question of what to do in case of breach has stirred considerable controversy, especially with regard to the EU Stability and Growth Pact which was launched without effective means of enforcement.

Some of the most difficult enforcement issues arise during growth spurts when revenues are buoyant, deficits have been eliminated or significantly reduced, and politicians are pressured to cut taxes or boost spending. It is during these times that fiscal discipline falters, commitments extending well into the future are undertaken, and the seeds of future budgetary distress are sown. One of the lessons of the Great Recession is that if countries are not prudent during the good times, they risk paying a heavy price during bad times.

3. Social contracts

Income supports and other transfers prescribed by law are intergenerational covenants that bind current and future taxpayers to finance payments promised in the past. These covenants also commit governments to make required payments in a timely, accurate manner. They echo Edmund Burke's justly famous declaration that "society is indeed a contract. It is […] a partnership not only between those who are living, but between those who are living, those who are dead, and those who are to be born" (Burke, 1790).

These entitlements are not fully binding contracts because a government can legislatively modify their terms, as quite a few OECD countries have done in anticipation of ageing populations or in response to financial crisis. With some notable exceptions, the adjustments have been marginal – such as raising the eligibility age for full benefits or recalibrating payment formulas – but the basic structure has remained intact. However, national governments may be impelled to legislate more far-reaching modifications in the future, especially in countries that already have high public debt burdens or have not made adequate provision to finance promised payments.

The prospect of future adjustments is heightened by several flaws in contracting for social transfers. One problem is that social contracts not only commit a government to future disbursements; they also inflate citizen expectations about what they will get in the future. With few exceptions, social contracts are open-ended commitments; they do not have fixed budgets or preset spending limits. They specify eligibility rules, benefit formulas and other relevant terms, but not the amounts to be spent during a specific fiscal period or during the lifetimes of a cohort of recipients. Not only is the amount to be paid to eligible persons open-ended, but many social contracts provide for upward adjustments as wages or prices rise or as individuals live longer, or in response to political pressure to enhance benefits. In many countries, the government's obligations increase in response to both favourable and adverse socio-economic conditions. To the extent that entitlement-fueled expectations beget still higher expectations, the social contracts on which contemporary welfare states have been built are doomed to fall short. The social contracts are not adequately funded and they cannot be sustained. It is not the Great Recession that has imperiled many social contracts; rather, it has spotlighted their built-in deficiencies and prompted corrective action in some countries.

A related problem is that social contracts often are based on indifference to, or miscalculation of, downstream costs. Governments often lack timely and accurate projections of future liabilities, and politicians often have incentives to disregard or underestimate the long-term costs of new commitments. For their part, citizens routinely take it for granted that the government is giving back only what it took from them; they therefore feel cheated when the government trims promised payments. The fact that beneficiaries usually pay only a fraction of the cost does not sway public opinion, nor does it induce the parties to social contracts to exercise due diligence when they establish commitments that extend indefinitely into the future. To make matters worse, few countries set aside sufficient funds to cover projected future payments. From the outset, therefore, these contracts carry substantial risk that the government will not be able to fulfil the agreed terms.

Evidently, social contracts have been grounded on the premise of sustained economic growth, possibly interrupted by mild downturns but with the economy quickly reverting to its expansionary trajectory. In effect, neither party to the agreement – not the current government nor current or prospective beneficiaries – bears the full cost. Instead, a significant portion of the cost is deferred on the assumption that it will be financed by the dividends of future economic growth.

Inadequate growth is only one of the financial risks held by national governments. In fact, many OECD governments hold a broad portfolio of socio-economic risks. They are at risk when people live longer, when citizens experience bouts of illness or unemployment, when expensive medical technologies and treatments are developed, when natural or man-made disasters occur, when the yield on investments declines or interest rates rise, and much more. The economic crisis has shed light on the exposure of governments to asset bubbles and financial meltdowns, and to the enormous cost of restructuring banks and indemnifying depositors. These mega risks have destabilised public finance, but the cumulative costs of mini risks, such as income support for individuals during old age and for health care, also threaten government finance.

It is no exaggeration to say that modern social contracts massively shift risk from households and enterprises to governments and future taxpayers. This arrangement has one great virtue: it enables society to pool risks among its members, thereby spreading the cost and softening the financial loss borne by impacted households and firms. A strong case can be made for a government to assume socio-economic risks, for only it can organise insurance pools that are as inclusive as society itself. Serious problems arise, however, when the government fails to account for its exposure to risks or fails to allocate sufficient funds for future payouts, as well as when the shift in risks induces morally hazardous behaviour that adds to future costs.

Some fiscally prudent countries have moved to reduce their financial exposure by transferring some risks back to beneficiaries. For example, shifting from defined benefit to defined contribution pension schemes reduces the government's exposure to risk and future costs. Most changes have been driven by fiscal stress: pressure to reduce debt levels and fiscal deficits, and to calm financial markets by producing significant savings.

Ideally, renegotiating social contracts should give due consideration to the interests of stakeholders, should fairly allocate costs, and should stabilise government finances. The remaining paragraphs of this section suggest guideposts for post-crisis social contracts.

3.1. Governments should account for the risks embedded in social commitments and, to the extent feasible, the projected costs of these risks

Most social contracts expose a government to contingent liabilities – that is, to future payments if certain events occur. Some contingencies are predictable; others have a great deal of uncertainty. Governments can reliably project the future size of retirement cohorts, but not long-term price trends or investment returns of its pension funds. Two decades ago, not a single OECD country systematically listed its contingent liabilities; now a growing number annex statements of these liabilities to the budget or other financial reports (Brixi and Schick, 2002). Member countries should be encouraged to identify explicit direct and contingent liabilities that arise out of social commitments and to build future costs into the budget, the medium-term frameworks, and the long-term fiscal projections. Governments can apply simplified "value at risk" models to estimate future costs, and update these estimates annually as well as when major events significantly increase or decrease risks. Most importantly, governments should estimate prospective costs before taking on new social commitments.

Two big issues stand in the way of full recognition of contingent liabilities. One is that, in many countries, key parts of the social contract are embedded in expectations rather than in law. For example, in some countries, the government periodically adjusts pensions to price changes or to increases in the minimum wage, even when it is not legally required to do so, and it indemnifies bank deposits for losses above the legal limit. The presumption that the government will act in the expected manner is a core feature of social contracts, but recognising expectations as liabilities increases moral hazard and exposes the government to additional risks and costs.

The second problem is that accrual accounting standards generally do not require governments to recognise all social commitments. Governments have to expense pensions and other obligations for their own employees, but not the much costlier pensions and other benefits promised to the general population. The rationale for this distinction is that the former are legally contracted obligations, while the latter are established in laws that can be modified through new legislation. However, the fact that crisis-afflicted countries have curtailed pensions and other benefits for public employees calls this distinction into question.

3.2. Revised social contracts should not be short-term fixes that will have to be corrected through further adjustments

To strengthen trust in public institutions, new social contracts will have to constitute credible commitments that the government will provide promised benefits well into the future. Toward this end, governments should restructure social commitments so that: *i)* they are financially sustainable over an extended period, including cyclical variations in economic conditions; *ii)* they have assured sources of funding; and *iii)* they are in a form that restricts or inhibits unilateral changes by the government. They should also protect vulnerable persons against severe financial adversity, ideally in ways that do not generate moral hazard.

3.3. Social contracts should distinguish between risks that benefit recipients and those that adversely affect them

Governments bear contracted costs when workers lose their jobs or become disabled, as well as when people live longer and benefit from medical innovations. A strong case can be made that recipients should share some of the increased costs when they benefit from developments that improve their quality of life or enable them to live longer. Private insurers routinely adjust premiums and payouts to changes in life expectancy, and many households prudently adjust spending habits to guard against outliving their money. It is prudent for governments to make similar adjustments, but doing so is difficult because proposals that appear to reduce benefits trigger political conflict and often damage the government's electoral prospects, compelling it to settle instead for modest savings that do not remedy fundamental imbalances.

Some innovative governments have adjusted future payments to changes in life expectancy. For example, Sweden pioneered a novel approach in 1998 by adopting an automatic balance mechanism that ensures its pension system's financial viability at a constant payroll tax rate (Valdes-Prieto, 2002). One feature of this mechanism links the amount paid to changes in life spans. When a cohort of pensioners is projected to live longer, monthly payments automatically decline for that cohort, except for persons who voluntarily delay the start of benefits. The government has estimated that average benefits will be cut 14% by 2055 for those retiring at age 65 (Weaver, 2006). Sweden has effectively shifted the risk and pension cost of living longer from the state budget to pensioners. It has been motivated by a determination to preserve the social contract, not by a desire to dismantle fundamental social benefits. A major advantage of the automatic mechanism is that politicians do not have to vote to raise the retirement age or to adjust benefits. These changes are made administratively in accord with a predetermined formula.

3.4. Social contracts should withstand adverse economic swings and should be sustainable

Whether public or private, the value of financial rights conferred on one party depends on the capacity of the other party to pay obligated amounts. Many of the entitlements established during boom times assumed that the economy would continue to expand, and that it was therefore appropriate to assign workers and other beneficiaries a fair share of future growth. The financial crisis has undermined both this confident assumption and the policies that have derived from it. Nowadays, the key public finance issue facing governments is not how to allocate the incremental dividends of economic growth, but whether existing commitments can be sustained across generations. Even countries that have come out of the crisis in sound financial condition have had to re-examine their capacity to pay promised benefits over the next 30-50 years or longer.

Sweden's automatic balance mechanism has a formula that reduces pensions when liabilities exceed assets in notional accounts. (Notional accounts do not have cash flows; they are bookkeeping entries based on interest rates and incomes.) Payments are automatically restored when the deficit is liquidated and accounts are solvent. The mechanism was applied for the first time in 2010, but only after the formula was modified by the Swedish Parliament the previous year to avert steep pension cuts. Minimum guaranteed payments to low-income pensioners are exempt from the balance mechanism. The fact that Parliament has tinkered with the rules to delay reductions indicates that even automatic formulas do not escape political pressure.

Germany has taken a different approach to assure long-term sustainability. In 2004, it partly linked pensions to changes in the ratio of workers to pensioners. When this ratio, which is referred to as the "sustainability factor", declines, the government makes adjustments to both the payroll tax and pensions. This is in contrast to Sweden's mechanism which allocates the entire adjustment to pensions. Germany's payroll tax rate has been projected to be four percentage points lower in 2040 than it would be without sustainability adjustments.

3.5. Governments should share risks and costs with stakeholders

A government that is the risk holder of last resort for society, as is the case in most OECD countries now, is almost certain to face intense fiscal pressures in the future, and in some countries possibly to the point of insolvency. Risk sharing is essential to reduce moral hazard and to protect governments against both catastrophic claims and the incessant rise in public expenditure, especially for health care. Co-pays, premiums, origination fees and deductibles are widely used means of shifting a portion of the cost to beneficiaries, but these often are set at levels that are too low to induce behavioural changes. Governments can also shift risk to third parties by purchasing reinsurance or catastrophe (CAT) bonds, or by selling a pool of risky assets and associated liabilities (for example, future premiums for medical care) to others. Regardless of the method, the objective should be to wean society away from the notion that the government is responsible for the entire cost, or almost all the cost, of major social risks.

The aim of these suggestions is to strengthen social contracts by protecting core citizen welfare while reducing the financial exposure of the government. Narrowing the reach and ambitions of social contracts by transforming them from open-ended, unrequited government commitments into reciprocal, limited obligations by both governments and citizens may lead to fewer benefits, but will make the contracts and the benefits they promise more viable.

4. Performance contracts

Performance contracts pertain to the portions of the budget that finance administrative operations and delivery of public services. Contracted performance is only implicit when the budget focuses on inputs, but is explicit when the budget is structured according to actual or projected results. Even though they classify expenditures by inputs, line-item budgets contain elements of performance contracts when they are supported by information on planned services and activities. The potential of input-based budgets to strengthen performance is evident when one examines the accomplishments of advanced democracies during the first 40-70 years of the 20th century. Despite line-item budgets, many developed countries made extraordinary progress in education, health care, transport, sanitation and other public services. These results suggest that commitment to perform may be more important than the format of the budget. When this commitment is absent or weak, stuffing the budget with performance indicators will not make much of a difference (Schick, 2003b).

If line items do not inevitably get in the way of results and output data do not assure results, what value is added by making the performance contract explicit? A related question is: how explicit should the budget be about results? Does it suffice to insert performance information into the budget, or should the government expressly link the amount spent with the volume of services and outputs? In addressing these questions, it is useful to regard the budget as a contract for payment of authorised amounts in exchange for delivery of agreed services. In the same way that commercial contracts specify relevant terms because the parties have different, sometimes antagonistic, interests, a budget contract spells out what will be accomplished with public funds to prod the parties to fulfil their obligations. All contracts, whether public or private, benefit from trust between the parties, especially when some terms are fuzzy or circumstances change. When trust does not suffice, formal agreements can compensate. Agencies and staff that are committed to produce value for money can perform well even when the budget does not explicate the results to be achieved. But when this commitment is weak, a budget contract can compensate by giving public agencies and employees clear signals of what is expected of them.

Thinking about the budget as a contract for performance is hindered by the enormous variety of performance budgets (PBs). In many countries, within the OECD area and outside, the PB label is routinely applied to any budget that contains data on workload, activities, services, projects, programmes, outputs or outcomes, even when there is no indication that the data have influenced spending decisions. In a small number of countries, the PB label signifies that the government considers the changes that may ensue in results if budget resources are increased or decreased (OECD, 2007).

To clarify the concept of the budget as a contract for performance, it is useful to distinguish these budgets from those that merely provide performance-related information. There are numerous versions of performance budgets, but the important distinction is between the PB as a means of allocation and the PB as a container for information. The closer it is to the allocative model, the more the performance budget becomes a genuine contract for performance, but most countries that claim to have a PB use it principally or only as an information bucket.

What is it about PBs that spurs governments to compile performance-related information, but not to formally base allocations on results? Governments have invested substantial amounts to measure performance, yet they do not often connect these measures to expenditures. This pattern is so widespread and occurs in countries with such different political systems and administrative cultures that it appears to be functional, not random or accidental. Government agencies enthusiastically measure what they do and the outputs they produce, especially when they are the ones who decide how the information is compiled and used, but they are congenitally wary of using performance indicators to decide which administrative units or activities get more and which get less. The agencies covet information that bolsters their budget demands, but are cognizant that the same information might be used to reduce their budgets. They delight in showcasing good performance, but not when they are ranked in "league tables" that compare their results with those of other service providers. They generally are willing to compare results against targets, but only when they set the targets.

Despite these concerns and the failure of PBs to transform budgeting, this article opts for the allocative model because it reinforces the notion of budgets as contracts for performance. Moreover, shining a bright light on results might spur government entities to perform better.

4.1. Identifying and measuring performance

There are many ways to describe and quantify what government agencies do and the results they achieve. Competing approaches stir passion and conflict because they look at government in different ways, and they sometimes generate different assessments of how government is performing. For the past two decades, outputs and outcomes – the goods and services produced by government agencies and the socio-economic impacts of public policies – have been the favoured terms. Older measures such as workloads, services and activities have receded in prominence. One explanation for this trend is that outputs are the language of markets and contracts, whereas services are the language of providers; and outcomes are the focus of policy, whereas activities are the focus of administrative units. It is feasible to describe and measure public outputs in market-like contracts that specify the amounts to be spent and produced. During the 1990s, New Zealand was probably the first and certainly the boldest country in structuring public management around a web of output-based contracts that included purchase agreements between ministers and departments and performance contracts between department heads and the government (see Schick, 1996).

Outputs are amenable to contractualisation because the parties to the agreement have effective control over the obligations they enter into. Outcomes, however, are a more difficult case because achieving them typically depends, at least in part, on matters beyond the effective control of the parties. For example, a school's success depends in significant part on family circumstances, peer influences and economic conditions. Despite their limitations, when they are voluntary and are treated as strategic signals rather than as binding commitments, outcome-based contracts can stimulate the government to review the effectiveness of established policies. In the school example, when measuring and assessing outcomes, policy makers should be mindful of conditions outside the classroom that affect what occurs inside.

Whether oriented to outputs or outcomes, performance contracts typically lack contestability and enforcement. When a government agency is the sole supplier of a public service, inscribing expected results in a contract does little to improve performance. And when failure to perform does not prejudice future budget allocations, and sometimes strengthens the case for more money, having a contract does not change behaviour or results. In these circumstances, government agencies have little commitment to achieve contract terms and do not bear any penalty when they do not achieve them.

4.2. Services and activities

Outputs and outcomes are a foreign language to most citizens, whose main concerns are the activities of the government and the services it provides. A citizen-centred education budget (or contract) would more likely focus on service measures such as class size, the types of courses offered and the number of guidance counsellors rather than on test scores and dropout rates. Does this suggest that governments should orient performance budgets to work and activities, rather than to outputs and results? The case for output/outcome-based PBs rests on the sensible notion that a government does not carry out activities for their own sake, but to produce social and economic good. A government does not operate schools just to offer courses in reading and arithmetic, but to give students skills that are essential for effective adulthood and productive employment. These end-purposes, the argument runs, should be the focus of performance-oriented budgets.

The counter-arguments do not deny the utility of output and outcome measures in assessing whether government policy is on the right course. It behooves all governments to probe whether the activities financed by the budget are achieving planned results and giving citizens value for money. Yet citizens know their government and form political attitudes on the basis of the services they receive, or fail to receive. An actual performance contract between citizens and their government would almost certainly be organised around the services delivered by public agencies.[3]

Measuring outputs and outcomes need not crowd out attention to services and activities. The former are most useful, as just suggested, for evaluating programme effectiveness, the latter for comprehending how the government spends public funds. It is difficult to gauge whether a government is allocating the optimal amount of resources without decomposing programme or organisational expenditures into discrete activities and then calculating the inputs needed to carry out each activity. This is the rationale for activity-based costing, which has been widely applied in the business sector to estimate the financial effects of curtailing or expanding particular activities.[4]

The budget is not the only instrument for planning and assessing government performance. A government also needs robust analysis of policy options and systematic evaluation of programmes, but cramming these processes into the tense conditions and tight deadlines of the budget cycle is likely to yield less useful data and insights on performance than if analysis and evaluation were separated from the congested routines of budgeting. The further one moves from financial and operational decisions to strategic consideration of objectives and results, the stronger the case for output and outcome-based measures of performance. But in allocating money, services and activities are indispensable data entries; they are what participants in the budget dialogue discuss in deciding whether to spend more or less.

4.3. Specifying costs

To bind both providers and purchasers of public services, a performance contract should specify the volume and quality of services or outputs, and the amounts to be paid. However, the pervasive lack of data on the unit cost of services/outputs severs the link between resources and results. With the possible exception of trading entities that are self-financed by income from the sale of goods and services, national governments do not have robust cost accounting systems that enable them to distinguish between fixed and variable costs, and between marginal and average costs. Lacking this capacity, governments cannot reliably measure the incremental costs of producing an increment in services.

The failure of governments to invest in cost accounting is largely due to the notion of budgets and appropriations as legal limits on government expenditures. In all countries, government agencies receive a fixed appropriation for operating expenses and provision of services; this amount limits expenditures and does not vary if agencies produce more or less. (However, transfer payments, which are the main element of social contracts, generally are open-ended obligations that vary automatically with changes in the number of eligible recipients and in the payments to which they are entitled.) Historically, the overriding purpose of fixed appropriations has been to limit the amounts spent, not to buy public services. Of course, governments, political leaders and parliamentarians expect to receive services in exchange for authorising expenditures, but they do not formally connect the volume of services to the quantity of money. They rarely authorise agencies to spend more if they do more, or require them to cut spending if they produce less. Repeated waves of performance budgeting and other reforms have not weaned budgeting away from its roots as a control process.

Uprooting this orientation in order to link appropriations to performance would likely require a shift from fixed to variable budgets, in which the amount authorised to be spent depends on the volume of services. Although common in commercial enterprises, variable budgets (for administrative costs and services) are virtually unknown in government. Every variable budget is inherently a performance-based budget; every fixed budget is inherently one in which performance has limited influence, if any, on resource decisions. A variable budget effectively makes the budget into a performance contract, and transforms appropriations from limits on expenditure into indefinite allocations whose actual amounts are determined during implementation of the budget. Constructing a variable budget entails a series of connected steps:

- the disaggregation of services into standard units such as patient days and x-ray procedures in hospitals, and student days and courses in schools;
- cost accounting or allocation systems that enable governments to apportion the fixed costs that do not vary with the volume produced, and variable costs that do fluctuate with volume;
- computation of the marginal cost per unit – that is, the incremental cost of producing additional units; and
- administrative rules that empower managers to efficiently produce services and control costs.

Few member countries have the capacity to construct variable budgets; but even if they do not construct such a budget, investing in basic cost accounting systems will enable them to operate more efficiently and improve services (see Schick, 2007).

Variable budgets are not suitable for all government services and activities. Variable budgets are most appropriate when the government agency has no control over the demand for its services. For example, the agency responsible for issuing passports must process all applications; it cannot control workload by generating more demand or by refusing to handle applications. Inasmuch as the number of applications that will be processed during the next year is unknown, allocating a fixed amount for passport services is an inducement for inefficiency, poor services, or both. On the other hand, any administrative unit that exercises significant control over the volume of services should not be funded by variable appropriations. A variable budget would give it license to extract more money from government.

4.4. Performance as change

A performance contract (or budget) that strives to itemise all public services and activities would likely obscure the options that a government faces when it allocates resources. In all countries, and in most budget seasons, policy makers focus on the incremental differences between the current budget and the one proposed or adopted for the next year. The key question for each issue is whether to spend more or less than in the previous year. Injecting performance into the process broadens budget options to include the consideration of what more or less society will get by way of services, outputs, results, etc., if the government spends more or less. In other words, the central issue is what will change as a consequence of budget decisions.

To make informed budget decisions, governments require estimates of the incremental changes in results expected to flow from incremental changes in resources. This form of performance budgeting would be based on analysis of the marginal utility of expenditures. Results that would occur regardless of changes in the amount of resources or in how they are managed would not be credited as performance.

Relevant changes come in many forms: efficiency of operations, waiting times and accessibility of public services, volume and quality of services, substantive outcomes, and so on. Ideally, agencies would bid for services by specifying expected changes in results if funding were forthcoming. Their bids would be supported by description and analysis of why the changes are sought and of how the funds are expected to produce the planned results.[5]

This type of performance budget would have essential characteristics of a contract, even if it were not formally styled as one. It would explicitly connect the money to be provided to the results to be produced. It would inform the producing party what it will be paid, and the paying party what it will receive.

5. Relational contracts: trusting government and repairing budgets

A contract specifies the rights and obligations of the parties to the agreement as well as remedies in case of failure to perform. But formal terms are only one feature of contracts, and not always the most important ones. No matter how detailed they are, most contracts are inherently incomplete – they cannot anticipate all the disagreements or misunderstandings that may arise in carrying out prescribed terms. Whether in markets or in government, incomplete contracts are vulnerable to opportunistic behaviour by self-interested parties who exploit gaps and ambiguities to gain untoward advantage. When the contract is discrete – namely, it is a one-time or occasional interaction – disputes often are settled through litigation because the parties lack incentive to maintain a trustworthy relationship. However, when the parties expect to interact on a continuing basis, they have incentive to maintain the relationship by resolving disagreements informally, without renegotiating the contract or drawing lawyers and courts into the dispute.[6]

Relational contracts are highly relevant to the theme of this article. The three types of contracts discussed thus far are built on political relationships, both within government and between citizens and the state. This is most evident in social contracts which deal with rights and obligations that span decades and sometimes generations; it is the relationship between citizens and the government that rationalises paying taxes today in expectation of benefits to be received 30-50 years hence. Performance contracts also have relational dimensions that pertain to the services citizens expect to receive from government agencies. Fiscal contracts establish a more generalised relationship, in which citizens entrust government with responsibility for managing the country's finances.

To illustrate the value of relational contracting in government, let us assume that budget decisions were made solely on an impersonal basis through the formal exchange of prescribed documents. Policies and rules issued by policy makers would flow downward along hierarchical pathways, and information on expenditures and activities of operating units would flow upward. In blueprint, central authorities (principally the finance ministry, the council of ministers and parliament) would obtain the information needed for intelligent allocations, and spending units would receive the optimal amount of funds for efficient operations. In practice, however, it is likely that budget decisions will be skewed by inadequate or misleading information because central policy makers are dependent on spenders who have both incentive and opportunity to withhold or distort information. Spenders often have the upper hand in this unbalanced relationship because they control critical information. They can misclassify public employees, record travel as training, pay for one unit's activities out of another's account, count dropouts as students, and use dozens of ploys to misreport expenditures or activities. With inadequate or distorted information, policy makers unknowingly provide too much money or too little, or for the wrong purposes.

Thinking of the budget in relational terms explains why participants who have antagonistic interests nevertheless co-operate. The recurring character of budget work, with the same routines repeated year after year by the same role players, motivates each side to deal forthrightly with others engaged in the process. Spenders want their bids to have credibility and to be given due consideration by central budget allocators, and the budget office wants to produce a defensible budget that avoids political pitfalls by cutting some requested funds without impairing basic or popular services. For each side to get what it wants, both have to engage in conversations that often are more forthright than their formal exchanges. Although the relationship may appear to be adversarial, and friction often flares up during tense negotiations, beneath the surface abrasions of the process there usually is a reservoir of trust and co-operation.

Relations are vital at all stages of the process, not only when the budget is formulated. In countries where the national legislature has an active voice in amending the budget, parliamentarians and staff often establish stable, harmonious relations with counterparts in government. The relationship sometimes appears to be hostile, especially in countries which separate legislative and presidential powers; but even in these situations there are lively, trusting exchanges of views and information. After appropriations have been voted, informal relations introduce a measure of flexibility into what might otherwise be a rigid process. Situations frequently arise during implementation of the budget that make it necessary or desirable to modify expenditure plans. Virements often are arranged informally, through discussions between budget and sectoral officials or between them and parliamentarians (or legislative staff).

In both markets and governments, there are gains and losses from relying on relationships to supplement or substitute for formal contracts. The gains include reduced conflict and buildup of trust among persons who work with one another on an ongoing basis, lower transaction costs and less opportunistic behaviour, and greater confidence in and support for decisions emerging from the process. However, substituting informal relationships for formal procedures makes the budget less transparent and may open the door to misuse of public funds. In some countries, it may enable insiders to promote personal interests at the expense of the public interest, and may weaken the budget's status as an authoritative statement of financial policy.

Budgeting benefits from having both formal contracts that prescribe and limit government action, and relational contracts that promote political agreement and administrative efficiency. The balance between the two types of arrangements varies among countries and depends in part on political conditions and budget rules. Fiscally stressed countries that have itemised budgets are more likely to rely on informal, relationally sanctioned adjustments than countries that have comfortable budget margins and make broad allocations to programmes or administrative units.

5.1. A matter of trust

Relational contracts do not pertain only to exchanges within government, but to relations with citizens and the state as well. Within government, relationships can mitigate conflict and de-rigidify budget actions. A very different dynamic is at work in contemporary citizen-state relations, for the impairment of fiscal, social and performance contracts has been exacerbated by declining trust and confidence in public institutions. Tables 1 to 3, drawn from recent Eurobarometer surveys, show low trust scores in approximately two-thirds of EU countries. Surveys conducted in other OECD countries and regions also reveal depressed levels of trust. Table 4, drawn from Trilateral Commission reports, indicates that the onset of declining trust occurred during the last decades of the 20th century.

Table 1. **Trust in institutions: Government**

Percentage who tend to trust

	November 2003	June 2005	May 2007	June 2009	June 2010
Austria	46	49	57	58	54
Belgium	38	44	62	35	22
Denmark	53	55	67	61	50
Finland	49	68	75	54	49
France	30	24	36	39	35
Germany	24	27	49	45	32
Greece	47	40	41	25	25
Hungary	n.a.	32	27	14	40
Ireland	31	40	41	20	21
Italy	27	29	37	25	25
Luxembourg	60	68	66	77	66
Netherlands	37	40	73	56	47
Portugal	39	33	46	28	20
Spain	42	40	52	34	20
Sweden	42	33	55	57	57
Turkey	n.a.	76	71	57	43
United Kingdom	24	34	34	21	26

Source: Eurobarometer.

Table 2. **Trust in institutions: Parliament**

Percentage who tend to trust

	November 2003	June 2005	May 2007	June 2009	June 2010
Austria	43	52	57	58	52
Belgium	40	49	66	41	28
Denmark	68	74	85	75	72
Finland	52	67	77	60	55
France	33	33	44	33	36
Germany	31	35	51	46	39
Greece	54	47	53	33	23
Hungary	n.a.	29	26	15	41
Ireland	34	40	43	23	22
Italy	33	35	39	27	26
Luxembourg	53	64	64	67	52
Netherlands	41	53	77	56	54
Portugal	46	40	49	36	28
Spain	41	37	52	32	21
Sweden	53	46	70	64	66
Turkey	76	73	74	58	46
United Kingdom	27	36	41	17	24

Source: Eurobarometer.

Table 3. **Trust in institutions: Political parties**

Percentage who tend to trust

	November 2003	June 2005	October 2007	June 2009	June 2010
Austria	19	31	30	40	40
Belgium	22	30	29	28	20
Denmark	39	51	40	58	49
Finland	19	37	26	32	30
France	12	14	17	13	14
Germany	12	18	18	24	19
Greece	20	22	21	15	9
Hungary	n.a.	16	8	10	29
Ireland	22	24	22	19	17
Italy	11	19	16	19	18
Luxembourg	26	46	30	50	40
Netherlands	26	35	35	41	45
Portugal	17	19	15	18	15
Spain	23	24	32	23	14
Sweden	18	22	25	36	37
Turkey	n.a.	28	23	26	24
United Kingdom	12	22	15	12	18

Source: Eurobarometer.

Table 4. **Trends in confidence in parliament**

Percentage*

	Early 1980s	Early 1990s
Belgium	40	44
Canada	43	37
Denmark	36	42
Finland	65	34
France	55	48
Germany (West)	51	50
Iceland	48	54
Ireland	52	50
Italy	30	30
Japan	28	29
Netherlands	45	53
Norway	77	59
Sweden	47	47
United Kingdom	40	44
United States	52	45

* The number reported here is the percentage of respondents who had “a great deal” or “quite a lot” of confidence in parliament.

Source: Pharr, S.J. and R.D. Putnam (2000), *Disaffected Democracies: What’s Troubling the Trilateral Countries?*, Princeton University Press, Princeton, New Jersey, United States, Table 3.2.

Deterioration in citizen regard is not an isolated phenomenon nor a pattern that has occurred only in countries that have undergone political upheavals or scandals. “The convergence of results across Trilateral democracies is striking,” a team of prominent scholars concluded, “because each has experienced its own unique political events” (Pharr and Putnam, 2000). Some observers take comfort in the fact that citizens in OECD countries overwhelmingly favour democratic forms of governance.[7] Their discontent appears to be directed at political institutions, particularly political parties and parliaments, not at the constitutional framework. Voters want competitive elections and the absolute right to select government leaders, but they have distaste for the noise and cacophony generated by unfettered competition. A cynic might complain that they want democracy, but not the government that democracy gives them.

The inverse relationship between favouring democracy and disfavouring politicians has spurred some people to argue that democracy is strengthened by having an attentive, sceptical public. This argument ignores the fact that, in the not-so-distant past, citizens held much more favourable views of political institutions and processes. It is the down trend in civil attitudes, not the absolute scores, that troubles practitioners and scholars and eludes easy explanation. Moreover, declining trust and confidence have been accompanied by political demobilisation: less attention to political news and events, weaker party identification, and less engagement in political activity. Whatever the reasons, there certainly is negative feedback from citizen values to the capacity of government to take the tough decisions required to repair its budget contracts.

The timing of the down trend provides a clue to the withdrawal of trust. The post-war economic boom, which continued for approximately a quarter of a century in many OECD countries and was interrupted only by mild cyclical swings, petered out during the 1970s in the aftermath of oil price shocks and other disturbances. National economies across the OECD area continued to expand, but generally at lower rates and more haltingly than in the immediate post-war period.[8] In the same way that governments and leaders previously took credit for robust growth, they now were blamed for disappointing economic growth. Worse yet, they no longer has sufficient growth dividends to distribute through expansionary budgets, but they were pressured to satisfy the financial commitments and expectations established during the boom years. In quite a few countries, politicians shifted from credit-taking to blame-avoidance and to tactics they hoped would shield them from the wrath of voters.[9]

However, although they are an important part of the story, economic trends do not provide a full explanation. For one thing, trust generally has not recovered when the economy has; the two variables have not moved in lockstep. For another, the concept of trust has cultural, normative, socio-political and other dimensions that need to be accounted for. Trust is not simply a referendum on the government of the day, but a statement concerning the relationship between citizens and the state. It is this relationship that has been impaired and that has to be rebuilt if budget contracts are to be repaired.

It is plausible to assume that adverse attitudinal trends are linked to deteriorating government performance, not just in a single year or activity, but over an extended period and across a broad swath of government responsibilities. There is little evidence, however, that governments are less efficient or productive than they once were, or that low performance is a cause of low trust. A team of senior World Bank researchers has examined the question of whether a performance budget that gives citizens a clear picture of how public money is spent might reverse the downward spiral in public regard. The team reviewed both public opinion surveys and various "drivers of trust" identified by prominent scholars. It concluded that "trust in government is not a simple function of perceived quality of service provision" (World Bank, 2010, p. 207). The team found a more complicated story, which it packaged into six pointed statements (World Bank, 2010, p. 203):

- Accountability matters more than performance in OECD countries.
- The effect of performance on trust erodes over time, even when performance itself remains constant.

- Improving performance matters most in services directly provided to citizens.
- The gain in trust due to improvements in performance and accountability can be squandered through perceived misdeeds.
- Overstated rhetoric can discredit performance results.
- Performance expectations matter.

A single theme runs through most of these conclusions. Except for accountability (the first item), all the findings deal directly or by implication with the alignment of expectations and results. Expectations are the building blocks of trust, and sometimes its undoing as well. Expectations and public trust rise when government expands, provides and promises more benefits, and improves performance. However, when benefits and performance are flat, expectations tend to remain elevated but trust is likely to decline. This is the contemporary version of the "what have you done for me lately" complaint of voters. The appealing but ultimately damaging response is for politicians to substitute promises for results – to proclaim, for example, that every child will be educated, everyone who wants to work will have a job, slums will be eradicated and the streets will be made safe, and so on down the roster of public responsibilities. Every promise pumps up expectations; every report that shows a shortfall in results deflates trust.

Though important, the gap between promised services and delivered results is only part of the disconnect between government and citizens. The trust problem is grounded as much in success as in failure, and probably as much in the functioning of modern society as in the performance of government. The great success of most OECD countries, which has roots in policies initiated decades before that Organisation was established, has been to liberate and empower the individual. Government programmes have been critical in universalising literacy, modernising transport, extending life expectancy, stabilising communities, boosting incomes, cushioning the financial effects of illness and unemployment, and enabling men and women to make their own financial and personal choices. Citizens have been made into consumers, armed with money to satisfy personal tastes and wants and with personal freedom to pursue their own interests. Obligations have been recast into rights that have been extended to once-limited or excluded persons – children, minorities, the handicapped and, in some countries, immigrants. The individualisation of expenditures by means of mandatory entitlements was vastly expanded during the first decades of the OECD, when governments were still in an expansionary mode and income transfers became the largest expense in national budgets.

The triumph of individualism has been assigned multiple labels which reflect its diverse impacts. From the perspective of public policy, it is the flowering of the liberal welfare state that invests citizens with personal freedom, political rights and financial means to satisfy their private wants. In Maslow's famous hierarchy of needs, the apogees of individualism are "self-actualising" norms that elevate personal fulfilment above other values (Maslow, 1943). To some political sociologists, individualism has weakened group ties and drained countries of the social capital that undergirds democratic politics (see Putnam, 1995). From the vantage point of public finance, individualism is associated with the steep rise in mandatory entitlements and in the increased rigidification of national budgets. In the burgeoning literature on trust, individualism is often labelled post-materialism and is tagged as the principal reason for the withdrawal of citizen regard.[10] The post-materialist individual is discomfited by all collective institutions and especially by the state which, no matter how open and democratic, is the most collectivist of all. The paradox of collective institutions empowering and constraining individuals is at once the modern democratic state's greatest accomplishment and greatest challenge.

The post-materialist citizen has financial security – in significant part through the largess of the government – but wants something more and different, such as more leisure or liberty to do his/her own thing. A government has a confined role in supplying these non-material wants. It has a hierarchy of capacities that mirrors the individual's hierarchy of needs, beginning with providing physical protection and moving up the hierarchy to enabling services, such as education and transport, then to providing financial security. But there is not much that a government can do to self-actualise its citizens. Getting out of the way is one option, but this tactic, which is favoured by the more market-oriented OECD countries, does not garner much applause from citizens. The alternative favoured by more collectivist countries is to provide an enriched menu of public goods, such as environmental improvement, cultural pursuits and more leisure. The problem with this approach is that self-actualising wants are boundless: the more the government capacitates its citizens, the more they expect from it.

This predicament arises because post-materialists really are quite materialistic: they covet the goods, services and financial well-being provided or enabled by the government. They take these for granted, which is why they do not reward the government with trust when their wants are sated.

The expectation of getting ever more – glorified in modern times as progress, and enshrined in league tables and comparative ranking – is why today's citizens bite the public hand that feeds them. National budgets give citizens more reasons to be grateful than before. Not long ago, governments extracted taxes to finance their own operations; now, they spend public money principally to endow households and individuals with financial security. Citizen and state are financially tethered together but, rather than breeding trust, interdependence appears to have had the opposite effect.

If this argument is valid, it portends both good news and bad news. The good news is that low trust scores do not connote that the government is an uncaring services provider or a poor performer. In almost all OECD countries, social security benefits and other payments are distributed with clockwork efficiency, public services are accessible to an even broader range of citizens, and governments invest substantial resources to evaluate and report results. The bad news is that governments have limited scope to re-earn trust by being better performers. When they have the means, governments can bestow more benefits on citizens, but doing so might not suffice to turn the tide, at least not in the short run.

In assessing the relationship between government and the governed, low trust may be similar to a low-grade fever: at times bothersome, but rarely of consequence to do something about it. Then came the Great Recession, and in countries facing austere budgets, higher tax burdens and programme cutbacks, low trust has the potential to become more toxic and to greatly complicate the task of rebalancing public finance. In some countries, withdrawal of trust is no longer a low-grade fever.

5.2. Trust and budgets

In the framework of this article, the problem facing OECD countries is how to repair budget contracts and relationships when they cannot draw on a reservoir of trust to ease short-term pressures while securing long-term fiscal stability. The solution foreseen here is to reverse the connection between trust and budget policy. Rather than viewing trust as enabling governments to repair tattered budget contracts, repairing these contracts is a pre-condition for boosting citizen regard of government. As long as citizens are disquieted by large fiscal imbalances, uncertain about whether promised social benefits will be forthcoming, and sceptical about government performance, they will distrust public institutions. The fundamental implication of this argument is that governments must make hard budget choices before citizens rally in support; in fact, the government of the day puts its political standing at risk by taking unpopular measures to stabilise public finance.

Although it might not suffice, a key to restoring public trust is to balance citizen expectations and government capacity. When citizens expect more from a government than it can effectively deliver, they cannot be confident that politicians and political institutions will fulfil their part of the bargain. Each country has to find its own way, consistent with its political orientation and economic condition, in aligning capacity and expectations. Some countries will aim to dampen expectations by reducing the footprint of the state and withdrawing from or curtailing some responsibilities; others will strive to upgrade government capacity by improving performance and expanding their revenue base. All will have to shift some risks and costs to households or enterprises; if they do not, new budget contracts will not be sustainable.

6. Restoring public trust and stabilising public finances

Each of the three types of budget contracts examined in this article requires distinct adjustments that were outlined earlier. But, regardless of the type of contract, all share several characteristics that are needed to repair relations between citizens and government.

- **Repaired contracts should aim for long-term sustainability, not only for short-term fixes.** In the aftermath of crisis, fiscally stressed countries have been tempted or pressured to make immediate policy changes that help stabilise public finance. While it is necessary to correct short-term imbalances, restoring trust is best facilitated by policy changes that can be sustained over a generation or longer. Bookkeeping tricks that defer expenditures or rely on one-off revenues will not restore budget balance or political confidence. False or temporary savings that compel a government to rewrite its budget contracts every few years will seed even more distrust among citizens who lack confidence that commitments and promises will survive the next political or economic cycle.
- **Governments should take account of downstream costs when they initiate or expand programmes.** The natural inclination of politicians is to use budgets to expand services or benefits. The process itself invites spending units to bid for additional resources and for the government to give them some fraction of what they requested. During boom times, groups and the media take it for granted that the budget will be a platform for programme expansion. Even when austerity is the order of the day, governments try to make some room in the budget for policy initiatives. They seek "sweeteners" that soften the cutbacks and enable them to claim that the government is doing good things and being responsive to citizen needs. One popular ploy is to "backload" spending increases by phasing them in over a period of years or having them take effect some years in the future. This tactic may buy political support and boost trust ratings but, sooner or later, the government will have to retreat from budget commitments, and trust will once again plummet.
- **Governments should reduce their exposure to financial and social risks.** Shifting large risks to governments helped boost economic output and personal well-being in OECD countries during the good times. But long before the Great Recession, fiscal

experts and social planners had warned that governments were overextended and would not be able to fully honour their financial commitments when populations age and escalating pension and health care obligations come due. The recession has hastened the day of reckoning in fiscally stressed countries, but other OECD countries are certain to feel the brunt of demographic and fiscal trends unless they act to shift some risks and costs off their books to families, households and enterprises.

The remedy applied by a few innovative countries, and recommended earlier in this article, is to have recipients share in the financial cost of "good news" such as improved health care and longer life. Health services and longevity are the two main drivers of unsustainable budget trends; any government intent about stabilising its fiscal future will have to deal with one or both of these factors. Countries that are currently in sound fiscal condition do not have to apply shock therapy to consolidate public finance. They can legislate changes in pension and health policies that have quite small effects at the start but cumulate to large savings 2-3 decades ahead. After all, advances in medical care and age expectancy inch ahead slowly; their large budgetary impacts are felt over time, not all at once.

- **Government budgets should more closely link resources and results.** Repairing budget contracts is inextricably linked to restoring public trust. There is no clear evidence that low trust scores are due to mal-performance by government; the rise of individualism, this article has argued, is the most prominent factor, though not the only one. Nevertheless, perceptions of performance take their toll in citizen attitudes and may have a greater impact than actual performance, especially with respect to critical public services such as education and health care. Budget procedures can make a modest contribution to aligning perceived and actual performance by explicitly linking the amounts allocated to the results produced or expected. Most performance-based budgets treat resources and results as separate entries that have no bearing on one another. These types of performance budget do not disclose changes in results that would ensue from spending more or less, or from reallocating funds from one activity to others.

  Constructing a true performance budget requires major changes in information, costing and measurement systems. Reformatting budget documents to show workload or output data does not suffice; the key difference is to accurately inform citizens of how spending options or choices affect the services they receive from the government.

When all is said, this article argued earlier, it is the misalignment of expectations and capacity that has damaged budget contracts and citizen perceptions. Dampening expectations is exceedingly difficult in democratic societies that have been acculturated to expect progressive improvement in economic well-being and government-financed benefits. Rewriting budget contracts is only one of the adjustments needed to restore public trust by bringing citizen expectations and government capacity into balance. Changes in private and social structures and relationships may also be necessary, along with political reforms that make governments more accessible and transparent. But although it is only one facet of the solution, repairing the budget relationship will be a prominent element.

Notes

1. See Schick, 1998. For an application of this typology to budget practices, see Schick, 2001.
2. The case for independent fiscal institutions was presented in Gruen, 2001.

3. The Citizens' Charter, introduced by the United Kingdom in 1991 but discarded in 1997, is a prototype of a service-based contract between the government and citizens.
4. The concept was developed by Kaplan and Bruns, 1987.
5. For a practical application of marginal analysis in performance budgeting, see Friedman, 2005.
6. The concept of relational contracts was advanced by Macneil, 1974, p. 691.
7. In the 16 countries covered by the 1999 European Values Survey and the 2002 World Values Survey, between 87% and 98% of respondents approved the idea of democracy, and between 78% and 99% regarded democracy as the best form of government (see Dalton, 2004, Table 2.5, p. 42).
8. Late 20th century data (which were subsequently revised in later OECD publications) showed that real GDP growth in the OECD area averaged 5.1% during 1960-68 and 4.7% during 1968-73, but only 2.6% during 1973-79 and 2.2% during 1979-85 (OECD, 1987, Table 3.1).
9. This pattern was initially identified by Weaver, 1986.
10. Ronald Inglehart is the leading proponent of the post-materialist argument. See Inglehart, 1997.

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