BOX G: INCENTIVE CHALLENGES IN PUBLIC EXPENDITURE MANAGEMENT: THE SOFT BUDGET CONSTRAINT AND THE RATCHET EFFECT

In the light of persistent expenditure overruns in health spending, this box focuses on some of the structural challenges that can affect the allocation and control of public expenditure, with an emphasis on the difficulties of ensuring spending Departments face appropriate incentive structures. It focuses in particular on two incentive challenges that face all public expenditure systems: the soft budget constraint and the ratchet effect.

THE SOFT BUDGET CONSTRAINT

The concept of the "soft budget constraint" (SBC) was introduced by János Kornai in the context of state-controlled firms. However, it has found wide application across various areas of economics, including the challenges of controlling public expenditure and avoiding bailouts of financial firms. In Kornai's original formulation, the budget constraint is *soft* – notwithstanding *ex ante* threats to impose a hard constraint – where the decision maker in control of day-to-day expenditure anticipates that the constraint is likely to be relaxed *ex post* if the original constraint is not met.[68] The concept has been reformulated using game-theoretic tools as a dynamic commitment problem, where the central authority cannot credibly commit to enforce a hard budget constraint *ex post* (see, e.g., Dewatripont and Maskin, 1995).[69]

Not surprisingly, the SBC has found particular application in the area of public expenditure. The SBC-related incentive challenge is likely to be especially difficult when it comes to health spending. There is a pattern of spending overruns in public health spending in Ireland. If health spending is not adequately controlled relative to budgeted spending early in the year, the implications of imposing hard budget constraints later in the year can be severe – e.g., avoidable suffering and possibly even deaths.

Anticipating a relaxation of constraints in the face of such consequences, decision makers are

[68] Kornai (1992, p. 143) describes the soft budget constraint in the following terms:

"The extending of external assistance is a random variable with a given probability distribution, of which the firm's decision maker (and his or her superiors) have a subjective "perception." The greater the subjective perception, that is, the safer the firm is in assuming it will receive external assistance, the softer the budget constraint. Another interpretation is the following: The promise to enforce the observation of the budget constraint is a commitment of the bureaucracy that it will not tolerate persistent loss-making. Hardness versus softness refers to the credibility of this commitment."

[69] Kornai *et al.* (2003) provides a synthesis of the subjective probability and dynamic consistency interpretations.

less fearful that the hard constraint will ultimately be imposed, and face weaker incentives to control spending earlier in the year in ways that are less detrimental to users of health services.

Looking at the problem through the lens of the SBC makes clear that simply "talking tough" in relation to a willingness to follow through on threats of hard constraints is unlikely to be sufficient to improve expenditure control. There must be a change in the incentive structures in a way that minimises *ex post* harm to service users. Possible changes to the structures include more intense monitoring and reporting earlier in the budget period, more direct remuneration or career consequences for decision makers where budget constraints are not met, potential forfeiture of local control if there is a pattern of failure to meet budget constraints, or direct consequences in terms of future budgets as a result of current-year budget overruns (although such threats may also face credibility problems).[70]

THE "RATCHET EFFECT"

Another common incentives-related challenge in public expenditure systems is known as the "ratchet effect". This refers to the phenomenon where future budgets are determined by current spending. In particular, under-spending of the current year's budget can lead to budget reductions for future years, in turn leading to perverse incentives to fully spend the current allocation, even where it is recognised that the marginal value of the spending is low. The ratchet effect can interact negatively with the SBC where the need to reduce the future budgets of under-spending Departments is increased by the need to "bail-out" overspending Departments (see, e.g., Roland, 2000).

The new expenditure ceilings framework attempts to minimise the damage done by the ratchet effect by allowing some carryover of unspent funds to future years.[71] Regular comprehensive expenditure reviews should also ensure that Departmental expenditure allocations reflect value considerations, instead of perversely rewarding bad – and punishing good – expenditure-management performance.

Overall, the new expenditure ceiling framework – reinforced by the expenditure benchmark under the revised Stability and Growth Pact and regular comprehensive expenditure reviews – appears to be a significant step forward in public expenditure management. However, careful attention will be required to ensure that the SBC and ratchet effect incentive challenges are tackled in the actual implementation of the new framework.

[70] The Department of Public Expenditure and Reform Circular 15/13 describing the implementation of the expenditure ceiling rules notes:
"[I]f the Department fails to implement the Government Decision and breaches the expenditure ceiling, on foot of a proposal from the Minister for Public Expenditure and Reform, the Government may require that the Department "repay" the overrun in the next year. In such circumstances, the Department will be subject to an offsetting adjustment in the Ministerial Expenditure Ceiling for the following year and will be required to devise policy measures to live within the reduced allocations. In circumstances where the Department cannot absorb the full required adjustment in the following year's expenditure ceiling, the Government can decide that it may be necessary either to spread the adjustment over two or more years or, in circumstances where the overall Government Expenditure Ceiling and/or the Government targets for the public finances do not allow such an approach, to allocate the balance of reductions across other Departments so that the overall expenditure path remains on target. This will require re-prioritisation of resources within each Ministerial envelope."

[71] See Item 15 of Circular 15/13, Medium-Term Expenditure Framework: Application to Current Expenditure, Department of Public Expenditure and Reform, 2013.